



CENTRE FOR POLICY ANALYSIS

EXECUTIVE SUMMARY

GHANA ECONOMIC REVIEW AND OUTLOOK

2006

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Centre for Policy Analysis
No. 11 Amilcar Carbral Road
Airport-Accra

Mailing Address:
P. O. Box AN 19010
Accra-North
Ghana

Tel: (233-21) 778035/779364-5
Fax: (233-21) 773670

For enquiries on publications Email: library@cepa.org.gh
Website: www.cepa.org.gh

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** This document summarizes the Ghana Economic Review & Outlook for 2006*

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EXECUTIVE SUMMARY

There is a need to put firmly in place a credible framework for macroeconomic policymaking in Ghana. Moreover, such a framework must recognize some long standing principles in policymaking, namely that:

- there are tradeoffs;
- there is uncertainty;
- different policies affect different groups in society differently;
- the proper role of the economic adviser is to inform policymakers of the consequences of difficult decisions; and
- it is the role of the political process to make the final decisions.

The most important of these principles is that it is the role of the political process to make the final policy decisions.

There is a tension in the macroeconomic framework informing policy between the need to undertake growth-enhancing expansion in expenditure and the demand for further fiscal restraint as a disinflation policy. After a considerable period of macroeconomic stability, the Government of Ghana feels rightly that there is a need for fiscal space to undertake the ‘flanking’ public investments that will promote growth. Growth after all, is the means to create employment and reduce poverty on a sustainable basis. Macroeconomic stability while necessary is not sufficient for growth and poverty reduction.

The Fund and the Bank of Ghana, on the other hand, consider the pursuit of single digit inflation as the single most important policy objective. The easiest way to achieve this without increasing interest rates is through fiscal restraint, reducing domestic debt and exchange rate appreciation.

These tensions need to be resolved. Even if the tension is resolved in favor of fiscal space for growth, the method of financing the increased expenditure is important. As discussed in CEPA's Issues Paper (July 2006) on "*The Search for an Accelerated Growth Strategy for Ghana*", the extent to which this room for maneuver for enhanced growth should be through revenue measures or increased spending remains a subject of disagreement and needs to be explored.

Ghana needs to programme the spending and absorption of external resource inflows in such a way as to avoid the Dutch Disease or 'resource curse' problems and make them serve the need to enhance our international competitiveness and relieve the domestic supply constraints on growth and development. Over the next several years, there will be a substantial and almost permanent increase in aid and other unrequited external transfers. Absorbing these inflows will lead to a widening current account deficit and a real appreciation of the exchange rate. This could adversely affect the development of the domestic economy. On the other hand, if the resulting imports were largely capital goods they could enhance the development of the domestic economy.

The Government of Ghana thinks it can borrow externally and spend its way to enhance growth. However, financing this through borrowing at non-concessional rates that threaten our debt sustainability is perhaps inappropriate. The principle of fiscal responsibility must involve setting targets for public sector deficits and/or debt to GDP ratios.

Policymaking is an exercise in political economy. The best external consultants can do is to respect the above-stated basic principles of policy advice. Ultimately, the political authority must be responsible and own both the process and outcome.

Fiscal Operations

The essence of fiscal policy is that it is the means to influence expenditure flows in the economy either directly through expenditure changes or indirectly through tax and

transfer changes. Such changes in flow magnitudes are the principal means of controlling the level of aggregate demand by the government.

A novel feature of this report is the extensive reliance on information from the Controller and Accountant General's Department (CAGD) for the assessment of fiscal performance. Two factors have made this possible: years of collaboration with the CAGD have paid off and placed CEPA in a position to take advantage of the success achieved by the Department to provide perhaps as never before, up-to-date information on the Consolidated Fund in fulfillment of its obligation under the Financial Administration Act 2003, Act 654.

As with previous CEPA reviews of fiscal operations, three summary measures – the overall broad balance (OBB), the domestic primary balance (DPB) and the net domestic finance (NDF) – are used to gauge the fiscal performance in year 2005.

The overall broad balance (OBB) is often used as a proxy measure for the public sector borrowing requirement (PSBR) - from both internal and external sources. Since fiscal policy normally influences the size of the actual PSBR, changes in the latter are commonly looked upon as an indicator of changes in the fiscal stance. This, however, is essentially fallacious because the size of the actual PSBR could vary in response to changing income levels. Thus, if the realized GDP growth is, for example, lower than the projected tax revenues could fall short of projections. Expenditures, in contrast, tend to be exogenously determined. Expenditure programmes are the means of providing desired public services and meeting agreed social objectives – for example, in the current situation, poverty reduction targets in the GPRS and the Millennium Development Goals (MDGs). In such a situation, the PSBR could turn out larger than planned without any conscious fiscal policy change.

As noted above, the data presented in the tables as CEPA actuals depend largely on information published in the Financial Statements on the Consolidated Fund by the Controller and Accountant General's Department (CAGD). In the accompanying notes,

the CAGD reports that information on project loans and grants as well as retained internally generated funds (IGF) of the Ministries, Departments and Agencies (MDAs) of government is not included. CEPA has therefore supplemented information from CAGD with that from other sources like the Aid and Debt Management Unit (ADMU) of the Ministry of Finance and Economic Planning (MOFEP) and its own staff estimates, especially in respect of external resource flows.

The second summary measure of the fiscal stance used in CEPA analysis is the *domestic primary balance (DPB)*. It is computed as the difference between total revenue and total domestic expenditure. As a rule, it provides a gauge of the country's own capacity to run a viable debt management policy. This is because where interest payments must be made on existing stock of debt, a smaller DPB surplus than required for interest payments due would mean that in the absence of inflows of foreign aid in the form of program grants, additional debt would have to be incurred to service the existing debt.

The third and final measure of the fiscal stance in CEPA assessments involves the *net domestic financing (NDF)* of the programme. Unlike the above-the-line data however, where CEPA relies essentially on the CAGD, financing data are obtained from ADMU and the government accounts in the banking system. Consequently there are no differences between the CEPA and official estimates.

The target for *Total Revenue and Grants* for 2005 as shown in Table 4 was ₵29,578 billion. This was equivalent to 30.5 percent of GDP compared to the outturn of ₵24,074 billion or 30.2 percent of GDP realized in the previous year 2004.

Total revenue comprises tax and non-tax revenues. Government was inclined to the view that the tax burden in Ghana has increased significantly over a short period and that a reduction in tax rates, especially in the corporate sector, could have beneficial long-run effects on growth. Nonetheless, the expectation was that the improvements in the efficiency of the tax revenue administration and enhanced tax compliance would

somewhat offset collection losses and overall result in a higher domestic resource mobilization outcome.

The three components of tax revenues are: indirect taxes, direct taxes and international trade taxes. *Indirect taxes* (inclusive of NHIL) were expected to contribute to the bulk of the additional revenues. There are four components shown under indirect taxes namely – Excise Duties (including Airport Taxes), Petroleum Taxes, VAT and the NHIL. Marginal improvements were expected in the performance under petroleum taxes and a more significant improvement (0.3 percent of GDP) in respect of VAT.

There are also four categories of *direct taxes* namely: Personal (PAYE), Personal (Self-employed), Companies and Other (NRL). In terms of shares of GDP, the targets for Personal (Self-employed), Companies and Other (NRL) were the same as the respective realised outturn in 2004. The target for Personal (PAYE) was marginally lower – by the equivalent of 0.1 percent of GDP while that for Companies was much lower – by the equivalent of 0.4 percent of GDP.

The target set for revenue from *taxes on international trade* and transactions – comprising import duties and cocoa export – was ₵4,648 billion. This was equivalent to 4.8 percent of GDP, and the same as that realised in 2004. In respect of the two components, there were offsetting targets. The target for import duties was higher – by the equivalent of 0.3 percent of GDP – than the outturn in 2004. On the other hand, that for the cocoa export tax was lower – also by the equivalent of 0.3 percent of GDP.

Expenditures in the public accounts published by the CAGD refer to payments in the form of fund releases authorised by the CAGD. Total expenditure comprises two main components – recurrent and capital.

Recurrent expenditure in turn has two subcomponents: non-interest expenditure and interest payments. The target set for non-interest expenditure of ₵15,039 billion was 13.7 percent higher than the realised outturn of 2004. CEPA estimated a non-interest expenditure of ₵15,180 billion in 2005 which was almost exactly on target.

There are three subcomponents of non-interest expenditure analysed in the review - personnel emoluments, goods and services, and transfers.

CEPA estimates of the 2005 outturn in respect of non-interest expenditure are closer to the target set. The CEPA estimate of personnel emoluments is significantly lower than both the official estimate (by about 1.0 percent) and the target (by 6.0 percent). In contrast, the CEPA estimate for spending on goods and services is higher than the official estimate by 10.1 percent and considerably in excess of its target – by over one quarter. Part of the explanation for these differences is once more on account of the CAGD classification of these expenditure items. Specifically, spending on goods and services includes some salary-related allowances that should properly be included in personnel emoluments.

Gauged in terms of shares to GDP, the performance was mixed. Savings were realised in respect of personnel emoluments (the equivalent of 0.4 percent of GDP) and transfers (about 0.3 percent). Spending on goods and services, however, overshot its provision by the equivalent of 0.4 percent of GDP. The achievement in respect of personnel emolument was remarkable, but the evidence from the labour market suggests that all is not well and the outcome may very well prove deceptive of the difficulties in the near to medium-term.

For interest payments, the target was a mere modest 7.9 percent higher than the previous year's payments - $\text{¢}3,745$ billion as against $\text{¢}3,472$ billion. This latter was based on favourable expectations regarding savings in interest payments - improved domestic debt management policy and external debt cancellation associated with the HIPC Initiative.

The target on interest payments reflected expectations based on improvement in domestic debt management and external debt cancellation associated with the HIPC Initiative. With Ghana reaching Completion Point in mid-year, the outcomes, not surprisingly, proved even than projected.

Capital spending may be broken down into domestically financed and foreign-financed components. This breakdown is of considerable public interest on account of perception of “excessive” aid-dependence and its associated vulnerability – resulting from conditionality and disbursement volatility. There is also the important issue of country ownership of the development agenda and process.

There are three subcomponents of domestically-financed capital expenditure – cash expenditure (including net lending and equity), statutory funds (DACF, GETF, Road Fund and Petroleum-related Fund) and HIPC-financed. The targets for the cash expenditure (1.6 percent of GDP) and statutory funds (3.2 percent of GDP) were set higher than their respective outturns of 2004. In contrast, HIPC-financed capital expenditure had a target equivalent to 2.4 percent of GDP which was about 0.6 percentage points of GDP lower than the previous year’s outturn.

In respect of the public concern with excessive aid-dependence, it is worth noting the following: the classification of HIPC-financed expenditure (with debt relief resources) under domestically-financed capital expenditure can be rationalised. However, program grant resources counted as budgetary support is used in part to finance capital expenditure. To that extent, the domestically –financed is overstated and correspondingly, the foreign-financed capital is understated.

The capital expenditures designated as foreign-financed, performed as expected – achieving exactly the target set - 6.1 percent of GDP. As with the HIPC-financed spending, these expenditures financed with the proceeds of project grants and project loans are protected from cut-backs although in some years may suffer from disbursement slowdowns or withholdings on account of conditionality.

Money, Credit and Prices

In consonance with the macroeconomic targets set for 2006, monetary policy is geared towards the attainment of single digit inflation buoyed on by tighter liquidity control—

projected growth rate for broad money supply is 17.8 percent by end-2006. In line with this benchmark, the Bank of Ghana (BOG) and its Monetary Policy Committee (MPC) continued to implement monetary policies with dual objectives—lower inflation rates and promotion of higher growth rates through the ‘crowding-in’ of the private sector. The MPC, has met thrice this year, reviewed the prime rate downwards in January by one-percentage point to 14.5 percent and maintained the same rate at its subsequent meetings in May and July. The downward joggling of the prime rate which begun in 2003, signifies commitment by the BOG to lower interest rates within the financial sector and subsequently ‘crowding-in’ the private sector for economic growth.

Over the first quarter of this year 2006, developments in monetary aggregates indicated quarterly monetary growth rates slightly higher than the previous years. With inflationary pressures largely contained, and the prime rate maintained at its last quarter position, the Bank of Ghana has slightly eased off the tight lid on liquidity perhaps to instigate domestic spending and increase business confidence. Quarterly growth rates in broad money supply inclusive of foreign currency deposits recorded 3.6 percent growth in the first quarter of 2006 compared to a decline of 0.8 percent in 2005 and a lower growth of 1.8 in 2004. By May 2006, M2+ had inched up further to 5.9 percent from the March figures. On a year-to-year basis, growth rates of M2+ indicated a 24.1 percent jump compared to 23 percent a year before.

Following the lowering of secondary reserve requirements from 35 to 15 percent in July 2005 and its subsequent abolition in August 2006, banks are gradually warming up to active lending practices, yet the pace is slow and cautious. Bank interest rates remained stable throughout the first quarter of this year with upward movements only observed in 3-month time deposit and call money instruments. Average savings and lending rates remained stagnant at 6.4 percent and 26 percent respectively irrespective of the lower prime rate effected in January 2006. The average base rates of banks also remained stable at 21.5 percent during the first four months of 2006. Thus, the average spread between savings and lending rates over the first half averaged around 20 percent compared to 26 percent the same period a year earlier.

The current levels of bank interest rate spreads in the financial sector clearly exhibit the ‘Pareto Principle’ or the ‘80/20’ rule where the most profitable but fewer clients benefit from better bank facilities. Reasons assigned by bankers for the observed wide interest spreads in the banking sector affecting small savers include high costs of transactions, high loan-loss provisions on advances, inherent operational inefficiencies of some banks and the absence of a credit referencing bureau. The latter reason is widely believed to be the key factor that stalls lending to most customers. According to some bankers, a credit reference bureau will not only provide enough information on most borrowers but also lessen the risks associated with lending.

It is evident that moral suasion as prescribed by the Bank of Ghana to motivate banks to narrow interest rates spreads under a fairly liberalized financial market is inadequate. Nevertheless, an opportunity currently working in favour of bank customers is the rising number of banks from 17 in 2000 to 22 by April 2006. Current trends within the banking sector depict increased competition, instigated among other things by increased number of banks with diverse modes of operations. The challenge faced by banks to innovate financial products that does not only attract, but also maintains customers and nurtures small enterprises is one clear way forward to narrow the current wide interest rate spreads that prevail within Ghana’s banking sector.

CPI annual inflation has remained on the downward trail since the last quarter of 2005 and into the first four months of 2006. Yearly inflation declined from 14.8 percent in December 2005 to 12.1 percent in February and then to single digits in March and April at 9.9 and 9.5 percent respectively. This was achieved against a backdrop of a statistical correction of blips in inflation the year before due to 50 percent petroleum price hikes. The first five months of this year has witnessed three petroleum price changes—a decline of 0.6 percent in January, 9.6 percent increment in February and a 10 percent increment in May. These changes notwithstanding, the impact on inflation has been minimal and both the February and May petroleum price increment resulted in 2.5 and 1.7 percent monthly growths in the CPI. The resultant effect on inflation however, was muffled for February (due to the statistical correction of a similar increase a year before) but given a

lag of two months and the May increment in petroleum products, its inflationary pass-through effect has emerged. Subsequently, the inflation rate rose from 9.5 percent in April to 10.2 percent in May and then again to 10.5 percent in June.

Trade and Payments

Developments in the external sector of the economy in 2005 have been similar to those of 2003 and 2004 both in terms of the foreign exchanges and on account of transactions with the rest of the world.

In the foreign exchange markets, the domestic currency (the cedi) has been relatively stable with respect to the US dollar, depreciating by less than one percent in nominal terms while appreciating by more than 5.0 percent in real terms — a tendency that has led to a widening gap between the PPP-based equilibrium exchange rate and the actual rate, resulting in increasing overvaluation of the domestic currency vis-à-vis currencies of major trading partners since 2003 and threatening to continue into 2006.

The stable nominal rate and appreciating real rate have generated a lot of debate, leading to questions being raised about the type of exchange rate regime being pursued by Ghana, and the impact of this on growth and employment creation.

While a number of analysts have expressed concern about the possible adverse impact on competitiveness of the real exchange rate appreciation in such a scenario, some others have argued that exports have a strong underlying growth rate in spite of the real appreciation, implying that no negative effects on exports growth can be expected from the real appreciation. It is strange that in spite of the downward trend in the volume of exports one can argue about a strong underlying trend in exports.

The notion that the exchange rate must appreciate with increased external resource inflows of doubtful duration is part of the pro-cyclical policy framework, which has been found to be detrimental to growth in less developed countries. It is also part of the

macroeconomic management in which inflation targeting takes centre stage. Such a framework treats the intermediate target, inflation, as the final outcome. One of the lessons of the implementation of the economic reforms in the 1990s in developing countries documented by the World Bank is that lowering inflation on the basis of appreciating nominal exchange rates stunts exports and GDP growth.

The more critical thing in terms of exporting is the effect of the appreciation on the incentives or profitability of exporting. It is the profitability of exporting that will determine the investments in the sector and the gains that can be made in terms of competitive advantage through productivity and product quality. There is evidence that the exchange rate affects investment positively through exporting and other effects in Ghana. A depreciation of the cedi encourages exports.

Other comparable developments in 2005 vis-à-vis the preceding two years were the continuing and widening deficits on both the trade and current accounts of the balance of payments. In 2005, the trade deficit increased by 68 percent over that of 2004. This followed a 122 percent increase in the trade deficit from US\$681.0 million in 2003 to US\$1,512.7 million in 2004. In terms of GDP, the trade deficit deteriorated from 8.9 percent of GDP in 2003 to 23.8 percent of GDP in 2005 — the largest recorded trade deficit in the last decade. Irrespective of the source of financing these deficits, they are not sustainable.

The increasing appreciation of the exchange rate made imports competitive. Combined with record-high world market prices of crude oil, merchandise imports increased substantially between 2003 and 2005. Not surprising therefore, oil imports was the largest source of the growth in imports.

On the supply side, the external payments difficulties were due to a deceleration in export earnings. Merchandise exports increased by less than one percent (0.6 percent) compared with 2004, representing a deceleration in the annual rate of growth of exports, which was 27.3 percent in 2003 and 8.7 percent in 2004. This somewhat disappointing growth rate was achieved on the back of gold and other minerals, namely bauxite, diamonds and

manganese. Gold export earnings increased by 12.6 percent to reach US\$945.8 million in 2005. The increase in earnings occurred largely as a result of continuing record-high rallies in gold prices on world markets. The average price per ounce, which had remained buoyant at over US\$400 in 2004 increased further to reach US\$504 by end-December 2005.

The resultant increased disparity between the annual rates of growth of exports and imports reflected in the widening of the trade deficit from US\$681.0 million in 2003 to US\$2,542.0 million in 2005.

As in the previous two years, the deficit on the trade accounts was largely financed by unrequited transfers from both official and private sources. These transfers almost doubled between 2003 and 2005. Official transfers (including HIPC grants) increased from US\$392.9 million in 2003 to US\$567.0 million in 2005 — about 43 percent of this in the first half of 2005. Over the same period, net private transfers increased from US\$801.4 million to US\$1,550 million. In spite of these massive transfers, the deficit on the current account balance (including official transfers) worsened from a surplus of US\$233.7 million in 2003 to a deficit of US\$754 million in 2005 — the equivalent of 7.1 percent of GDP and the worst since 2001.

In spite of widening deficits on both the trade balance and the current accounts, Ghana's overall balance of payments position turned to a surplus amounting to US\$309 million at the end of 2005. This surplus in the overall balance of payments was in sharp contrast to both the deficits of US\$10.1 million registered at the end of 2004 and the US\$4.1 million programmed for 2005 — a massive turnaround on both accounts. Substantial external resource inflows, consisting of project and programme grants, debt relief on account of the HIPC Completion Point programme and foreign direct investment from private sources, were largely responsible for the massive turnaround in the overall balance of payments — mostly in the second half of the year.

In spite of the huge overall surplus, the rate of accumulation of reserves declined. As a result, import coverage of gross international reserves declined slightly to 3.2 months in 2005 from 3.3 months in 2004.

Economic Outlook—2006 and beyond

Fiscal Operations

In Ghana's current "monetarist" macroeconomic policy framework, the domestic debt to GDP ratio is the nominal fiscal anchor. For this year 2006, the target is to reduce the ratio further by 2.1 percentage points from an estimated 10.8 percent at the end of 2005 to a projected 8.7 percent for end-2006.

The Appendix Tables show revenues and grants in the programme agreed with the IMF, the modified programme - on account of the supplementary budget statement - and the provisional outturn projected by CEPA. The CEPA provisional outturn projections extensively use published current year 2006 data from the Controller and Accountant General's Department (CAGD).

The total revenue target for 2006, is likely to be achieved albeit with an insignificant overall shortfall equivalent to about 0.1 percent GDP. The tax revenue component is projected to fall considerably short of its target - by the equivalent of about a full percentage point of GDP. Non-tax revenues, in contrast, are projected to over-perform - by an estimated 0.8 percentage points of GDP. This, however, would not be enough to make up for the shortfall in projected tax revenue collections.

Shortfalls are projected in respect of the direct and indirect taxes. Over-performance is, however, projected in collections of taxes on international trade and transactions. CEPA projects an overall shortfall of about 0.4 percent of GDP in collections of direct taxes. This is on account of what appears to be a rather disappointing performance in company tax collections - about 0.8 percent. In his supplementary budget statement, the Minister for Finance and Economic Planning was rather optimistic, claiming that the observed

collection shortfall in the first four months of the year “is mainly due to the delay in assessment of companies for the year”.

In contrast, PAYE collections are projected to significantly exceed the target by the equivalent of a 0.8 percent GDP. In view of the apparent delays in wage settlements with public sector employees, this development is quite remarkable. The data provided in the supplementary budget, also, lend support to the CEPA assessment. The better-than-planned performance in this category, however, is not enough to make up for the shortfalls in the other direct taxes.

The total collections of indirect taxes are also projected to fall short of target by the sizeable margin equivalent to some 0.8 percent of GDP. It is not quite clear why VAT collections appear to be performing so poorly. The CEPA provisional actuals suggest that the tempo of economic activity especially in the manufacturing sector may well be lower than had been anticipated. This may be a contributory factor to the relatively poor performance of both company taxes and VAT (domestic).

The over-performance in respect of petroleum taxes has been a cause of considerable concern. This is because prices of petroleum and petroleum products have recorded sharp increases in international markets. Given the policy of full cost recovery upon the introduction of the independent and automatic mechanism for petroleum products pricing, upward price adjustments have been effected in February, May and July this year. The higher than planned petroleum tax collections indicate that retail prices of products have been raised by more than warranted by the cedi value of increases on world markets. Appropriate Parliamentary approvals have been given to rectify the anomalies caused by an ad valorem tax and a rising landed price base.

Collections of taxes on international trade and transactions are projected by CEPA to perform better than had been expected. Import duties, however, are likely to perform poorly, though only marginally so – a shortfall of about 0.2 percent of GDP. Cocoa export duty collections, however, are running far ahead of official projections. This is

largely because the assumptions on which the official projections were based appear in respect of both volume of exports and world market prices seriously flawed.

Traditionally, grants have been categorised into the following: project grants, program grants, and HIPC assistance. The supplementary budget has added another dimension to grants known as the Multilateral Debt Relief Initiative (MDRI).

Program grants and HIPC assistance (multilateral) show no change as a result of the supplementary budget – 2006 programme and 2006 programme (modified). However, the project grants increased by ₵492 billion or a difference of 0.6 percentage points of GDP. MDRI assistance also increased from ₵1,243 billion to ₵1,517 billion, a difference of 0.3 percentage points of GDP on account of projected additional MDRI debt relief from the IDA and AfDB.

The supplementary budget, sought to take advantage of additional resources primarily but not exclusively, released from MDRI debt relief, to augment public investments and poverty-related expenditures. The PRGF programme with the IMF projected total expenditure in 2006 of ₵36,362 billion – equivalent to 32.4 percent of GDP. As a result of increased foreign-financed capital spending in the supplementary budget, total expenditure has been raised to ₵38,168 billion – about 34.0 percent of GDP in the modified programmes.

The CEPA provisional actuals (with its basis in CAGD data) cannot provide a breakdown of poverty-related expenditures separately into its components of non-debt expenditure and capital (shown under MDRI). Consequently, the apparent non-debt spending overrun of 2.1 percentage points of GDP in CEPA estimates is, at least in part, on account of capital expenditure to be financed with resources from the MDRI debt relief. Correspondingly, there is a projected under-spending equivalent to 1.3 percent of GDP shown in respect of capital expenditures in the CEPA provisional actuals. Altogether, CEPA assessment of the overall expenditure outcome is an excess over the programme

target equivalent to 0.9 percent of GDP – 34.9 percent of GDP compared to the modified programme target of 34.0 percent of GDP.

The 2006 programme agreed with the IMF, has been somewhat modified by the supplementary budget of July 13, 2006. Specifically the projected disbursements of grants increase by about ₵766.0 billion, on account of MDRI debt relief from IDA and AfDB, Millennium Challenge Account (MCA) project grants, and project grants from the Areeba Telephone Company. Thus, with domestic tax and non-tax revenue unchanged, total revenue and grants increased to ₵33,526 billion – equivalent to 29.8 percent of GDP and implying an increase of 0.7 percentage points of GDP over the original, agreed programme target (all on account of increased grant disbursements).

Again total expenditures, in the modified programme, increased by ₵1,805 billion. This is on account of increased capital spending financed with two project loans totaling ₵1,317 billion – a short term loan from local sources and a concessionary long term loan from Deutsche Bank - together with the project grants from Areeba and the MCA. It may be noted that no adjustment was made to the ₵1,831 billion capital expenditure in the programme to be funded with MDRI debt relief.

Consequently, the overall broad balance (OBB) (above the line) deficit widened by 28.8 percent. In terms of ratio to GDP, the deficit increased from 3.2 percent to 4.1 percent. The CEPA provisional actuals indicate that the year may end with a much wider OBB deficit than planned.

As a general rule of thumb a domestic primary balance (DPB) surplus, large enough for debt servicing, is a key ingredient of a prudent debt management policy. The programme target is a DPB surplus of ₵1,552 billion, equivalent to 1.4 percent of GDP.

CEPA provisional actuals show that the year could end with total domestic expenditure in excess of the target by some ₵2,640 billion. Non-interest spending is projected to be in excess of its target by ₵2,355 billion. And excess domestic capital expenditure –

including HIPC-financed - is projected to be another ₵285 billion. It is important to point out however, as noted earlier that poverty-related expenditures financed with resources from MDRI debt relief may have been in the goods and services expenditure category of domestic-interest expenditure in the data of the CAGD on which the CEPA provisional actuals are based.

On a cash basis, CEPA again projects a deficit equivalent to 0.8 percent of GDP compared to a programme surplus target of 0.7 percent – a turnaround equivalent to 1.5 percent of GDP. The government wage bill together with personnel related emoluments included in the goods and services expenditures category poses a particularly difficult challenge to the fiscal programme this year. The final outturn, complementarity of fiscal and monetary policy and sustaining macroeconomic stability could very well depend on how the public sector wage bill is managed especially with the clamour for improved remuneration and conditions of service in the critical health and education sectors of the labour market.

The net domestic financing (NDF) of the budget amount of ₵215 billion excludes the net repayment of ₵71 billion in respect of the Government of Ghana Index-Linked Bonds (GGILBs). These estimates agreed with the IMF are unaffected by the supplementary budget. The NDF is a performance criterion given the fiscal anchor of the government.

Based on the calculations in the Appendix Tables, a larger than planned float would be necessary. Thus, instead of a discrepancy of negative ₵685 billion largely to provide for float cheques issued late in 2005 (estimated at ₵637 billion), CEPA provisional actuals indicate that late issuance of payment vouchers resulting in float checks totalling ₵483 billion would be carried from this year into 2007. The fiscal space for contingency including that in respect of public sector reform would appear to be totally depleted.

Monetary and Inflation Outlook

The Bank of Ghana's commitment to lower inflation rates is without dispute. Persistency of this policy objective has contributed to subdued inflationary pressures in the economy.

Lower money supply growth rates, recorded in 2005 and the first quarter of 2006, indicate slower but slightly higher growth rates than previous years. As noted by the IMF Country Report in June 2006, *“this pattern — particularly in the latter part of the year — reflected containment of government bank borrowing, with intensified fiscal efforts to reduce domestic debt in the fourth quarter of 2005. These efforts have helped to contain inflation, even with significant increases in domestic petroleum prices that raised inflation markedly early in the year”*. There are no indications that the Bank of Ghana will let up its hold on liquidity and subsequently inflation for the rest of the year. It is therefore envisaged that the targeted broad money supply growth rates for 2006 may be achieved subject to further containment of inflation pressures.

The challenge of monetary management is not only to achieve price stability but the ability to harness the benefits of a stable inflationary environment to promote economic growth. The main players in this transition are mostly the financial institutions. Annual growth rates of credit to the private sector slowed down slightly in the first quarter of 2006. But the trend may change by the end of the year as per the Bank of Ghana’s announcement of abolition of secondary reserve requirement from 1st August 2006 by the banking sector. The Bank of Ghana continues to streamline the operations of the banking system to improve its efficiency and soundness within a competitive environment.

Accompanying an efficient banking sector is the challenge of directing credit to growth targeted sectors within the economy. In this light, continuous effort to direct credit to the sectors of the economy, particularly agriculture, which may provide the needed boost to Ghana’s targeted higher economic growth rates, must be improved. The agricultural sector still holds the key to Ghana’s higher growth rate targets. Aside from it being the largest employer, it captures a sizeable share of the national income. However, credit towards the sector has been dismal partly because it not only requires long-term investments but also its profitability requires long gestation periods — characteristics that are highly unfavourable to domestic bank lending. Perhaps, foreign inflows expected from the Millennium Challenge Account — a chunk of which has been targeted at the

agricultural sector — could well be the stimulator for a possible ‘Green Revolution’ in Ghana.

The stated primary goal of the Bank of Ghana is to achieve single-digit rate of inflation this year. The expectation is that this will be achieved despite the impact of utility price adjustments. CEPA’s analysis points to a possible Optimistic Scenario, which envisages that the observed headline inflation of 10.5 percent reached in June 2006 is sustainable for the rest of the year. Given the leads and lags in the impact on inflation of monetary aggregates, such a scenario would involve the use of the considerable foreign exchange inflows to intervene in the foreign exchange market with a view to inducing substantial nominal appreciation of the exchange rate in order to support the disinflation policy of the Bank of Ghana. While technically feasible, there are, however, costs in terms of international reserves depletion as well as dampening pressure on domestic import-competing sectors of the economy, including food agriculture and in employment generation.

Judging from the current state of the three-year ‘economic’ cycle — the upswing phase commenced in the fourth quarter of 2005, the balance of government concerns over macroeconomic stability and accelerated economic growth, the two major short-term risks, namely the uncertainties surrounding international prices of petroleum and petroleum products, and the current unrest in the labor market — CEPA analysis would suggest that year-on-year headline inflation would most likely remain in the 11-12 percent per annum range over the period to March next year. Thereafter, as the economy enters the downswing phase of the cycle, headline inflation would be expected to follow a generally declining trend to trough in single digits in the third quarter of 2008.

External Sector Outlook

The relative stability of the foreign exchange market will continue to the end of 2006, with a tendency towards greater real appreciation. The current policy on inflation targeting and using the exchange rate as a nominal anchor will continue, with pressures for a nominal appreciation of the exchange rate. The Multilateral Debt Relief may boost

these developments. If this relief, together with the other inflows, is perceived to be permanent, then the equilibrium real exchange rate may be thought to have increased. This may strengthen the tendency and argument for real appreciation through nominal appreciation of the exchange rate. Indeed, if these flows are treated as permanent then one has to deal with all the issues related to the 'resource curse'.

Ghana has to decide whether its exchange rate will be managed to protect productive incentives or to stabilize consumption. For a country in search for an accelerated growth strategy one would have thought that the exchange rate will be managed to promote growth and poverty reduction. The transitory issues of the effect of the exchange rate on consumption could be dealt with through the growth in incomes.

To the extent that the current real appreciation of the exchange rate is not based on productivity gains, there is the need to consider the issues of premature real appreciation. However, the constituency for such an approach may be limited in view of the substantial flows and the current policy may continue even beyond 2006.

The upsurge in the three-year agricultural or weather cycle started in the fourth quarter of 2005. This implies that cocoa production will increase. Already by the end of April 2006, cocoa purchases from the 2005/2006 main crop had exceeded the total purchases for the whole of last year by 9.3 percent according to Bank of Ghana sources. However, prices of cocoa beans on world markets are lower than last year.

Gold prices on world markets are continuing the upward movement witnessed in 2005. This may stabilize at levels substantially above those of last year. With possible new production on the line, gold exports will most likely increase in 2006.

However, the continuing high and rising crude oil prices and the real appreciation of the exchange rate means that imports will again increase substantially in 2006. This will lead to another large trade deficit in the balance of payments.

The effect of this on the current account balance may be moderated by transfers. However, there is uncertainty about the levels of private transfers even though they have increased substantially in the first half of the year.

In spite of the uncertainty that may surround the outcome of the current account, the Multilateral Debt Relief benefits and other capital inflows may maintain a modest surplus in the overall balance of payments.