



CENTRE FOR POLICY ANALYSIS

**THE CURRENT STATE OF THE
MACRO ECONOMY OF GHANA
2000-2009**

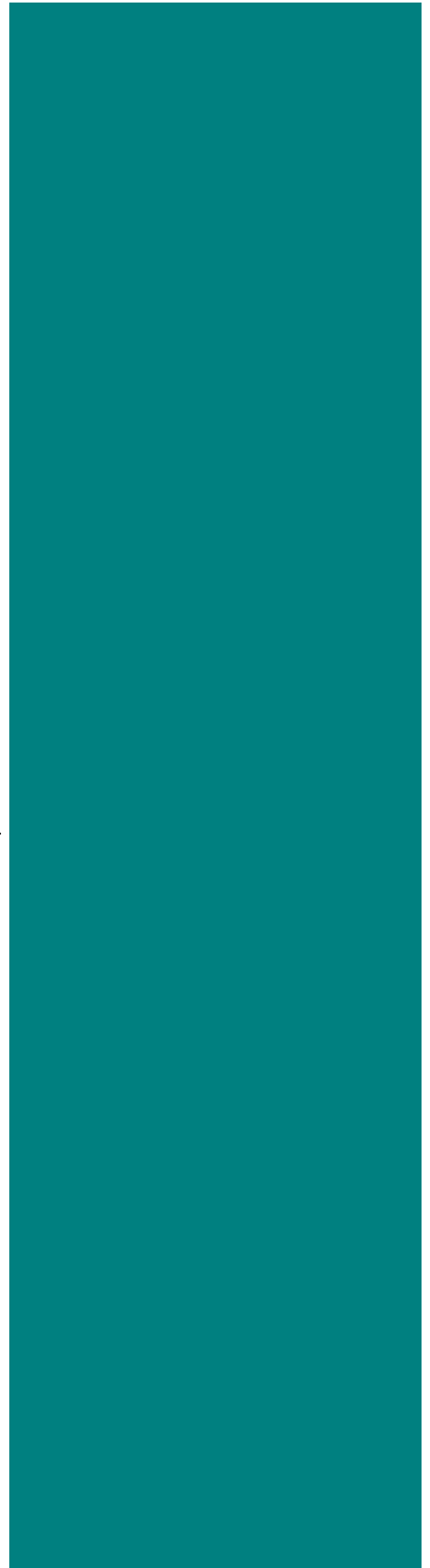


TABLE OF CONTENTS

EXECUTIVE SUMMARY	2
INTRODUCTION.....	10
BACKGROUND.....	12
BUDGETARY PERFORMANCE	14
PUBLIC SECTOR DEBT.....	16
PUBLIC SECTOR WAGE BILL.....	18
MONETARY POLICY AND INFLATION	21
INTERNATIONAL TRADE.....	29
WAY FORWARD.....	32

Executive Summary

Introduction

The key economic issues that featured prominently in the national debates of the just-ended presidential and parliamentary elections of 2008 were the general state of the Ghanaian economy, promoting accelerated economic growth and job creation. The ultimate objective of the debates was the facilitation of a shared view to prosperity and poverty reduction.

Underlying these issues and national debates is the choice of two contrasting strategies for the development of Ghana's economy: accelerated economic growth with macroeconomic stability, on the one hand; and macroeconomic stability with economic growth, on the other hand.

Central to resolving the above issues, is the budget deficit and its financing. CEPA's earlier assessment of the state of Ghana's macro-economy in its Ghana Economic Review and Outlook: Part I, Focusing on Fiscal Performance, which was published in May 2008, drew attention to: "a stubbornly high and widening deficit" (page 42). The key challenge that the new President is confronted with is how to tackle this deficit problem within the context of the national medium-term goal of sustained and accelerated growth with macroeconomic stability.

Moreover, solutions must be sought in the context of the current global financial crisis (dubbed the "credit crunch" or "financial protectionism"), and the downgrading of Ghana's sovereign ratings, both of which make foreign direct investment (FDI) as well as external borrowing from international capital markets even on commercial terms more difficult to obtain.

Following the successful completion of a two-term presidential rule — first time in post-Independence Ghana — and the peaceful hand-over of the reins of government across the political divide in 2001, the nation received what has been described as a "handsome democracy dividend". In spite of this, or, perhaps because of it, fiscal excesses in the early years of the new Administration led to the failure and abandonment at the end of September 2002, of the three-year economic programme of 1999-2002 agreed with the International Monetary Fund (IMF) under its Poverty Reduction and Growth Facility (PRGF). This debacle was largely on account of:

- higher-than-budgeted for public sector wage bill; and
- subsidies to the petroleum, water, and the electricity sub-sectors.

A successor programme agreed with the IMF for the period 2003 to 2005 required the removal of the petroleum price subsidies as conditionality. A policy of import parity pricing, meaning a full pass through of changes in the cedi value of world market prices of petroleum and petroleum products to domestic consumers was instituted. A mechanism to give effect to this policy was also put in place. Consistent with the poverty reduction objective, the mechanism included cross-subsidization of products of importance in the consumption baskets of the poor — such as kerosene.

Given the high social and political costs involved, however, the policy was not consistently implemented. Subsequent continued increases of international prices of petroleum and petroleum products were not fully passed through to domestic consumers. The Government of Ghana apparently, could not countenance any such domestic price increases since (as was communicated to the IMF and the development partners) in its view, this could be politically “destabilizing”. In January 2005, with the 2004 elections out of the way, petroleum product prices were increased, on average, by 50 percent.

Thereafter, the policy of full pass through of price changes in the world market, once more, was not consistently implemented resulting in significant losses and debt at Tema Oil Refinery (TOR) currently estimated at GH¢1.4 billion (Business & Financial Times (B&FT), January 28, page 15).

These experiences in the oil sector, concerned with subsidies, fiscal discipline and macroeconomic stability serve to illustrate the futility and unsustainability of pursuing the strategy of macroeconomic stability with growth. They also show the possible high cost of procrastination in responding to shocks whose consequences linger on — in other words better considered as permanent rather than temporary shocks. A good rule in policy management is that permanent shocks calls for policy adjustment: temporary adverse shocks are best financed. Delayed response to a persistent or permanent shock could accentuate cost which could be destabilizing.

Budgetary Performance

Over the period from 2005 to 2008, the budget has performed continually much worse than planned. The overall broad balance has registered deficits which have widened from about 3 percent of national income¹ in 2005 to 7.8 percent of national income in the following year, 2006 — far above its target in the budget and over two and a half times the previous outcome. This

¹ National income is used in this document to be synonymous to gross domestic product (GDP) as measured by the Ghana Statistical Service.

latter outcome, termed a “fiscal surprise” by the rating agency, Fitch, was cited as the reason for its downgrading of Ghana’s sovereign rating in year 2007.

The primary reason for the deteriorating fiscal performance over the last four years has been the rapid growth of expenditure. In each of these years, expenditure has risen faster than national income and overshoot the budgetary provision by considerable margins. Thus, from a share of 26 percent of national income in 2005, the share of domestic expenditure in national income (i.e. excluding foreign-financed expenditure) rose to 30.1 percent in 2006, and then to an estimated 30.7 percent in 2007; and for 2008, CEPA forecasts a share of at least 38 percent of national income.

In contrast, the share of domestic revenue² in national income was relatively stable over the two year period from 2000 to 2002 and declined to 2007 and it is forecast to rise to 25.1 percent of national income in 2008 on the back of the “Talk Tax”. Overall, as depicted from the linearized fit in Figure 2, domestic revenue has risen faster than national income (shown by the positive slope or trend); as shown, it has risen more mildly than domestic expenditure. The differences in the pace of these increases underlie the widening budget deficits. The evidence thus strongly suggests that the revenue mobilization effort has been quite successful, with revenue rising, at the minimum, apace with national income.

Public Sector Debt

The debt relief and debt cancellation provided by the IMF, World Bank and bilateral donors under the Enhanced HIPC Initiative and Multilateral Debt Relief Initiative (MDRI) helped reduce Ghana’s debt stock from 198.3 percent of national income in 2000 to 118.8 percent of national income at end-December 2003, and further down to a trough of 41.9 percent of national income at the end of 2005. Since then it has turned on an upward path reaching 49.8 percent of national income at the end of 2007 and an estimated 52 percent of national income at the end of 2008.

According to the Bretton Woods Institutions — the IMF and the World Bank — about 60 percent of this new debt has been contracted on commercial terms in the international capital market, export credit agencies, and local-currency denominated government bonds. In particular, in September 2007, the Government of Ghana placed US\$750 million in Eurobonds with a coupon of 8.5 percent at 10-year maturity.

² This comprises tax and non-tax revenues; the non-tax element excludes the portions retained by the collecting agencies.

This will imply annual interest payments of about US\$64 million. The remaining part of the new external public debt has been contracted on concessional terms with multilateral institutions and bilateral official creditors (see Ghana: Joint IMF and World Bank Debt Sustainability Analysis, June 16, 2008 paragraph 2 page 3).

The point of considerable concern that arises from the above analysis of a rising public debt is the disturbing picture Ghana is presenting of a HIPC that is following a path back to high indebtedness soon after having the bulk of its original debt cancelled. Paul Rawkins of the Fitch Rating Agency is quoted by the Business Financial & Times (BF&T) of February 2nd, 2009 on this subject as follows: “if it keeps going this way, they will lose all the benefits they got from debt relief. If it got towards 70 percent, that would certainly be bad news.....that would certainly be negative for credit rating”.

Public Sector Wage Bill

The public sector wage bill has been an important contributory source of budgetary excesses. And yet, inability to control it has also been a perennial problem over the past eight years. Moreover, CEPA has regularly drawn attention to this perennial problem in its reviews of the state of the economy. The official reasons given for this phenomenon, however, have varied. The common strand in the various explanations given for wage bill overruns is summarized in the foreword of the 2007 Budget Statement:

There are problems at the labour front resulting partly from a distorted public sector salary structure which is also poorly administered. Government has, therefore decided to begin the implementation of a new comprehensive public sector pay reform that emphasizes equal pay for work of equal worth. The broad objective is to aim for wage increases in line with productivity gains, cost effectiveness and efficiency.....To ensure order and equity all round, government is setting up a Fair Wages and Salaries Commission to oversee the implementation of this new programme.....The public sector reforms that are being pursued will be sustained to boost private sector development through an enhanced public services delivery in order to deepen public-private sector partnerships for accelerated growth (2007 Budget Statement, pages 5 and 6) (emphasis added).

The Fund Staff has urged that: Civil Service reform needs to resume in earnest, with the medium-term goals of attracting high quality labour and reducing total public sector employment. In pursuit of the above, the Fund staff recommended that: temporarily freezing hiring in the public sector (beyond the automatic absorption of trainees in health and education) is required in order to keep the wage bill within the 2008 budget. They go on to suggest that the freeze should last until Civil Service reforms regain momentum (possibly after the elections).

CEPA agrees with the views expressed in the foreword of the 2007 Budget Statement, namely:

- To aim for wage increases in line with productivity gains, cost effectiveness and efficiency;
- To ensure order and equity all round, government is setting up a Fair Wages and Salaries commission to oversee the implementation of this new programme; and
- To boost private sector development through an enhanced public services delivery in order to deepen public-private sector partnerships for accelerated growth.

Certainly, in the key sectors of health and education a lot needs to be done about remuneration to attract and retain the professionals at home. Their skills are needed for the development of the healthy and skilled human resource necessary for the preferred path of accelerated growth with macroeconomic stability. Moreover, their absence or insufficient presence could mean an intensification of socio-political instability which could flow out of poor service delivery in the key social sectors.

The freezing of public sector hiring ahead of a buoyant and booming private sector able to create the much-needed jobs on considerations of the requirements of short-run macroeconomic stability is not a viable option and is simply unacceptable; so also any attempt to freeze the wage rates. It must be stressed that socio-political stability is a necessary condition for sustainable macroeconomic stability.

Growth, an accelerated one as such, in our context, must be a priority. The differences between the CEPA position and the IMF stem from the contrasting visions of Growth with Macroeconomic stability as against Macroeconomic stability with growth. Not surprisingly, while the Government of Ghana and Ghanaians aspire to the Asian type growth rates in the range of 7 to 9 percent per annum, most IMF medium-term growth projections for Ghana are, at best, in the range of 5 to 6.5 percent per annum.

Monetary Policy and Inflation

Ghana has often experienced high rates of inflation — the recent ones being in 1999-2000 and 2002-2003. These have been caused by a combination of external shocks, unsustainable macroeconomic policies and exchange rate depreciation. Alas, all of these are present in the current situation witnessed since the fourth quarter of 2007. Indeed, other than the year 2005, controlling money supply growth has been problematic – in both the monetary base control period of 2000 and 2004 and the latter period of inflation targeting of 2006 to 2008.

Notwithstanding the difficulties of controlling the money supply growth, the performance record in respect of inflation and inflation expectations have been commendable.

As noted elsewhere, Ghana is vulnerable to severe supply shocks from weather and commodity price developments. Abstracting from these adverse exogenous factors, the record of inflation performance in the period from January 2002 to the last quarter of 2007 (averaging 13.5 percent per annum) can indeed be described as reasonably satisfactory — just outside the recommended range of 8 to 13 percent per annum for Ghana at this time.

The unpalatable fact is that disinflation requires that a negative output gap sooner or later opens up. This output gap — output and employment lost to the economy — is a measure of the short-run sacrifice required for disinflation. Moreover, for any given economy, the evidence suggests that there is a context-specific range of inflation rates — currently estimated to be between 8 percent and 12 percent for Ghana — below which the sacrifice ratio becomes exorbitantly high. For a developing country with widespread and deep poverty, keeping the ratio to the barest minimum is of outmost importance.

In our circumstances, aiming to keep output at its potential level has an obvious justification since this is a fundamental objective of the Growth with Macroeconomic Strategy. Output and job losses could have particularly grave socio-political consequences in an economy already facing rising joblessness, high levels of underemployment and open unemployment. Moreover, in the current international environment where a high country risk premium may be charged on Ghana Government debt instruments, hiking the interest rate could turn out to be counterproductive — an exercise in futility — as it may fail to induce the expected net capital inflows.

International Trade

The experience over the past years reveals once again the vulnerability and fragility of a primary commodity-dependent economy which moreover, is losing export market shares in international markets. This worrisome situation appears to be the result of a combination of an overvalued currency (which may be squeezing profit margins of exporters and import-competing enterprises) and an inadequate incentive scheme that together make products made in Ghana uncompetitive at home and abroad.

With regards to traditional export commodities, gold export earnings led the way and as a result its share in overall export earnings in 2007 represented 43 percent of the total. Indeed, since 2004, the share of gold export receipts in overall export earnings exceeded those of all other export commodities, thus making gold the dominant export commodity. Gold exports increased by almost 36 percent in value terms in 2007. This was both on account of record-high prices on world markets and increased export volumes. While export volumes increased by 19 percent above the average for the preceding year, world market prices rallied by more than 15 percent above the average registered in 2006. An issue of some concern is that while the gold sector has witnessed considerable boom in recent times, its contribution to the country's international reserves and budgetary revenue has been minimal.

In comparison, export earnings from the shipment of cocoa beans and products fell by 7.1 percent in 2007 relative to 2006. The decline in earnings was largely due to a sharp fall in the volume of cocoa beans shipments even in the face of continuous price rallies on world markets. Thus, the average price increased by about 23 percent while the volume shipped declined by 14.8 percent in 2007.

Foreign exchange earnings from the group of export items dubbed non-traditional exports (NTEs) — defined here to exclude cocoa and wood products — have performed rather poorly. Over the past four years, the contribution of NTEs to overall export earnings has been falling, with an apparent dwindling in shares of the horticultural category of agricultural goods. The evidence suggests that over the past four years, export volumes of pineapples — which used to be the highest earner in the horticultural category of agricultural NTEs — slumped by 66 percent on account of an unexpected shift in demand from the smooth cayenne variety preferred by Ghanaian farmers to the so-called MD2 variety mostly produced in South America.

Some Lessons from East Asia and China

Lessons from the experiences of the East Asian Tigers and lately China and India, have shown that increased emphasis on higher education — highlighting science and engineering courses and vocational and entrepreneurial training and skills development — as well as massive investments in research and development that is oriented towards the creation of new products and product designs, marketing methods and organizational forms, can be important in bringing about the dynamism required for intensifying competition between enterprises and between countries.

Knowledge and information have become the key drivers of international competitiveness, making it crucial to respond rapidly and efficiently to evolving technological changes.

It is about time Ghana's export diversification drive was charted along these lines.

A first step would be to address the myriad institutional and infrastructural bottlenecks that seem to be holding back efficient service delivery in the non-traded goods sector — namely, improving the legal and institutional environment for doing business in Ghana, and minimizing the bureaucratic processes of service delivery in financial and public sector institutions, including deposit money banks, public utility agencies, as well as the MDAs.

Way Forward

Given the natural long-term goal of **Growth with Macroeconomic Stability**, the key challenges over the medium-term are the following:

- Priority needs to be given to the near-term policy challenges of pulling back from the current expansionary fiscal policies. Limiting the fiscal deficit would also make more room for private sector development through “crowding in” of the sector. In any case, fiscal policy must carry the brunt of the needed adjustment. Public financial management (PFM) reforms have continued but recent and on-going fiscal slippages have exposed recurring weaknesses which must be rectified.
- CEPA supports the proposed enactment of the Fiscal Responsibility Law (FRL) – improving fiscal discipline and anchoring fiscal expectations. Even though we regard it as a necessary condition, it is by no means sufficient. CEPA has noted that “The passage into law of a Fiscal Responsibility Law (FRL) by itself is not sufficient to promote fiscal discipline” Ghana Economic Review and Outlook, Part I: Focusing on Fiscal Performance, page 32, Box 1. At the same time there is evidence it could help. The PRGF programme agreed with the IMF for the period 2003 to 2005 (this had to be extended to October 2006) contained an explicit medium term conditionality namely: *The end 2002 domestic debt to GDP ratio shall be halved by end 2005*. Adherence to this, even if with difficulty, certainly contributed to the macro-economic stability achieved over the period. The FRL, when it comes into being, could play this role in any future programme.
- Further re-orienting fiscal priorities towards development — in terms of government expenditure, tax policy that leaves more resources in the hands of workers, entrepreneurs and

investors (making it profitable to work and invest in Ghana), improved public service delivery, eliminating wasteful expenditure and insisting on value for money; and

- A sharper focus on the enhancement of productivity through technical and vocational training skills development particularly management, increased use of knowledge and improved technology in production, and efficient investment in infrastructure especially in transportation and energy.

The flight of private capital means emerging and developing economies with current account deficits face a drought of both financing and export earnings, particularly from non-traditional exports (NTEs). Likely developments in respect of world market prices of gold and cocoa on the one hand, and the low and declining price of oil on the other hand, suggest a possible positive outcome for Ghana's commodity terms of trade — a comparative measure of prices on imports and exports.

The perennial problem of subsidies, however, is likely to remain even if with a twist to it. The difference is that instead of subsidies for the imports of petroleum products, electricity and water sub-sectors, the problem in the near term will be how to fund and channel the subsidies to prop up the NTEs and possibly even cocoa (being a commodity) in the event that world market prices fall too low to sustain profitable production and cocoa producer price.

Introduction

The key economic issues that featured prominently in the national debates of the just-ended presidential and parliamentary elections of 2008 were the general state of the Ghanaian economy, promoting accelerated economic growth and job creation. The ultimate objective of the debates was the facilitation of a shared view to prosperity and poverty reduction.

Underlying these issues and national debates is the choice of two contrasting strategies for the development of Ghana's economy: **accelerated economic growth with macroeconomic stability**, on the one hand; and **macroeconomic stability with economic growth**, on the other hand. The differences here are of a fundamental nature and not a matter of semantics. It would appear from official documents including the Growth and Poverty Reduction Strategy (GPRS II) that the national preference is the former — **accelerated economic growth with macroeconomic stability**. CEPA has argued for and is committed to this position. As against this, the policy choice of the Bank of Ghana (BOG) consistent with the Bank of Ghana (BOG) Act of 2002 — which establishes its independence and statutory mission of price stability — would appear to be that of **macroeconomic stability with economic growth**. This would appear to be the preference of the International Monetary Fund (IMF) for Ghana as well.

Central to resolving the above issues, is the budget deficit and its financing. CEPA's earlier assessment of the state of Ghana's macro-economy in its Ghana Economic Review and Outlook: Part I, Focusing on Fiscal Performance, which was published in May 2008, drew attention to: “*a stubbornly high and widening deficit*” (page 42). The key challenge that the new President is confronted with is how to tackle this deficit problem within the context of the national medium-term goal of sustained and accelerated growth with macroeconomic stability.

Dealing with the deficit is important because of the threat it otherwise poses to regaining and sustaining macroeconomic stability in the form of:

- high and accelerating inflation rates;
- rapidly depreciating exchange rates of the cedi against major international currencies;
- high interest rates, particularly borrowing costs to businesses from the financial sector (banks and non-bank financial institutions);
- ever-widening international trade and current account deficits; and
- dwindling stock of international reserves in terms of months of import cover.

Moreover, solutions must be sought in the context of the current global financial crisis (variously dubbed the “credit crunch” or “financial protectionism”), and the downgrading of Ghana's sovereign ratings, both of which make foreign direct investment (FDI) as well as external borrowing from international capital markets even on commercial terms more difficult to obtain. Furthermore, the increased uncertainties and risks both at home and abroad, including what

appears to be (quite naturally) an ongoing re-examination by donors of aid commitments given their own large deficits and priority to domestic concerns, will exacerbate the situation.

In his book The Age of Turbulence, Alan Greenspan, a past Chairman of the US Federal Reserve Board (equivalent to Governor of the Bank of Ghana) wrote of a comparable dilemma that President Clinton had faced. Against the charge of pandering to the whims and caprices of financial markets, the reality was that, credibility of his economic program was critical to its success. The deficit had to be cut in order to convince financial markets and thereby bring down long-term interest rates. To paraphrase somewhat:

Clinton found himself faced with a choice that was increasingly stark. Either he could opt for a package of spending programs that would fulfil some of his campaign promises or he could opt for a deficit-cutting plan, whose success would depend on impressing the financial markets and that would pay off chiefly in the longer term. There was no in-between, we could not afford both. The dilemma had opened a rift in the White House staff, some of whom privately ridiculed the deficit-cutting approach as a sell-out to Wall Street (page 146).

...the hard truth was that Reagan had borrowed from Clinton, and Clinton was faced with the burden of having to pay it back. There was no reason to feel sorry for Clinton — these very problems were what had enabled him to defeat George Bush. But I was impressed that he did not seem to be trying to fudge reality to the extent politicians ordinarily do. He was forcing himself to live in the real world on the economic outlook and monetary policy. His subsequent decision to go ahead and fight for the deficit cuts was an act of political courage. It would have been very easy to go the other way. Not many people would have been the wiser for a year or two or even three (page 147).

A majority of senators and members of Congress (members of Parliament) hated his budget plan not surprisingly, since it aimed at abstract, distant goals and offered no new highway projects or lucrative goodies to bring home to their constituents (page 148). Clinton had to fight, arm-twist, and horse-trade to push his budget through. But he persisted and persevered and it paid off in the end: “a consistent, disciplined focus on long-term economic growth became the hallmark of his presidency (page 150) (emphasis added).

Background

Following the successful completion of a two-term presidential rule — first time in post-Independence Ghana — and the peaceful hand-over of the reins of government across the political divide in 2001, the nation received what has been described as a “handsome democracy dividend”. In spite of this, or, perhaps because of it, fiscal excesses in the early years of the new Administration led to the failure and abandonment at the end of September 2002, of the three-year economic programme of 1999-2002 agreed with the International Monetary Fund (IMF) under its Poverty Reduction and Growth Facility (PRGF). This debacle was largely on account of:

- higher-than-budgeted for public sector wage bill; and
- subsidies to the petroleum, water, and the electricity sub-sectors.

A successor programme agreed with the IMF for the period 2003 to 2005 required the removal of the petroleum price subsidies as conditionality. A policy of import parity pricing, meaning a full pass through of changes in the cedi value of world market prices of petroleum and petroleum products to domestic consumers, was instituted. A mechanism to give effect to this policy was also put in place. Consistent with the poverty reduction objective, the mechanism included cross-subsidization of products of importance in the consumption baskets of the poor — such as kerosene. Based on similar considerations, indirect subsidies were provided in the cost to producers of gas-oil for mass transportation and premix fuel in the small-scale fisheries sector. These subsidies were to be funded by levies on premium petrol (considered to be relatively more consumed by the rich). Determining the size of the levy to be put on premium petrol depended on three factors, namely: the exchange rate effects, world market prices (in dollars) and the amount of cross-subsidy. The removal of subsidies in February 2003, necessitated increases in prices of petroleum and petroleum products, on average, by 80 percent. This helped to restore fiscal discipline but at a high cost in social and political terms.

Given the high social and political costs involved, however, the policy was not consistently implemented. Over this period, increases in the exchange rate of the cedi vis-à-vis the US dollar (in which world market prices for petroleum are quoted) dominated the cedi value of world market prices. The prices quoted for these petroleum products are naturally in the local currency — the cedi — and these prices are a product of the exchange rate and the world market price. The issue of a subsidy therefore, must reflect, the price cost differential which could be due to either one. CEPA analysis during that period pointed out that depreciation of the exchange rate was the dominant cost factor (Ghana Macroeconomic Review, 2000, pages 50 – 61).

Subsequent continued increases of international prices of petroleum and petroleum products were not passed on to domestic consumers. The Government of Ghana apparently, could not countenance any such domestic price increases since (as was communicated to the IMF and the development partners) in its view, this could be politically “destabilizing”. The consequence of this, however, was that the regained fiscal discipline proved short-lived. Another hike in the domestic prices of petroleum products (averaging 50 percent) had to be effected in January 2005 after the election in December 2004. They also show the possible high cost of procrastination in responding to adverse shocks whose consequences linger on, in other words, better considered as

permanent rather than temporary shocks. Temporary shocks need not have policy responses and are perhaps better financed. In contrast, permanent shocks require appropriate policy response or else could be destabilizing. Delayed responses to the oil price shocks have resulted in significant losses and debt estimated at GH¢1.4 billion on the books of the Tema Oil Refinery (Business & Financial Times, B&FT, January 28, page 15). This experience serves to illustrate the futility and unsustainability of pursuing the strategy of macroeconomic stability with growth.

Budgetary Performance

Over the period from 2005 to 2008, the budget has performed continually much worse than planned. The trends over the period are shown in Table 1 and Figure 1. The overall broad balance has registered deficits which have widened from about 3 percent of national income in 2005 to 7.8 percent of national income in the following year, 2006 — far above its target in the budget and over two and a half times the previous outcome. This latter outcome, termed a “fiscal surprise” by the rating agency, Fitch, was cited as the reason for its downgrading of Ghana’s sovereign rating in year 2007.

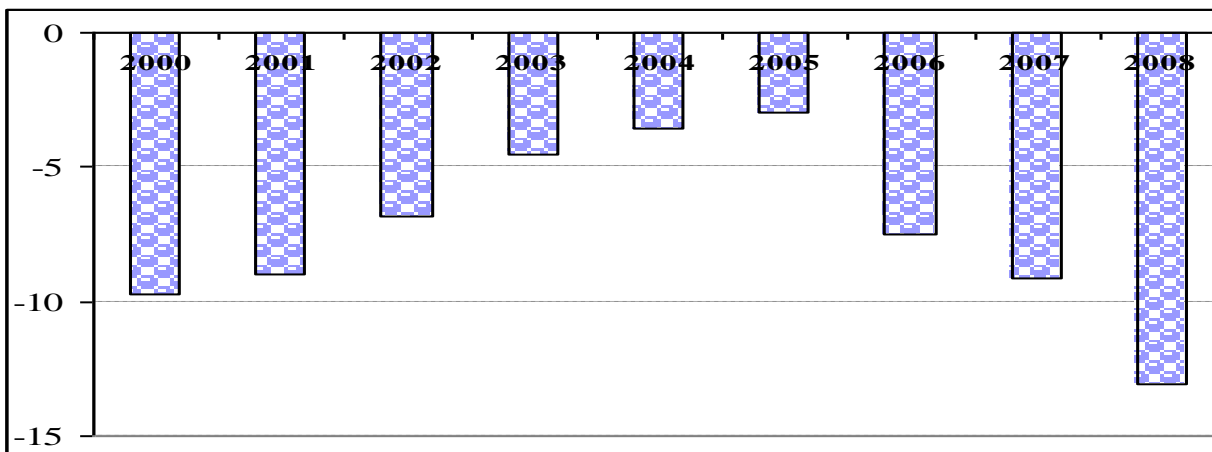
Table 1: Government Budgetary Operations (% of GDP)

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Budget Deficit (Overall Broad Balance)	-9.7	-9.0	-6.8	-4.5	-3.6	-3.0	-7.8	-9.0	-13.0
Domestic Financing (net)	8.5	2.3	4.8	0.6	0.1	-1.7	4.9	4.8	6.0
Total Revenue and Grants	19.8	25.0	21.1	25.5	30.1	29.1	27.4	28.6	30.4
Domestic Revenue	17.7	18.1	18.0	20.8	23.8	23.8	21.9	22.5	25.1
Total Expenditure	29.5	34.0	27.9	30.0	33.7	32.1	35.2	37.6	43.4
Domestic Expenditures	22.6	24.7	24.5	25.6	27.7	26.0	30.1	30.7	37.9
Foreign-financed Capital Expenditure	6.9	9.3	3.4	4.4	6.0	6.1	5.1	6.9	5.5

Source: CEPA and IMF Staff estimates

CEPA estimated the deficit for year 2007 at about 9 percent of national income compared with the provisional outturn of 5.8 percent of national income. For election-year 2008, CEPA conservatively forecasts a deficit of about 13 percent of national income, well over double the target set in the 2008 budget and the largest in the Fourth Republic — the previous peak of 10.7 percent of national income was in 1997.

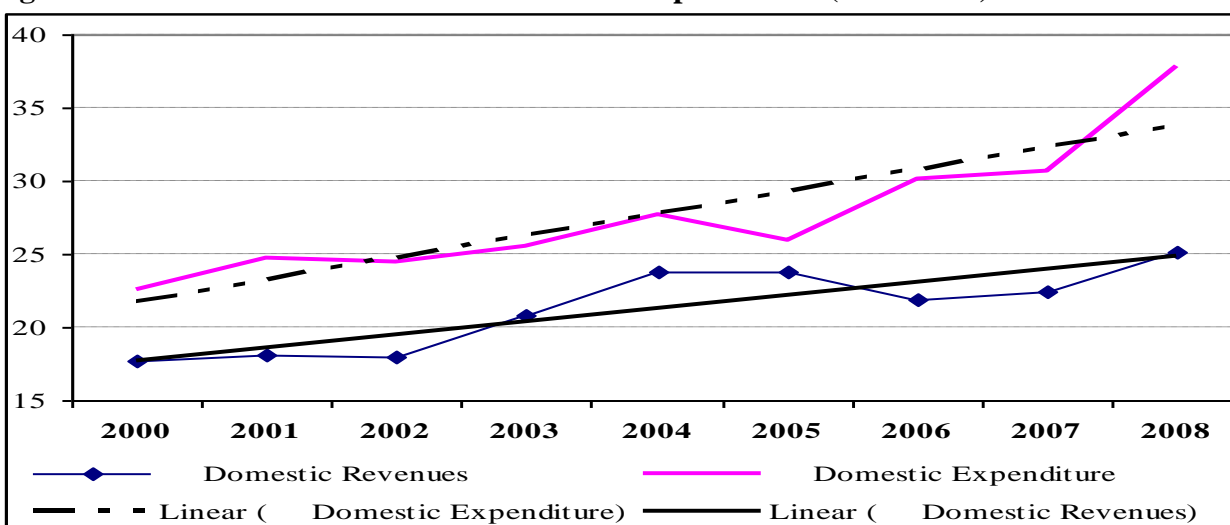
Figure 1: Central Government Budget Deficit (Overall Broad Balance: % of GDP)



Source: CEPA and IMF Staff estimates

The primary reason for the deteriorating fiscal performance over the last four years has been the rapid growth of expenditure. In each of these years, expenditure has risen faster than national income (shown in Figure 2 by the rising trend of the share in national income of domestic expenditure)³ and overshoot the budgetary provision by considerable margins. Thus, from a share of 26 percent of national income in 2005, the share of domestic expenditure in national income (i.e. excluding foreign-financed expenditure) rose to 30.1 percent in 2006, then to an estimated 30.7 percent in 2007; and for 2008, CEPA forecasts a share of at least 38 percent of national income (see Table 1).

Figure 2: Government Domestic Revenues and Expenditures (% of GDP)



Sources: Based on IMF data and CEPA Staff estimates

³ Domestic expenditure simply refers to total expenditure less foreign-financed capital expenditures.

In contrast, the share of domestic revenue⁴ in national income was relatively stable at about 18 percent of national income over the three-year period from 2000 to 2002.

It improved somewhat since then to reach 23.8 percent of national income in 2005 but declined to 22.5 percent of national income in 2007. It is forecast to rise to 25.1 percent of national income in 2008 on the back of the “Talk Tax”. Overall, as depicted from the linearized fit in Figure 2, domestic revenue has risen faster than national income (shown by the positive slope or trend); as shown, it has risen more mildly than domestic expenditure. The differences in the pace of these increases underlie the widening budget deficits. The evidence thus strongly suggests that the revenue mobilization effort has been quite successful, with revenue rising, at the minimum, apace with national income.

Public Sector Debt

In assessing the economic situation inherited from its predecessor National Democratic Congress (NDC) Administration, the then Minister of Finance, in the maiden budget of the Kufuor Administration, March 2001, addressed Parliament as follows:

The crux of our economic difficulties is that our expenditures are more than our revenues with debt service being our single largest expenditure item. Personnel expenditures and debt servicing alone eat up about 75 percent of our revenue. Huge foreign and domestic debts stare us in the face. This means we have very little financial wiggle room (paragraph 6, page 4 — emphasis added).

He continued:

In view of the debt trap in which we find ourselves, debt sustainability analysis carried out in Ghana and our inability otherwise to raise enough revenue from our own resources or attract external inflows beyond the present committed levels, His Excellency the President of the Republic of Ghana has decided that Ghana should take advantage of the HIPC Initiative immediately (paragraph 427, page 90 — emphasis added).

The debt relief and debt cancellation provided by the IMF, World Bank and bilateral donors under the Enhanced HIPC Initiative and Multilateral Debt Relief Initiative (MDRI) helped reduce Ghana’s debt stock from 198.3 percent of national income in 2000 to 118.8 percent of national income at end-December 2003, and further down to a trough of 41.9 percent of national income at the end of 2005. Since then it has turned on an upward path reaching 49.8 percent of national income at the end of 2007 and an estimated 52 percent of national income at the end of 2008.

⁴ This comprises tax and non-tax revenues; the non-tax element excludes the portions retained by the collecting agencies.

In the debt sustainability analysis (DSA) by the IMF, Ghana is rated in Category B. The median nominal debt-to-national income ratio for this category is 45 percent and it is therefore suggested that it would be prudent for Ghana to keep its own debt-to-national income ratio at this median level. The import of this suggestion is discernible in Table 2 and Figure 3 below. Even though the situation has improved compared with 2000, the debt-to-national income ratios in both 2007 and 2008 have risen above the recommended 45 percent target.

Table 2: Public Sector Debt (% of GDP)

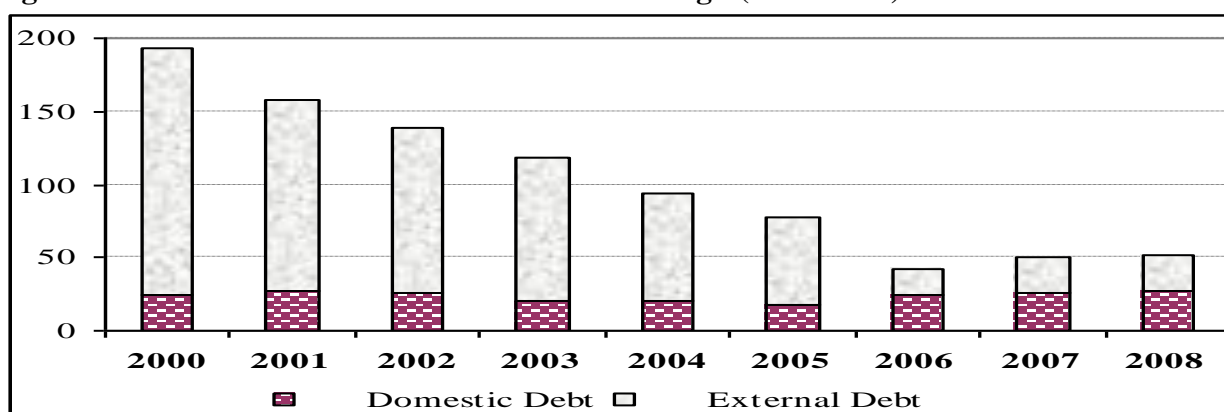
	2000	2001	2002	2003	2004	2005	2006	2007	2008
Total Government Debt	193.8	158.3	138.5	118.8	93.4	77.1	41.9	49.8	52.0
Domestic Debt	24.1	26.8	26.2	19.8	20.7	17.9	24.8	26.1	27.2
External Debt	169.7	131.5	112.3	99.0	72.7	59.2	17.1	23.7	24.8

Source: CEPA staff estimates & IMF Country Report No. 08/344, October 2008

As the IMF notes:

The external debt sustainability analysis (DSA) indicates that Ghana's external debt dynamics is subject to moderate risk of debt distress, and when taken together with domestic developments, the overall assessment suggests that Ghana's debt distress has increased compared to the 2007 DSA. This results from the high current account and fiscal deficits that expose the country to structural vulnerabilities in the event of a reversal of favourable terms of trade.

Figure 3: Public Sector Debt — Domestic and Foreign (% of GDP)



Sources: Based on IMF data and CEPA Staff estimates

According to the Bretton Woods Institutions — the IMF and the World Bank — about 60 percent of this new debt has been contracted on commercial terms in the international capital market, export credit agencies, and local-currency denominated government bonds. In particular, in September 2007, the Government of Ghana placed US\$750 million in Eurobonds with a coupon of 8.5 percent at 10-year maturity. This will imply annual interest payments of about US\$64 million. The remaining part of the new external public debt has been contracted on concessional

terms with multilateral institutions and bilateral official creditors (see Ghana: Joint IMF and World Bank Debt Sustainability Analysis, June 16, 2008 paragraph 2 page 3).

The point of considerable concern that arises from the above analysis of a rising public debt is the disturbing picture Ghana is presenting of a HIPC that is following a path back to high indebtedness soon after having the bulk of its original debt cancelled. Paul Rawkins of the Fitch Rating Agency is quoted by the Business Financial & Times (BF&T) of February 2nd, 2009 on this subject as follows: “if it keeps going this way, they will lose all the benefits they got from debt relief. If it got towards 70 percent, that would certainly be bad news.....that would certainly be negative for credit rating”.

Public Sector Wage Bill

The public sector wage bill, as noted above in the maiden budget of the Kufuor Administration, has been an important contributory source of budgetary excesses: *Personnel expenditures and debt servicing alone eat up about 75 percent of our revenue*. And yet, inability to control it has also been a perennial problem over the eight years of the Kufuor Administration. Moreover, CEPA has regularly drawn attention to this perennial problem in its reviews of the state of the economy. The official reasons given for this phenomenon, however, have varied.

For instance, in respect of 2002, the official explanation given in the 2003 budget statement attributed the wage over-run to the following:

- Unbudgeted wage increases to selected groups of staff, notably in the Ministries of Health and Education, “**to stem a mass exodus of staff and service disruption**”; and
- Ministries, Departments and Agencies (MDAs), particularly, some subvented organizations, did not universally apply the established procedures for controlling wage and salary expenditures.

Reporting on these — the alleged malfeasance and indiscipline of public officials — in its Review and Economic Outlook (2003), however, CEPA drew attention to the fact that: *public officials interviewed by IMF staff had countered that they were not given the political mandate to apply the established control mechanisms to the wage bill*.

In respect of the overrun of 2004, the 2005 budget statement claimed that this was:

.....partly as a result of payment of increased Additional Duty Hours Allowance (ADHA) for health workers as well as increased transfers to foreign missions (to mitigate the effect of the weakness of the US dollar vis-à-vis the euro and pound sterling on the international markets) and other transfers to subvented agencies” (2005 Budget Statement, paragraph 105)

Clearly the ADHA was a way of avoiding wage increases that may have ramifications for other public sector workers.

For 2005, the official provisional estimate painted a remarkable picture of the wage bill having been brought under control. Savings were reported in an amount equivalent to about 0.4 percent of GDP (national income). Commenting on this remarkable outcome in its publication, Ghana Economic Review and Outlook, 2006, page 65, CEPA noted that this picture belied signs from the labour market, labour dissatisfaction and unrest. These signs portended difficulties in the near to medium term. Moreover, *“the evidence especially in the first half of the year suggests that the 2005 achievement was simply technical — delayed agreement and implementation of wage settlements”*.

The protracted negotiations meant that there were no commitments agreed with the public sector which would have formed the basis for what the true provision would have been. Provision, however, had to be made in the 2006 budget to deal with the wage settlement problems carried over from 2005.

Thus, in its Press Release of March 19, 2007, the Monetary Policy Committee (MPC) of the Bank of Ghana (BOG) commented on the fiscal outcome in 2006 as a source of considerable stimulus, *“driven mostly by exceptional expenditures in the supplementary budget and the large public sector wage settlements”* (emphasis added).

The official explanation given for the overrun stemming out of the large public sector wage settlements on account of 2006 was as a result of extraordinary pressures on the public sector labour market, beginning in the second half of the year. The problem of protracted wage negotiations and the consequences for the labour sector in 2006 may be replayed in 2009.

The official explanation given in respect of the above overrun in 2006, as it were, let the cat out of the bag: the existing wage rates in the public sector are inadequate to attract and retain skilled professionals and technical personnel in the key priority sectors. Moreover, the piecemeal approaches ironically contributed to the labour unrest in the public sector. In the foreword of the 2007 Budget Statement, the President pronounced on the matter in the following terms:

There are problems at the labour front resulting partly from a distorted public sector salary structure which is also poorly administered. Government has, therefore decided to begin the implementation of a new comprehensive public sector pay reform that

emphasizes equal pay for work of equal worth. The broad objective is to aim for wage increases in line with productivity gains, cost effectiveness and efficiency.....To ensure order and equity all round, government is setting up a Fair Wages and Salaries Commission to oversee the implementation of this new programme.....The public sector reforms that are being pursued will be sustained to boost private sector development through an enhanced public services delivery in order to deepen public-private sector partnerships for accelerated growth (2007 Budget Statement, pages 5 and 6) (emphasis added).

In respect of 2007, according to the IMF, official explanations given in discussions between the Government of Ghana and the donors pointed to:

- Incomplete payroll automatization (that) allowed line ministries and decentralized agencies to do significantly more hiring than budgeted (emphasis added) (IMF: Country Report No. 08/344 page 6); and
- That the wage bill was higher than budgeted because of hiring outside the centralized budget process and higher than budgeted wage growth (IMF: PIN No. 08/84 July 16, 2008, page 1).

For his part, the Executive Director representing Ghana on the Executive Board of the IMF echoed some of the sentiments in his statement at the Board meeting of June 30, 2008, that:

The wage bill has been another major area of spending overrun. The excess spending went largely into increased hiring for the key health and education sectors. The authorities admit to ineffective application of hiring policy and the need for more work in that area. They also agree on the need to reinvigorate civil service reform to achieve a right-sized, productive, and well-remunerated work force. Keeping the wage bill under control is essential to avoid crowding out priority social and development spending.

Against these official pronouncements, the staff of the IMF has expressed concerns that Civil Service reform has all but stalled. Plans to “right-size” — i.e., cut back on — the large Civil Service has not advanced. Following the passage of the Fair Wages and Salaries Act in 2007, the Fair Wages and Salaries Commission is not expected to make recommendations before 2009.

Consequently, the Fund Staff has urged that: Civil Service reform needs to resume in earnest, with the medium-term goals of attracting high quality labour and reducing total public sector employment. In pursuit of the above, the Fund staff recommended that: temporarily freezing hiring in the public sector (beyond the automatic absorption of trainees in health and education) is required in order to keep the wage bill within the 2008 budget. They go on to suggest that the freeze should last until Civil Service reforms regain momentum (possibly after the elections) (ibid, page 12).

CEPA agrees with the views expressed in the foreword of the 2007 Budget Statement, namely:

- To aim for wage increases in line with productivity gains, cost effectiveness and efficiency;
- To ensure order and equity all round, government is setting up a Fair Wages and Salaries commission to oversee the implementation of this new programme; and
- To boost private sector development through an enhanced public services delivery in order to deepen public-private sector partnerships for accelerated growth.

Certainly, in the key sectors of health and education a lot needs to be done about remuneration to attract and retain the professionals at home. Their skills are needed for the development of the healthy and skilled human resource necessary for the preferred path of accelerated growth with macroeconomic stability. Moreover, their absence or insufficient presence could mean an intensification of socio-political instability which could flow out of poor service delivery in the key social sectors.

The freezing of public sector hiring ahead of a buoyant and booming private sector able to create the much-needed jobs on considerations of the requirements of short-run macroeconomic stability is not a viable option and is simply unacceptable; so also any attempt to freeze the wage rates. It must be stressed that socio-political stability is a necessary condition for sustainable macroeconomic stability.

Growth, and accelerated one as such, in our context, must be a priority. The differences between the CEPA position and the IMF stem from the contrasting visions of Growth with Macroeconomic Stability as against Macroeconomic Stability with Growth. Not surprisingly, while the Government of Ghana and Ghanaians aspire to the Asian type growth rates in the range of 7 to 9 percent per annum, most IMF medium term growth projections for Ghana are, at best, in the range of 5 to 6.5 percent per annum.

Monetary Policy and Inflation

Ghana has often experienced high rates of inflation — the recent ones being in 1999-2000 and 2002-2003. These have been caused by a combination of external shocks, unsustainable macroeconomic policies and exchange rate depreciation. Alas, all of these are present in the current situation witnessed since the fourth quarter of 2007.

The Bank of Ghana used to play a central role in the financing of the domestic purchase of cocoa — Ghana's main cash crop — from cocoa farmers via the Ghana Cocoa Marketing Board (Cocobod). In the process, large quantities of cash were injected each year into the economy in

amounts determined by the size of the harvest and the producer price. The larger the amount so injected and the resultant money supply growth, the higher the inflation rate thus caused. It was clear that the phenomenon was strongly correlated with the timing of the purchase of the main crop.

Typically, the purchasing of the main crop officially begins in October and continues through the following year until the end of April, followed by the minor-crop purchases from May till about August. Relatedly, the inflation cycle troughed in September at about 10 percent per annum in the pre-2003 period and then rose steadily, peaking some eighteen months later in March at about 30 percent over the same pre-2003 period. This was followed by the next trough in September, some eighteen months after the peak.

Monetary policy in programs agreed with the IMF in the late 1990s and early 2000s was based on this inflation model. In these programs, however, a slightly more sophisticated version of the model was adopted. In particular, the cash reserve base of the monetary system⁵ — reserve or high powered money — is taken as exogenously determined. It was then used as an intermediate instrument for determining the broad monetary aggregate in the model.

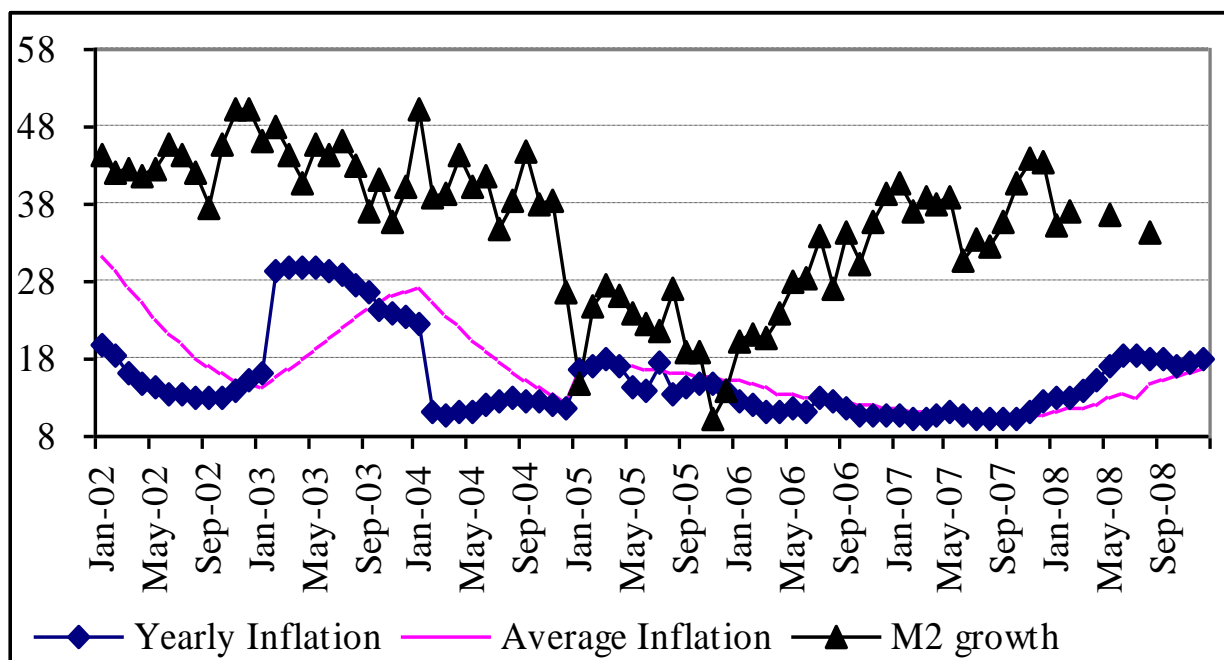
Subsequent changes in the financing of the cocoa crop purchases resulted in an increasing role for the deposit money banks through syndication and a correspondingly smaller role for the Bank of Ghana. In spite of this change, the direct injection of liquidity into the economy remained correlated with the three-year cocoa cycle. The reduced role of the Bank of Ghana, however, served to moderate the amount of new cash thus injected. As a consequence, the amplitude of the inflation cycle was significantly lowered — troughs estimated at 7.5 percent and peaks at 12.5 percent — compared to the pre-2003 period. Figure 4 depicts the last of these (three-year) cycles for both year-on-year and average rates of inflation, somewhat distorted by the petroleum price shocks of 2003 and 2005.

It is worth emphasizing that important as cocoa crop purchasing was for monetary developments, it was not the only or most important. Other sources include government borrowing to finance the fiscal deficit and the accumulation of international reserves by the BOG. The amounts involved have varied from year to year and contributed to the high and variable growth of money supply.

⁵ The cash reserves of the banks, including their deposits with the BOG together with currency held by the non-bank public.

Notwithstanding the difficulties of controlling the money supply growth, the performance record in respect of inflation and inflation expectations have been commendable. As noted elsewhere, Ghana is vulnerable to severe supply shocks from weather and commodity price developments. Abstracting from these adverse exogenous factors, the record of inflation performance in the period to the last quarter of 2007 (averaging 13.5 percent per annum) can indeed be described as reasonably satisfactory – just outside the recommended range of 8 – 13 percent for Ghana at this time.

Figure 4: Consumer Price Inflation and Money Supply Growth, 2002-2008 (% year-on-year)



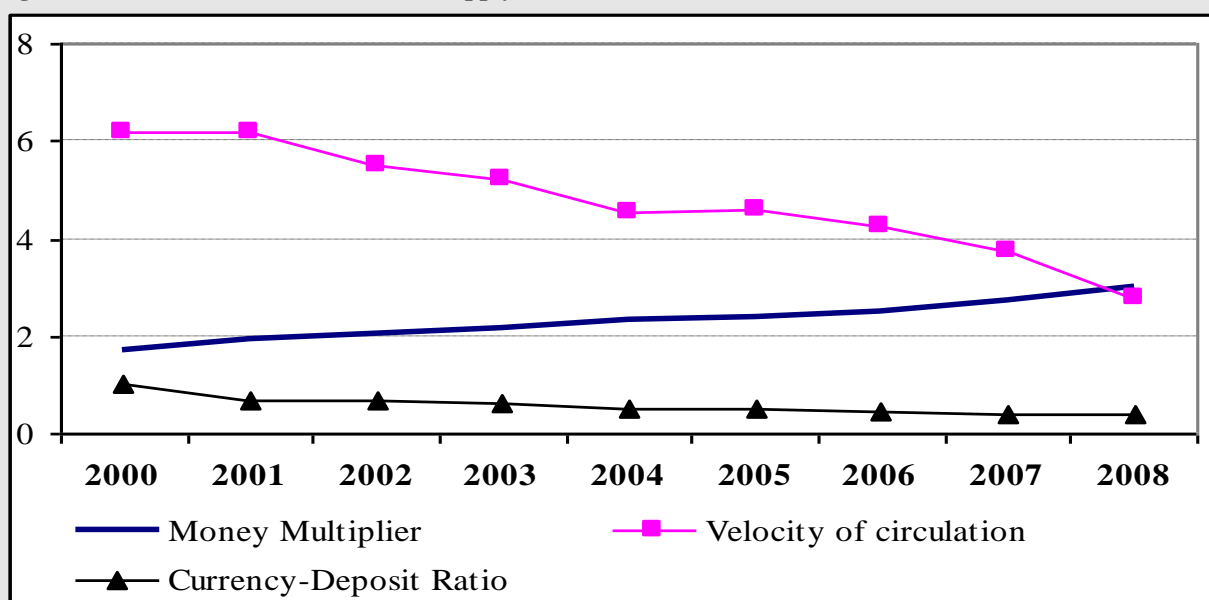
Part of the explanation for this was because some success was achieved in reducing inflationary expectations in the economy (shown in Box 1 by the declining trend in the velocity of money in circulation). It was also partly because resources from debt relief, debt cancellation, in terms of the HIPC and the multilateral debt relief initiative (MDRI), new aid flows and external loans, inward private transfers including remittances, were used by the central bank to “buy off” the otherwise accelerated rates of inflation in the economy. This option — increased indebtedness — however, may not be available to the new government in the face of dwindled international ratings, the global financial crisis (popularly dubbed the “credit crunch” or “financial protectionism”), and the risks and uncertainties associated with borrowing both domestically and internationally. Thus, care needs to be taken with regards to measures used to manage both the fiscal deficit and monetary policy.

Box 1: Determinants of Demand and Supply Pressures in the ‘Monetarist’ Model

As shown in Figure B.1, the velocity of circulation of money has followed a falling trend over the last eight years. For a developing country, this could be interpreted to indicate an increasing demand for money. Higher incomes enable people to acquire proportionately more of the convenience (mainly in carrying out transactions) which the holding of larger money balances allows.

From at least a monetarist perspective, the money supply is exogenous — determined without regard to the value of other variables such as money incomes and interest rates in the economic system. Consequently, the existence of this significant statistical relationship between changes in the money stock and changes in money incomes must be assumed to reflect the influence of changes in money stock on incomes. In a situation such as Ghana’s where the growth rates of real incomes are relatively stable — real GDP growth rate confined to a narrow range of between 5.5 to 6.5 percent per annum — changes in money incomes are dominated by changes in prices.

Figure B.1: Indicators of Demand and Supply Pressures in the Model



Sources: Based on IMF data and CEPA Staff estimates

This then is the basis for the observed relationship between money supply growth and inflation in Ghana.

Certain functional relationships such as the public’s desired cash-to-deposit ratio, which determine (the money multiplier) the total volume of the money stock consistent with a given volume of reserve money, are treated as endogenous — behavioural relationships influenced by other variables in the system.

As shown in Figure B.1, the money multiplier has followed a rising trajectory since 2000. This has been attributed to financial deepening, diminishing dependence on cash and increased deposit mobilization efforts by the banking system as reflected in the decline of the currency-to-deposit ratio (see Figure B.1).

There is no reason for currency/deposit ratio to stay constant over time. Obviously, it may be affected by technological change – for example the introduction of credit cards which could result in a reduced dependence on cash for ordinary transactions. Again, at least in theory, with a broad definition of bank deposits to include demand, savings and time deposits, there is no obvious reason for the ratio to remain constant over time.

Again, the money multiplier – the ratio of the broad money aggregate to reserve money – also needs not be constant. In the programming exercises with the IMF, it is used as an instrument for controlling the growth of the broad monetary aggregate. And yet, it can be reasonably argued that to the extent that there is a line of causality at all, it must run from the broad money aggregate to reserve money rather than the other way round.

Currency held by the non-bank public is demand-determined largely in response to current and past changes in consumers’ expenditures. The direction of causation therefore running from nominal income to currency in circulation in the hands of the non-bank public and thence (with the addition of the revenues of the deposit money banks) to reserve money. The relevant part is that in the early phases of financial development when interest rate may not be an

effective instrument for controlling the growth rate of the broad money aggregate, the reserve money could very well be the only instrument of choice available for the purpose.

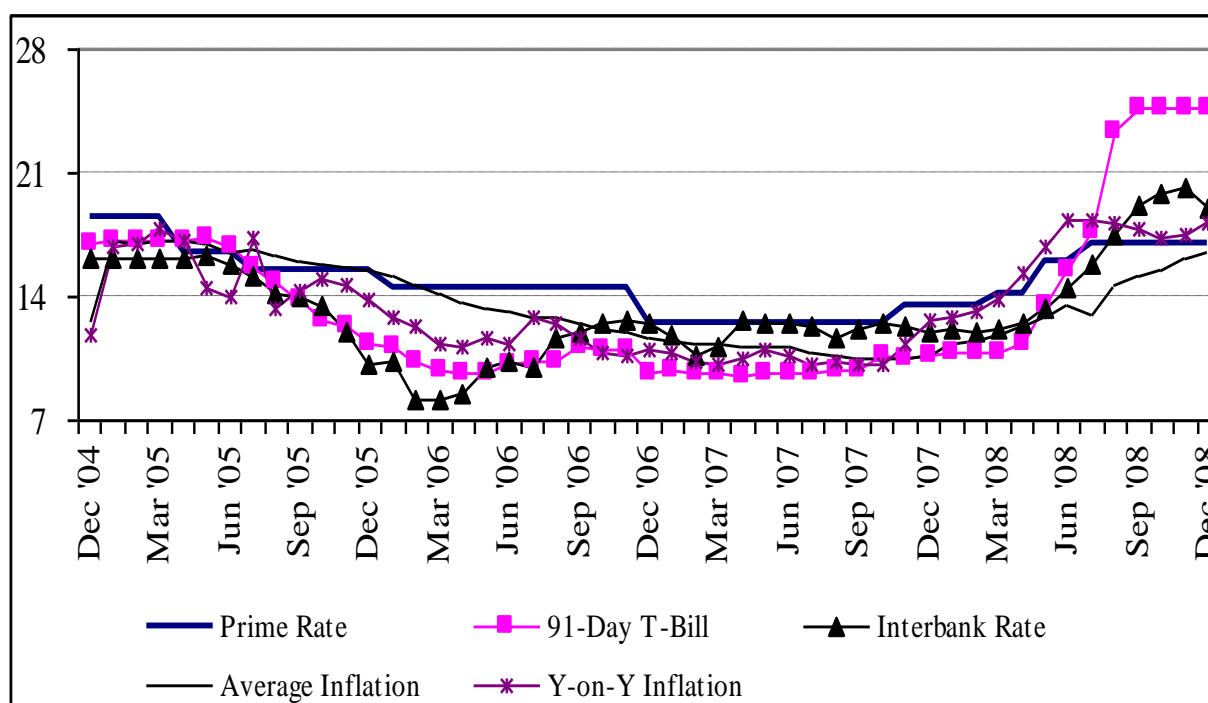
Monetary programming thus has had to contend with the control of reserve money as well as a variable and not readily predictable money multiplier over the period. At the same time, as shown in the path charted by the velocity of circulation in Figure 5, the demand for money has also been neither stable nor predictable.

In the monetary programs, the Bank of Ghana (BOG) was to focus on its net domestic assets (NDA). Thus in the 2001 program:

- To reduce overall inflation to 25 percent by end-2001, the Ghanaian authorities have targeted a slowdown in the growth rate of broad money this year to 34 percent, from 40 percent last year. To this end, the Bank of Ghana will rely on restraining growth in its NDA to achieve monthly indicative targets. The Bank of Ghana will use appropriate monetary instruments to control the growth of reserve money, which is not expected to exceed 29 percent for the year. Broad money is expected to grow by about 34 percent during the year sufficient to accommodate a rebuilding of (the targeted level) of net international reserves (NIR) as well as the target level for credit to the government.
- Given the low level of NIR and the need to keep a tight rein domestic credit, the BOG intends to focus control on the net domestic assets in its balance sheet, particularly net credit to government and liquidity support to the banks and/or public enterprises. The monetary program assumes that the average velocity will rise slightly this year, consistent with recent trends. (In the event, velocity actually declined.) The program also assumed that the money multiplier will continue to increase as a result of financial deepening, increased deposit mobilisation effort by the banking system and diminishing dependence on cash for example through increased use of cheques and the introduction of credit cards could all reflect in the decline of the currency to deposit ratio.

Demand pressures originating from the large budget deficit and election-year private spending have been the major factor in the recent acceleration in inflation beginning since the fourth quarter of 2007. Supply-side shocks emanating from crude oil and food price hikes in international markets also played a part, though a relatively minor one in the pre-harvest period of January to May last year 2008. The Bank of Ghana (BOG) responded to the rising inflation by policy tightening — increases in its prime rate also referred to as the policy rate from the fourth quarter of 2007 to mid-year 2008 — but this proved inadequate to dampen credit demand and rein in spending. The observed deceleration in year to year inflation was due to a post harvest effect. As shown in Figure 5 average inflation continued on its rising path from the fourth quarter of 2007. Moreover, the resurgence of year on year inflation in the fourth quarter of 2008 would appear to be totally unanticipated by the BOG.

The failure to raise interest rate thereafter did not help to induce net inflows of foreign exchange. The attempt to moderate the rate of depreciation in the face of this large fiscal stimulus resulted in the considerable loss in international reserves.

Figure 5: Prime Rate of BOG, Interest Rates and Inflation (% per annum)

Sources: Based on Bank of Ghana data and inflation rates as measured by the Ghana Statistical Service

The transmission of policy through interest rates may be limited in an environment of financial dearth and some period of nurturing may be required. Moreover, perennial supply shocks present additional challenges to disinflation in a small, open, low-income economy like Ghana. In our circumstances, monetary policy is not only incapable, by itself, to contain inflation; it also runs the risk of precipitating an inflation spiral together with sizable short-term output losses.

Inflation Targeting

Ghana is one of several emerging market economies to adopt inflation targeting (IT). According to the IMF it may very well be the only low-income country to have done so. But as a small, open, low-income economy, in its conduct of disinflation policy, Ghana faces several major challenges such as the following:

- The economy is highly vulnerable to supply shocks;
- Deviations from inflation targets tend to be larger during disinflation than with low levels;
- Inflation expectations can be volatile based on past experience; and
- The technical capacity of the BOG is sufficient but still evolving.

With the enactment of the Bank of Ghana Act in 2002, all the key institutional components of modern central banking — especially “**independence and a statutory mission of price stability**” — were put in place. And with this, the BOG commenced building the main analytical and communications elements of an inflation targeting framework. After three years of what has been

described as “informal IT management” the BOG formally adopted IT in May 2007. The staff of the IMF describe the current regime as “inflation-targeting lite” because according to them,

....exchange rate stability is an important secondary objective and because operational transparency has not developed sufficiently to classify it as a full-fledged IT regime. (IMF, Inflation Forecast Targeting in a Low Income Country: the Case of Ghana page 5, paragraph 10).

A large measure of “goal transparency” was established with the formal launch of the IT. In support of its inflation targeting, the BOG has, reportedly, also developed an inflation forecasting model and a detailed communication strategy. For example, after each Monetary Policy Committee meeting, it issues a press release and holds a press conference, chaired by the Governor, at which it explains its decision. A detailed monetary policy report is subsequently published.

Inflationary developments since the last quarter of 2007 — with what appears to have been a temporary respite in the post-harvest period — have posed an early challenge for the IT regime.

The economy is experiencing excess demand pressures and experienced an external oil price shock — reaching up to US\$147 per barrel: inflation is high, growing fiscal deficits and easy monetary conditions are stimulating further inflation. In the view of the IMF:

.....the present disinflation path and communication strategy seem too rigid to respond well. As a result, the BOG credibility that was built over the last four to five years may be at risk (IMF, Inflation Forecast Targeting in a Low Income Country: the Case of Ghana page 5, paragraph 12).

Low credibility results in upwardly-biased inflation expectations. Moreover, it is all too often easier to lose credibility than it is to regain it once lost. This is because it takes time and a period of significant slack in the economy to re-anchor inflation expectations. Consumers can become reluctant to spend and investors reluctant to invest when they have no reliable framework of expectations, since they have no way of knowing what will happen next in an environment of unrealized policy objectives.

The BOG would need to rebuild its credibility by openly focusing its policy on more than just hitting annual targets, recognizing that its actions could involve short-run trade-offs and being mindful of undesired effects on output and employment. A sufficient track record of delivering on its targets would be needed. To achieve this would almost certainly call for a more gradualist

approach than at present. Unnecessary cumulative output losses that would come with the disinflation process must be prevented, and in any case, kept to a bare minimum.

Given the current high level of inflation and inflation expectations and the lags in the expectations process, the BOG is confronted by the spectre of having to further raise its prime rate substantially in order to achieve the desired increase in the real interest rate. The hope of such a hike must be that of inducing the net capital inflows required to cause the nominal exchange rate of the cedi to appreciate. A sufficiently large net inflow, together with the inflation differential vis-à-vis major trading partners, is to be relied upon to ensure that the real exchange rate appreciates significantly. The increased interest rate and real appreciation of the cedi (reduced real price of foreign exchange) can both then be expected to cause a reduction in demand for domestic output.

Furthermore, in as much as inflation expectations have a direct effect on actual inflation, monetary policy would have to be tighter, the less the credibility of the BOG; and logically following from this, the greater the loss of output and employment. It is this consideration that underlines the critical importance of the credibility of the central bank to deliver on its inflation targets. The cost — measured in terms of lost output and jobs — rises inversely with the credibility of the central bank.

In present circumstances, it is increasingly clear that there is little, if any, room for monetary policy to play an effective role in the fight against inflation without the restoration of fiscal discipline. In both nominal and real terms, interest rates are high. Consequently, any further increase is likely to face strong resistance from industry, labour and, as has been the case since 2003, by the Government as well. (IMF Country Report No. 08/332, October 2008, page 27, paragraph 19).

The unpalatable fact is that disinflation requires that a negative output gap sooner or later opens up. This output gap — output and employment lost to the economy — is a measure of the short-run sacrifice required for disinflation. Moreover, for any given economy, the evidence suggests that there is a context-specific range of inflation rates — currently estimated to be between 8 percent and 12 percent for Ghana — below which the sacrifice ratio becomes exorbitantly high. For a developing country with widespread and deep poverty, keeping the ratio to the barest minimum is of outmost important.

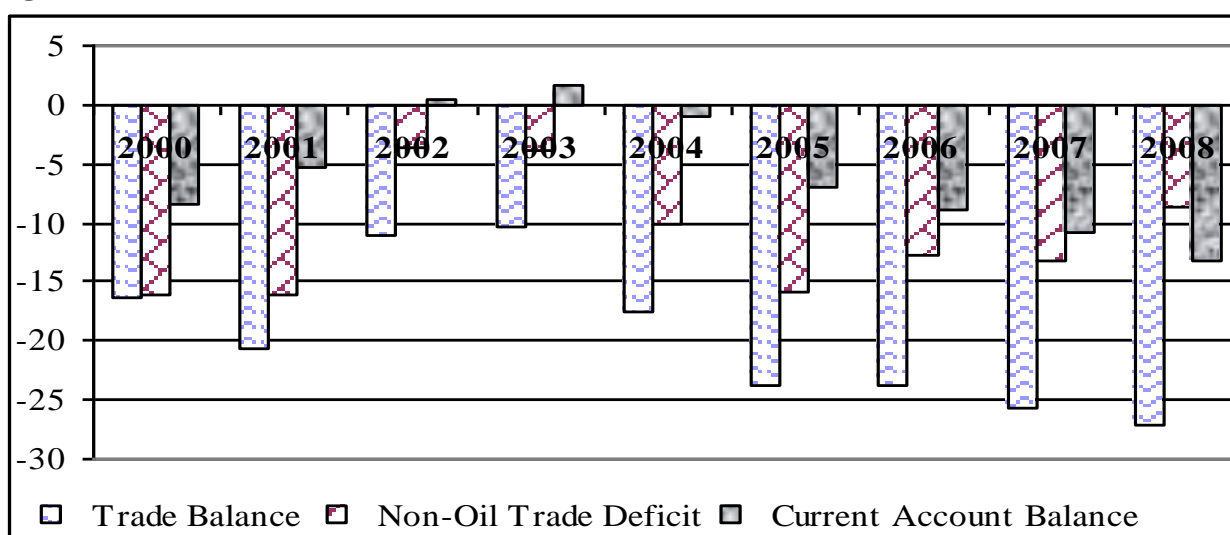
In our circumstances, aiming to keep output at its potential level has an obvious justification since this is a fundamental objective of the Growth with Macroeconomic Strategy. Output and job

losses could have particularly grave socio-political consequences in an economy already facing rising joblessness, high levels of underemployment and open unemployment. Moreover, in the current international environment where a high country risk premium may be charged on Ghana Government debt instruments, hiking the interest rate could turn out to be counterproductive — an exercise in futility — as it may fail to induce the expected net capital inflows and the real appreciation of the exchange rate needed to help slow down inflation.

International Trade

The current account deficit (including official transfers) of the balance of payments — the twin of the budget deficit — widened in step with its twin from 7 percent of gross domestic product (GDP) in 2005 to 9 percent in the following year and further to 10.9 percent in 2007. In election-year 2008, it is expected to widen further and reach a peak (at least in the Fourth Republic) of about 13.2 percent of GDP (IMF estimate). Given that the current account deficit is a measure of the country's liability — by way of foreign loans and equity — to the rest of the world, the persistent widening of the deficit raises obvious concerns of sustainability.

Figure 6: Trade and Current Account Balances of the BOP (% of GDP)

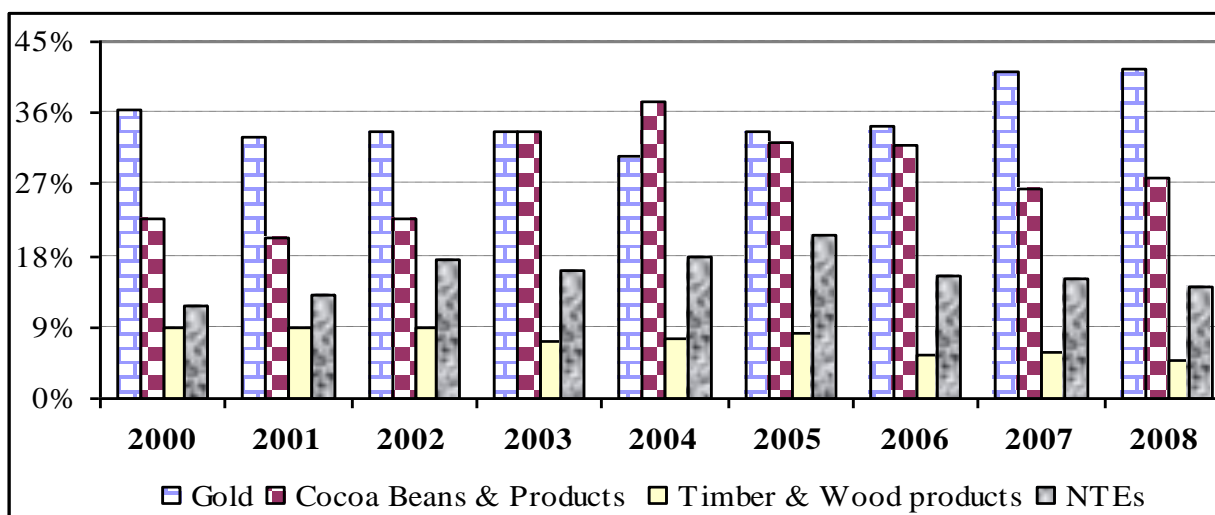


Sources: Based on IMF data and CEPA Staff Estimates

The current account balance comprises the trade balance and the services, income, and transfers (official and private) balance. Over the four-year period of 2004-2007, the deficit on the trade balance has widened continuously from 17.6 percent of GDP to reach 26 percent of GDP, with the non-oil trade deficit widening from 10.2 percent of GDP in 2004 to 13.1 percent of GDP in 2007.

The experience over the past years reveals once again the vulnerability and fragility of a primary commodity-dependent economy which moreover, is losing export market shares in international markets. This worrisome situation appears to be the result of a combination of an overvalued currency (which may be squeezing profit margins of exporters and import-competing enterprises) and an inadequate incentive scheme that together make products made in Ghana uncompetitive at home and abroad.

Figure 7: Shares of Selected Export Commodities in Total Export Earnings



Sources: Based on IMF data and CEPA Staff estimates

On the side of export earnings, the key elements are gold, cocoa (beans and products) and the group of non-traditional export (NTE) commodities.

Gold export earnings led the way and as a result its share in overall export earnings in 2007 represented 43 percent of the total. Indeed, since 2004, the share of gold export receipts in overall export earnings exceeded those of all other export commodities, thus making gold the dominant export commodity. Gold exports increased by almost 36 percent in value terms in 2007. This was both on account of record-high prices on world markets and increased export volumes. While export volumes increased by 19 percent above the average for the preceding year, world market prices rallied by more than 15 percent above the average registered in 2006. An issue of some concern is that while the gold sector has witnessed considerable boom in recent times, its contribution to the country's international reserves and budgetary revenue has been minimal.

In comparison, export earnings from the shipment of cocoa beans and products fell by 7.1 percent in 2007 relative to 2006. The decline in earnings was largely due to a sharp fall in the volume of cocoa beans shipments even in the face of continuous price rallies on world markets.

Thus, the average price increased by about 23 percent while the volume shipped declined by 14.8 percent in 2007.

Foreign exchange earnings from the group of export items dubbed non-traditional exports (NTEs) — defined here to exclude cocoa and wood products — have performed rather poorly. Over the past four years, the contribution of NTEs to overall export earnings has been falling, with an apparent dwindling in shares of the horticultural category of agricultural goods. The evidence suggests that over the past four years, export volumes of pineapples — which used to be the highest earner in the horticultural category of agricultural NTEs — slumped by 66 percent on account of an unexpected shift in demand from the smooth cayenne variety preferred by Ghanaian farmers to the so-called MD2 variety mostly produced in South America.

The Interim Economic Partnership Agreement (I-EPA)

The evidence thus points to a generally lack-lustre performance of the NTE sector. Moreover, the indications were that the trend was likely to persist if not get worse. Against this background, and given the importance of trade to Ghana's growth objective and consequently trade liberalization and integration into the global economy, an interim Economic Partnership Agreement (I-EPA) with the European Union (EU) was initialled on December 13, 2007.

The Agreement allows for 100 percent trade liberalization of Ghanaian exports to the EU, with a transition period for rice and sugar. On the other hand, it allows a gradual liberalization of 80 percent of Ghanaian imports from the EU over a period of 15 years.

Agricultural produce, processed and manufactured goods — considered sensitive on grounds of food security, livelihood or rural development and/or “infant industries” — and amounting to about 20 percent of total Ghanaian imports from the EU are placed in an exclusion list. This means that these imports are not subject to any tariff liberalization whatsoever under the I-EPA. The market access offer made by Ghana in the I-EPA seeks to preserve tax revenue by postponing the liberalization of items with high customs duties as far as possible — some 10 to 15 years after the agreement comes into force. As a consequence and as noted by the staff of the IMF, the I-EPA “*is likely to have a smaller negative fiscal impact in the near term.*”(IMF Country Report No. 08/344 October 2008 paragraph 23, page 16).

Some Lessons from East Asia and China

Lessons from the experiences of the East Asian Tigers and lately China and India, have shown that increased emphasis on higher education — highlighting science and engineering courses and vocational and entrepreneurial training and skills development — as well as massive investments in research and development that is oriented towards the creation of new products and product designs, marketing methods and organizational forms, can be important in bringing about the dynamism required for intensifying competition between enterprises and between countries. Knowledge and information have become the key drivers of international competitiveness, making it crucial to respond rapidly and efficiently to evolving technological changes.

It is about time Ghana's export diversification drive was charted along these lines. A first step would be to address the myriad institutional and infrastructural bottlenecks that seem to be holding back efficient service delivery in the non-traded goods sector — namely, improving the legal and institutional environment for doing business in Ghana, and minimizing the bureaucratic processes of service delivery in financial and public sector institutions, including deposit money banks, public utility agencies, as well as the MDAs.

Way Forward

Given the national long term goal of **Growth with Macroeconomic Stability**, the key challenges over the medium term are the following:

- Priority needs to be given to the near-term policy challenges of pulling back from the current expansionary fiscal policies. Limiting the fiscal deficit would also make more room for private sector development through “crowding in” of the sector. In any case, fiscal policy must carry the brunt of the needed adjustment. Public financial management (PFM) reforms have continued but recent and on-going fiscal slippages have exposed recurring weaknesses which must be rectified. CEPA supports the proposed enactment of the Fiscal Responsibility Law (FRL) — improving fiscal discipline and anchoring fiscal expectations even though we regard it as a necessary condition it is not an only condition;
- CEPA supports the proposed enactment of the Fiscal Responsibility Law (FRL) – improving fiscal discipline and anchoring fiscal expectations. Even though we regard it as a necessary condition, it is by no means sufficient. CEPA has noted that: The passage into law of a Fiscal Responsibility Law (FRL) by itself is not sufficient to promote fiscal discipline” Ghana Economic Review and Outlook, Part I: Focusing on fiscal Performance, page 32, Box 1). At the same time there is evidence it could help. The PRGF programme agreed with the IMF for the period 2003 to 2005 (this had to be extended to October 2006) contained an explicit

medium-term conditionality namely: *The end 2002 domestic debt to GDP ratio shall be halved by end 2005*. Adherence to this, even if with difficulty, certainly contributed to the macro-economic stability achieved over the period. The FRL, when it comes into being, could play this role in any future programme.

- Further re-orienting fiscal priorities towards development — in terms of government expenditure, tax policy that leaves more resources in the hands of workers, entrepreneurs and investors (making it profitable to work and invest in Ghana) and improved public service delivery eliminating wasteful expenditure and insisting on value for money; and
- A sharper focus on the enhancement of productivity through technical and vocational training skills development particularly management, increased use of knowledge and improved technology in production, and efficient investment in infrastructure especially in transportation and energy.

The flight of private capital means emerging and developing economies with current account deficits face a drought of both financing and export earnings particularly from non-traditional exports (NTEs). Likely developments in respect of world market prices of gold and cocoa on the one hand, and the low and declining price of oil on the other hand, suggest a possible positive outcome for Ghana's commodity terms of trade – a comparative measure on prices on imports and exports.

The perennial problem of subsidies, however, is likely to remain even if with a twist to it. The difference is that instead of subsidies for the imports of petroleum products, electricity and water sub-sectors; the problem in the near term will be how to find the subsidies to prop up the NTEs and possibly even cocoa (being a commodity) in the event that world market prices fall too low to sustain profitable production and cocoa producer price.

Appendix Table A.1: Ghana — Selected Economic Indicators, 2000-2008

	2000	2001	2002	2003	2004	2005	2006	2007	CEPA Estimates 2008
National Accounts and Prices									
Real GDP Growth (%)	3.7	4.2	4.5	5.2	5.6	5.9	6.4	6.3	6.5
Real GDP per capita (annual % change)	1.2	1.6	1.9	2.6	3.0	3.2	3.7	3.6	3.8
GDP Deflator	27.2	34.6	22.8	28.6	14.4	15.0	12.8	14.4	16.2
Consumer Price Index (annual average)	25.2	32.9	14.8	26.7	12.6	15.1	10.2	10.7	16.5
Consumer Price Index (end-December)	40.5	21.3	15.2	23.6	11.8	14.8	10.9	12.8	18.0
Government Operations (% GDP)									
Overall Broad Balance (OBB) modified	-9.7	-9.0	-6.8	-4.5	-3.6	-3.0	-7.8	-9.0	-13.0
Domestic Financing (net)	8.5	2.3	4.8	0.6	0.1	-1.7	4.9	4.8	6.0
Total Revenue and Grants	19.8	25.0	21.1	25.5	30.1	29.1	27.4	28.6	30.4
Domestic Revenues 1/	17.7	18.1	18.0	20.8	23.8	23.8	21.9	22.5	25.1
Tax Revenue	16.3	17.2	17.5	20.2	21.7	20.6	19.9	22.3	24.5
Grants	2.1	6.9	3.1	4.7	6.4	5.2	5.4	6.0	5.4
Total Expenditure	29.5	34.0	27.9	30.0	33.3	32.1	35.2	37.6	43.4
Domestic Expenditure (recurrent plus capital) 2/	22.6	24.7	24.5	25.6	27.7	26.0	30.1	30.7	37.9
Capital Expenditure	10.9	14.1	7.9	9.0	12.9	13.4	13.3	14.7	18.4
o/w Foreign Financed	6.9	9.3	3.4	4.4	6.0	6.1	5.1	6.9	5.5
Domestically Financed	4.0	4.8	4.5	4.6	6.9	7.3	8.2	7.8	12.9
Public Sector Debt (% of GDP)									
Domestic Debt	193.8	158.3	138.5	118.8	93.4	77.1	41.9	49.8	51.4
External Debt	24.1	26.8	26.2	19.8	20.7	17.9	24.8	26.1	27.6
Total	169.7	131.5	112.3	99.0	72.7	59.2	17.1	23.7	24.8
Money and Credit (annual % change)									
Net Domestic Credit	50.8	11.9	27.1	12.7	43.6	22.0	28.7	32.5	47.0
Net Claims on Government	49.6	0.0	42.8	-11.5	66.8	7.0	12.2	-21.8	-8.2
Credit to rest of the economy	51.6	25.9	17.1	40.4	26.9	50.6	42.7	60.0	55.4
Credit from DMBs to Private Sector	20.6	19.9	31.5	34.7	21.4	47.8	42.8	59.7	57.6
Broad Money (M2 +)	46.5	41.2	50.5	38.1	26.0	14.3	38.8	36.3	40.7
Broad Money (M2)	33.7	47.9	50.7	40.9	26.6	13.7	39.4	43.5	34.5
Reserve Money	52.6	31.3	42.6	33.4	18.8	11.2	32.3	30.6	20.7
Velocity (ratio of GDP/annual average M2+)	4.6	4.6	4.1	4.0	3.5	3.6	3.3	3.0	2.3
Velocity (ratio of GDP/annual average M2)	6.2	6.2	5.5	5.2	4.5	4.6	4.3	3.8	2.8
Reserve Money Multiplier (M2+/RM)	2.3	2.5	2.7	2.8	2.9	3.0	3.2	3.3	4.0

Reserve Money Multiplier (M2/RM)	1.7	1.9	2.0	2.2	2.3	2.4	2.5	2.7	3.0
Currency/M2+ Ratio	0.4	0.3	0.3	0.3	0.3	0.3	0.2	0.2	0.2
Currency/M2 Ratio	0.5	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Currency/Deposit Ratio (including FCD)	0.6	0.4	0.4	0.4	0.4	0.4	0.3	0.3	0.2
Currency/Deposit Ratio (excluding FCD)	1.0	0.7	0.7	0.6	0.5	0.5	0.4	0.4	0.4
External Sector (% GDP; unless otherwise stat									
Gross International Reserves (US\$ million)	264	340	632	1,427	1,732	1,895	2,325	2,738	1,900
(months of imports of goods & services)	0.9	1.2	1.9	3.2	3.6	3.7	2.8	2.6	1.9
Exports f.o.b. (% of GDP)	37.9	34.8	32.5	32.7	30.9	26.2	29.8	28.1	35.0
Imports f.o.b. (% of GDP)	54.2	55.4	43.6	43.0	48.5	50.0	53.9	54.0	60.8
Trade Balance (% of GDP)	-16.3	-20.6	-11.1	-10.3	-17.6	-23.8	-24.2	-26.0	-25.8
Current Account Balance (incl. off. transfers)	-8.4	-5.3	0.5	1.7	-0.9	-7	-9	-10.9	-13.2
Terms of Trade (annual % change)	-16.6	4.8	9.4	14.8	-15.1	-6.9	4.8	11.1	5.6
Foreign Exchange Market									
Ghana cedi per US dollar (end-period)	0.689	0.726	0.835	0.885	0.905	0.913	0.924	0.971	1.204
Nominal depreciation (-=appreciation)	96.8%	5.3%	15.1%	6.0%	2.2%	0.9%	1.1%	5.1%	24.1%
Real Depreciation (-=appreciation)	35.5%	-12.8%	-14.0%	0.5%	0.4%	-18.6%	-1.2%	2.9%	10.9%

Sources: IMF County Report No. 04/209, July 2004 for 2000-2003 data

IMF County Report No. 05/286, August 2005 (Ghana Statistical Appendix)

IMF Country Report No. 08/344 October 2008, pp.19-24 for 2004-2007 data

Notes: 2008 data are CEPA Staff estimates; Nominal depreciation of 24% based on December 2008 data from BOG website

1/ Domestic Revenue is simply Total Revenue and Grants less Grants

2/ Domestic Expenditure is Total Expenditure less foreign-financed capital expenditures