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Current State of the Ghanaian Economy

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The Centre for Policy Analysis is an independent, non-governmental think-tank, which provides rigorous analysis and perspectives on economic policy issues. Our objective is to: promote a non-partisan informed debate on macroeconomic, growth and poverty alleviation issues which are pertinent to the Ghanaian economy, to enhance the capacities of institutions in Ghana through training and finally to disseminate and publish economic information in order to raise public awareness of economic and developmental issues.

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CURRENT STATE OF THE GHANAIAN ECONOMY

1 INTRODUCTION

A primary objective of the current Growth and Poverty Reduction Strategy (GPRS II) — the successor to GPRS I — is to move from the concentration on macroeconomic stability of GPRS I and to focus further on accelerated economic growth as the primary instrument for poverty reduction and national prosperity. Within its very first year of implementation, however, the strategy appears to have run into some serious problems. Perhaps the most pressing of these problems, and coming a decade after the drought-related hydropower crisis of 1997/98, is the “energy crisis” from the third quarter of 2006. This crisis necessitated the “embarrassing and expensive” load-shedding programme of the VRA that commenced in August 2006 and is still ongoing with no fixed date for its completion. Moreover, the adverse impact of the crisis continues to be dreadfully severe, escalating the operating costs of businesses and limiting production and hence output growth — particularly in energy-sensitive sectors of mining and manufacturing — all of which have serious implications for profits and employment as well as for government revenue targets.

It must be emphasized that the energy crisis comes in the wake of three continuous years of real exchange rate appreciation, leading to the overvaluation of the domestic currency vis-à-vis the currencies of major trading partners. Already, there has been some loss of price competitiveness of Ghanaian products on account of the real exchange rate overvaluation emanating from the disinflation policy of the Bank of Ghana. Research surveys carried out in recent months lend credence to these developments.

But there are other recurring problems as well, including the challenge of effectively managing the wage bill — the largest economic item in discretionary expenditures on the Consolidated Fund. CEPA research indicates that the large wage bill not only crowds out other categories of spending in the domestically financed current budget, it also makes their funding over-dependent on external aid from development partners. Meanwhile, the government has expressed its continued concern about its ability to attract and retain qualified personnel needed for the goal of bolstering service delivery and value for money. And yet at the current level of remuneration, the Civil Service could lose highly productive staff, particularly in the top priority health and education sectors. Granted that Civil Service wages have increased rapidly in recent years, they have done so from a very low base. Moreover, they continue to lose grounds against those in the private sector. Attempts to

contain the situation have been ad hoc and piecemeal, resulting in serious distortions in relativities, which have become a cause for widespread dissatisfaction and labour unrest.

This report is about the current state of the Ghanaian economy. It is basically a non-technical synopsis of some of the challenging issues confronting the economy and the nation in the short- to medium term. Given the commitment to the Growth with Stability goal of GPRS II, CEPA sees the key challenges over the medium-term (2007-2010) to be the following:

- decisive resolution of the energy crisis to enable real economic growth at an average of 6.5 percent per annum;
- consolidating macroeconomic stability — (single digit inflation at a level close to the average of major trading partners and continued build up of international reserves to the equivalent of at least four months of imports);
- pursuing structural reforms, particularly in the financial sector to bolster private sector-led growth;
- maintaining a competitive exchange rate to ensure that micro-level incentives for investment and growth are in consonance with the export-led growth strategy;
- judicious use of the opportunities made available by the benign external environment and the substantial development assistance — in

the form of debt relief and scaled-up inflows of aid, especially the Millennium Challenge Account (MCA), as well as substantial inward transfers, including private remittances — to lay the foundations for accelerated growth;

- effective management of the wage bill and better synchronization of the public sector wage negotiation process with that of budget preparation; and
- human resource development for and domestic retention of professional and technical skills.

The rest of the report is organized into six broad sections. Section 2 highlights the growth performance of the economy in 2006. It is CEPA's critique of the official assessment of the overall growth performance of the economy as contained in the 2007 Budget Statement. While it draws attention to some inconsistencies among some tables as well as between the text and some tables, it raises serious issues with the official growth rates reportedly realized in some sub-sectors of Industry — particularly Electricity and Water and Construction. On the basis of its analysis, CEPA concedes that the national accounts data provided in the Budget Statement, are only revised projections based on partial and preliminary data, perhaps not more than the first half of the year and certainly before the severity of the energy crisis and its full impact could be objectively assessed. In the

circumstances, CEPA estimates an overall real GDP growth of 5.3 percent for 2006 — the upper limit of a range implied in a World Bank assessment.

Section 3 of the report presents the background leading to the energy crisis, the short- to medium-term interventions proposed to address the crisis, and the impact of the crisis on society and the economy. This is followed by the Budgetary and Financing Operations of Central Government activities in Section 4. This section draws particular attention to severe revenue shortfalls, sizeable expenditure overruns, wider-than-planned deficits in the government accounts necessitating large net domestic borrowing, and an off-trend domestic debt stock relative to GDP — the fiscal anchor. It calls for a forward-looking fiscal policy design to improve the quality of public spending while continuing to promote fiscal discipline.

An analysis of Money, Credit and Prices is presented in Section 5, which among other things, draws attention to two competing and partly contradictory objectives of monetary policy, narrowly considered. The section also focuses on inflationary trends in the economy with a near-term outlook.

Section 6 of the report discusses the provocative issue of the overvalued currency, its bias towards imports, and its impact on exporters and producers of import-competing manufactured goods. The section also deals with the issue of scaled-up aid and exchange rate management. It argues that aid is good provided it is used in ways that enhance growth and employment; it cautions that pro-cyclical exchange rate policy in which aid is used to purchase lower inflation can create long-run difficulties.

The final section of the report, Section 7, raises exclusive and problematic issues of Public Expenditure Management in Ghana, particularly, issues related to the credibility, predictability and control over public expenditure. The conclusion emanating from the analysis is the tendency for the predictability and credibility of the budget to be eroded on account of inability to control spending on the wage bill, especially in the priority social sectors of education and health. Furthermore, infrastructural investments have tended to suffer payment shortfalls for these excesses, and in turn, crowd out the private sector in credit markets, while increasing aid dependence.

2 GROWTH PERFORMANCE OF THE ECONOMY

2.1 Background

In the Budget Statement and Economic Policy for 2007, which was presented to Parliament by the Minister of Finance and Economic Planning, the economy was reported to have grown at its fastest pace since the Second Republic — registering a real GDP growth of 6.2 percent per annum for 2006, and programmed to reach 6.5 percent per annum in 2007. This accelerated growth performance, according to the Budget Statement, was broad-based across all three major sectors, with the Industrial Sector outperforming — perhaps for the first time in a decade — both the Services and Agricultural sectors.

It is worth emphasizing that the national accounts data provided in the Budget Statement are only revised projections based on partial and preliminary data — perhaps not more than the first half of the year and certainly before the severity of the energy crisis and its impact could be objectively assessed. Moreover, they can only be preliminary and tentative because of the weaknesses of the statistical surveys on which they are based. In this regard, the observation of the staff of the IMF in the Country Report No. 02/38 of March 2002 is pertinent. To quote:

“To improve the reliability of the national accounts, a comprehensive overhaul of the basic data sources would be needed. The existing sector surveys that form the basis for the

estimates are outdated” (Appendix IV, paragraph 12, page 69 — emphasis added).

Even in the best of circumstances, extrapolation beyond the period of the data must be undertaken with appropriate caveats duly served. To do so across a structural break as would be implied by the energy crisis is a most hazardous undertaking. Without doubt, the Ghana Statistical Service (GSS) would be forthcoming with at least provisional actual estimates now that the relevant data on the crisis, the consequent load shedding and the impact on the economy are available. In all of this, it is of utmost importance that the GSS be given all the support and resources it would need to do its work. The data presented in the Budget Statement show inconsistencies among some tables as well as between the text and some tables. Above all, the professional independence and integrity of the GSS must be safeguarded at all times, and especially in the present circumstances.

2.2 Review of the Growth Performance

The energy crisis necessitated what has been described as an “expensive and embarrassing” load shedding exercise from August to December 2006, which adversely affected production and output particularly in the energy-sensitive Mining and Quarrying, and Manufacturing sub-sectors. The official account of the sectoral growth performance shows that the

Industrial Sector grew at 7.3 percent in 2006, led by the Electricity and Water sub-sector — with an incredible growth rate of 23.0 percent.

In the Budget Statement (2007), the Electricity and Water sub-sector — the source of the crisis — is described as “the major contributory sub-sector” of the Industrial Sector (paragraph 76, emphasis added). Moreover, the revised growth rate of the sector, though marginally lower than the 7.7 percent growth recorded in the previous year 2005, is nonetheless more than a full percentage point higher than the original 6.0 percent projected, in spite of the energy crisis. CEPA takes serious issue below with the revised growth rates in respect of the Electricity and Water as well as the Construction sub-sectors.

The Agricultural sector — including cocoa, forestry and logging — is the largest of the three sectors though its share in GDP has been falling over the years. In 2005, it constituted 36.0 percent of total GDP. Within the sector, thanks to the application of the high-tech measures and the resultant production boom, the share of the important cocoa sub-sector has risen sharply, and now constitutes 12.8 percent of the total Agricultural GDP. The official estimates reduced the sector’s growth rate from the 6.6 percent originally projected to 5.7 percent. According to the Budget Statement (2007), this was on account of the “the underperformance of the Cocoa Production and Marketing and the

Forestry and Logging sub-sectors” (paragraph 73, page 23). The statistics show that the growth rate of the Crops and Livestock sub-sector was also lowered, though only marginally, from 6.2 percent to 6.0 percent.

Two recurring and somewhat disturbing issues have been raised with respect to output in the cocoa sub-sector. The first is the alleged cross-border smuggling effect on account of the political crisis in neighbouring La Cote d’Ivoire. The implication is that high purchase figures may be the result of inward smuggling rather than increases in cocoa output. The second issue has to do with the so-called purple bean syndrome — the result of inadequate drying of cocoa beans. This phenomenon, from CEPA research, is due to the phenomenal increase in crop yields as a result of the application of the high-tech cocoa package. This reportedly has caused some of Ghana’s cocoa beans to be rejected on international markets. Therefore, lower shipment figures of cocoa could be confused with production data.

Production data for 2006 point to a new record cocoa crop of about 780,000 metric tons (comprising a light crop of 90,786 metric tonnes and an estimated main crop of 689,214 metric tonnes) in 2006 compared to the previous record of 722,163 metric tonnes (comprising a light crop of 72,490 metric tonnes and main crop of 649,673 metric

tonnes) in 2005 — an increase of 8.0 percent. This is somewhat lower than the official growth estimate of 8.7 percent for the sub-sector.

It is evident from the cocoa production statistics above, however, that the reported underperformance of the cocoa sub-sector reflected more the over-optimism in the original growth projection of 12.2 percent rather than to the performance of the sub-sector — a new record.

In view of the considerations above, CEPA, however, accepts the higher official growth rate of 8.7 percent for the cocoa sub-sector, and with that the Agricultural sector growth rate of 5.7 percent for 2006. Again, the official growth rate of the Services sector of 6.5 percent is also accepted as credible.

The energy crisis has adversely affected output particularly in energy-sensitive sectors such as Mining and Manufacturing. Consequently, in the revised projected growth assessments for 2006, the official statistics acknowledges the slowdown in the growth performances of these sub-sectors of Industry. Output growth in the Mining and Quarrying sub-sector was lowered to 3.0 percent for 2006 — same as that realized in 2004 — compared with a growth rate of 6.3 percent in 2005, which was also the target for 2006. Manufacturing growth rate was also revised downwards to 4.2 percent compared to a target of 5.0 percent. The

CEPA assessment retains the 2006 revised growth performances of these energy-sensitive sub-sectors of Industry as reported in the Budget Statement.

CEPA assessments raise serious issues with the official growth rates of two remaining sub-sectors of Industry. In the official growth assessments, output in the Construction sub-sector is reported to have grown by 8.2 percent. According to IMF Country Report of March 2002, calculation of construction investment is based on the estimated values with 1993 as base. The 1993 value is extrapolated over the years “based on the production of cement”. Anecdotal evidence has it that in the last quarter of 2006, the difficulties with access to power and interruptions in power supply created production bottlenecks for cement manufacturing, resulting in increased ex-factory price of the product on retail markets.

The March 2007 Press Release of the Monetary Policy Committee (MPC) of the Bank of Ghana confirmed this with its observation of “notable declines of cement sales and industrial consumption of electricity, which have strong links with the ongoing electricity load management”. Cement production according to the official statistics is estimated to have grown by 5.7 percent. Consequently, following the established practice of the GSS cited above, CEPA estimates the growth

rate of the Construction sub-sector at 5.7 percent in 2006 — the same growth rate as for cement production.

CEPA also finds it puzzling that in the midst of combined water and power crisis a key driver of the impressive performance of the Industrial sector is the Electricity and Water sub-sector, with a staggering growth of 23.0 percent in 2006 over the output of 2005. Amazingly, this “super performance” of the Electricity and Water sub-sector, moreover, is set to continue into 2007 even as the hydropower crisis deepens. Given the severity of the power crisis in the last five months of 2006, the CEPA estimate assumes that the output performance of the Electricity and Water sub-sector in 2006 was at best equal to that of the previous year — implying zero growth for the sub-sector in 2006.

On the basis of the CEPA growth estimates for the Electricity and Water and the Construction sub-sectors, together with the retained official growth rates for the Mining and Quarrying and Manufacturing sub-sectors, the Industrial Sector growth is estimated at 4.0 percent for 2006, compared with the official growth rate of 7.3 percent — lower by 3.3 percentage points. The projected real GDP growth rate for the Industrial sector in the official statistics for 2006, in CEPA’s view, is over-optimistic and unrealistic.

Accepting the Services sector growth of 6.5 percent and that of Agriculture (including cocoa) of 5.7 percent together with the Industrial sector growth of 4.0 percent, an overall real GDP growth of about 5.3 percent for 2006 appears both more realistic and credible.

In a recent Report, the World Bank estimated that on account of the combined loss in output in the Mining and Manufacturing sub-sectors as a result of the power crisis, there would be a reduction in overall real GDP growth of between 0.7 and 0.9 percent. To quote from the Report:

“The combined impact of the crisis and lower water levels on mining and manufacturing are expected to reduce real GDP growth in 2006 by about 0.7 to 0.9 percent.” (World Bank, Ghana’s Growth Story: How to accelerate growth and achieve MDGs? April 2007, page 17, footnote 4 — emphasis added)

This estimate of the World Bank refers only to the impact of the crisis in energy-sensitive Mining and Quarrying and Manufacturing sub-sectors of Industry. It does not include the consequences for production in the Electricity and Water sub-sector itself, nor does it include the consequences for the Construction sub-sector of the lower output growth of Manufacturing — specifically, of cement. In spite of this, we would use this conservative assessment of the crisis and its impact, pending the expected official assessment of the Ghana Statistical Service.

CEPA's adjustments in respect of the Electricity and Water and the Construction sub-sectors meant 0.9 percent loss in contribution of these sub-sectors to overall real GDP growth. This is the upper limit of the range derived from the World Bank assessment. Thus, the World Bank assessment provides support for the CEPA estimate of overall real GDP growth in 2006.

An alternative way of viewing the World Bank assessment is in terms of growth rates. Applying the derived range of 0.7 percent to 0.9 percent to the official target of the overall real GDP growth of 6.0 percent for 2006 places real GDP growth in a range of between 5.1 percent and 5.3 percent. Again, the World Bank assessment provides support to the CEPA overall real GDP growth estimate of 5.3 percent — the upper limit of the range.

3 THE ENERGY CRISIS AND ITS IMPACT ON THE ECONOMY

3.1 Background

The Government has recognized the energy crisis the country is facing, the adverse impact that the power rationing is having on industry, and the threat these pose to economic growth targets. In his Sessional State of the Nation Address to Parliament on February 8 2007, President Kufuor enunciated short to medium term proposals “*to put an end to the embarrassing and expensive load shedding which society and industry*

have been subjected to over the past six months". The proposals, he hoped, would go a long way to reducing the anxiety and the fears of the business community and the public in general. To prepare the ground for possible tariff increases, the President also drew the attention of the nation to the fact that thermal plants — even of the size of Aboadze — fuelled by crude oil are “*extremely costly to run*”.

Consequently, the critical elements of the crisis — quantity and price — have been laid bare. Any assessment of the response to the crisis would therefore have to consider the consequences of both elements for society and the economy — assuming that the proposed response passes the test of technical feasibility.

3.2 Impact on the Economy and Society

Local manufacturing costs, as would be expected, have already risen as a result of the load-shedding exercise leading to significant increases in cost build-up. The country's largest manufacturer, Unilever is said to be spending about US\$45,000 per month on energy generation. Companies that use energy intensively, especially in the metals and plastic sub-sectors, are similarly reported to spend huge sums of money on fuel to run generators. There are reports quoting business surveys that production costs have risen by 20-30 percent. Wahome Steel in the

metals sub-sector is reported to have cut production by 50 percent and sent 200 of its workers home.

Aluworks Limited is scheduled to import aluminium, its main raw material, to augment reduced supplies from VALCO. The latter has closed down as a result of the energy crisis. The imported aluminium, on account of transportation and other charges would be more expensive. Moreover, Aluworks' own costs of production would go up on account of the energy crisis. Consequently, the clients of the company would also be faced with higher prices, in addition to their own higher energy costs. The situation is not different at the Ghana Aluminium Company Limited (GHANAL) which has also had to grapple with importing aluminium coils from Nigeria as a result of Aluworks' reported failure to satisfy its demands following the closure of VALCO.

The production difficulties and escalated costs of business, as well as the consequences for profits and employment could also have serious implications for government revenue targets. The Commissioner of the Internal Revenue Service (IRS) is reported to have already remarked that:

“Government has lost in excess of ₵140 billion in revenue as a result of a fall in production in various sectors including manufacturing, mining and quarrying. The IRS is targeting to

take in ₵8.8 trillion for the year but the load shedding exercise might negatively affect the Service's revenue mobilization drive."

Given the rising production costs and loss of productive working hours on account of the energy crisis, domestic prices could go up, though judging from the official inflation statistics this has apparently not happened yet. Business managers are reportedly constrained by fear of pricing themselves out of the market. This fear stems from the fact that the market is flooded with cheaper imported substitutes. Their customers may shift to the cheaper imports if prices of competing locally manufactured goods go up. Already, as may be seen in the downward revision of manufacturing sector growth rate in 2006, there has been some loss of price competitiveness of Ghanaian products on account of the real exchange rate overvaluation emanating from the disinflation monetary policy of the Bank of Ghana. As so often happens when the domestic currency is overvalued, non-traditional exports such as domestic manufactured goods could lose grounds in international markets while import-competing domestic products lose out to cheaper imports at home.

Alternatives to price increases currently under consideration include:

- review of production targets for the year;
- cost-cutting measures such as reduction in wages of employees;

- reduced working hours; and
- forced leave (in advance pending measures to resolve the energy crisis).

A Business and Financial Times survey reportedly carried out at Tema found that “*although most industries have made contingency plans to avert any adverse impact on their production some industries have been forced to undertake job cuts*”. As the above-cited Report of the World Bank observed, “*... the adverse impact of the energy crisis is likely to be felt during most of 2007*”.

Unless appropriate remedies are found to contain the escalating production costs there would unfortunately be more closures as enterprises fail to cover their variable input costs.

3.3 Short- to Medium-Term Proposals

Government interventions comprising various short to medium term proposals to contain the disruptive effects of the power crisis on productive capacity include:

- An emergency power programme comprising the Ministry of Energy’s 60 MW of power and the VRA’s component of 50 MW;
- An investment of US\$470 million in the energy sector over the next three years to improve energy generating capacity of the country;

- West African Gas Pipeline Project — delayed from December 2006 on account of construction difficulties — is now due in August 2007. US\$40 million has already been paid up as equity;
- Supply from the West African Power Pool arrangement, with Nigeria supplying 80 MW and La Cote d’Ivoire supplying 120 MW — an IDA loan guarantee will support Ghana’s participation;
- VRA and the Ministry of Energy will procure an 80 MW power plant to be operational by April 2007;
- The Osagyefo Power Barge to be operational by August 2007 to produce 125 MW;
- 126 MW power plant to be procured by VRA by August 2007 (the entire MDRI for 2006 has been earmarked for this);
- Construction and expansion of Takoradi International Company Plant (110 MW) to commence in 2007;
- consortium of three American companies to produce up to 110 MW by end-April 2007;
- 300 MW power plant to be installed in Tema by 2009;
- consortium of mining companies to supply 80 MW by June 2007;
- Bui hydro-electric dam to be built with funds from the Chinese Government, to add 400 MW to the power generating capacity of the country; and
- a private Ghanaian-Chinese joint venture to add 600 MW in two phases;

Regarding the Emergency Power Programme, 38 generators with capacity to generate 44 MW have already been commissioned. For a number of reasons, however, actual generation only averaged 25 MW — less than 60 percent of the installed capacity. Problems with domestic fuel supplies, switches and mechanical faults have been blamed for the hiccups: *“Fuel in Ghana is very dirty requiring filtration to clean it. Filters sometimes clog up which could cause the pumps to cease and burn the motor.”* To ensure full production adequate provision would have to be made to supply the required diesel fuel on a sustained basis. The danger is that of real or speculative scarcities that could play havoc on the transportation sector.

As the President warned in his Sessional Address, diesel-powered generators are very expensive to run. One of these generators guzzles about 84 gallons of fuel an hour. Thus the fuel cost of operations alone is estimated at ¢2.76 billion a day for the 38 generators. At current exchange rates this works out to 24 US cents per unit of one kWh. By way of comparison this is:

- twice the cost of thermal power at Aboadze; or
- twelve times the cost of power at Akosombo.

The above Emergency Power Programme of the VRA in full gear would supply 50 MW — making up for about one-twelfth of the

estimated 600 MW shortfall. Therefore its impact is relatively small. The real issue with it, however, is whether utility prices would be adjusted upwards and if not, whether the VRA would be directed to absorb the losses which would be unsustainable — a quasi fiscal operation which could further damage the balance sheet of the VRA — or whether in line with the stated social policy of government, budgetary subsidies would be provided to cover the costs. This latter could mean larger deficits and possibly increased domestic borrowing by government which could keep the domestic debt-to-GDP ratio off its planned trajectory with adverse consequences in inflation and high interest rates.

The West African Power Pool is estimated to have the potential capacity of 600 MW and appears to be a project between oil-rich Nigeria on the one hand, and Benin and Togo on the other, for the supply of energy to the latter two countries.

Some scepticism has been shown towards the credibility of the Nigerian window. First, a spokesperson of the Peoples' Democratic Party (PDP) — the ruling party in Nigeria — was quoted to have observed that Nigeria's total supply of 1,200 MW is woefully inadequate to keep Nigeria itself going. The spokesperson was therefore reported to have

questioned the basis for the supply of 80 MW to Benin and Togo in order to free Ghana from the obligation to supply same.

A number of firms have apparently expressed interest to operate the Osagyefo barge, where it is now, under lease agreement. The government appears to have changed its mind about relocating the barge at Tema and is said to be now willing to leave the barge where it is since “the objective is to get power”. Apparently the cost of relocation has proved much higher than expected and hence the decision to explore the leasing-out option.

In spite of these various proposals and initiatives there is no quick end in sight. The immediate problem is to coordinate efforts and intensify the search for increased supply of electricity to productive users. The nation would also have to place higher emphasis on conservation and the unproductive and wasteful use of power. Increased power generation, however, must also pay greater attention than now to the cost implications. Bringing forward the start-up dates for the intervention that would generate upwards of 200 MW, wherever feasible, should be given utmost priority. The feasibility of sharing the cost burden between the business community and the budget would depend critically on how short the short-term is; in other words, on how quickly we can reach the medium to long-term solutions. A good rule of

thumb when faced with a cost-escalating shock is to fund it if it is of short duration but to make appropriate behavioural adjustments if it is likely to persist into the medium term.

4 BUDGETARY AND FISCAL OPERATIONS

4.1 Background

The year 2006 was characterized by severe revenue shortfalls, sizeable expenditure overruns, wider-than-planned deficits, which necessitated large net domestic borrowing, and an off-trend, rise in the domestic debt stock relative to GDP.

A primary goal of the current Growth and Poverty Reduction Strategy (GPRS) II captured in the 2007 Budget Statement is Growth with Stability. This calls for a forward-looking fiscal policy designed to improve the quality of public spending while continuing to promote fiscal discipline. To be successful, the framework requires two safeguards:

- transparency, which allows the public to scrutinize policymakers and thereby to hold them accountable; and
- fiscal rules, which address specific issues in the fiscal outlook.

Choosing an appropriate fiscal rule boils down to deciding on a medium-term macroeconomic objective for fiscal policy that is

ultimately related to some concept of sustainability. The idea of the fiscal rule is to anchor the fiscal policy framework. The objective is to thereby reduce the risk of painful, abrupt adjustment that would take a toll on much-needed investment in infrastructure and social areas or require that revenue be raised through taxes that could prove distortionary.

In Ghana, since GPRS I, the domestic debt-to-GDP ratio has been the nominal fiscal anchor. At the level of macroeconomic policy, maintaining the fiscal anchor on track requires that relevant and interrelated measures of the fiscal stance remain on target. Three such measures that CEPA has traditionally focused on are:

- (i) the overall budget deficit — measured by the overall broad balance (OBB),
- (ii) the domestic primary balance (DPB), and
- (iii) the net domestic finance (NDF) for the deficit.

The net domestic debt-to-GDP ratio continues to be the fiscal policy anchor, rather than any particular spending targets or budgetary deficit. Achieving a low fiscal deficit has been an important intermediate target — the overall broad budget balance has been reduced from a deficit of 9.7 percent of GDP in 2000 to 2.1 percent of GDP in 2005 — especially in the context of a disinflation objective. Success with the fiscal anchor

has allowed the Bank of Ghana — the central bank — to reduce interest rates to “crowd in” private sector activities.

4.2 Total Domestic Revenue and Grants

In the 2006 budget a target was set for domestic revenue and grants of about ₵34.0 billion — equivalent to a share of 30.0 percent of national income. In terms of its two main components — domestic revenue and grants — the targets were about 23.0 percent of national income for domestic revenue and about 7.0 percent of national income for grants (including debt relief). Largely on account of the on-going restructuring and realignment (to ECOWAS) of the tax system, tax rates have been lowered since 2005. In spite of intensified efforts to increase the efficiency of the revenue collecting agencies — particularly CEPS — however, the outturn for domestic revenue has fallen short of its targets since the commencement of the restructuring exercise.

Domestic revenue, in turn, is comprised of three main sub-components — tax revenue, the National Health Insurance Levy (NHIL) and non-tax revenue. The largest of these is tax revenue, and domestic revenues go as tax revenues go. In 2006, CEPA estimates show a shortfall in domestic revenue collections equivalent to 1.8 percent of GDP, which is of the same order of magnitude as that of tax revenue — 2.0 percent of

GDP. All categories of taxes — direct, indirect and international trade — contributed to the underperformance.

CEPA estimates show that in contrast, non-tax revenue over-performed by a sizable 63.0 percent over its target. The extraordinary measures in non-tax revenue mobilization taken in 2005 were repeated in 2006. In addition, there is a technical issue as to the treatment of the so-called internally generated funds (IGFs) — the retained portions of non-tax revenues by the collecting ministries, departments and agencies (MDAs). The over-performance in respect of non-tax revenues was however, inadequate to fully offset the underperformance of tax revenue, resulting in the overall shortfall equivalent to 1.8 percent of GDP.

Aid disbursements have been characterized as volatile and uncertain. The estimates show that 2006 was not exceptional in that regard. There was a shortfall in the receipt of grants of about 5.0 percent — the equivalent of 0.5 percent of national income in 2006.

4.3 Expenditures and Payments

Total expenditure is composed of recurrent and capital expenditures. Recurrent expenditure is also broken down into non-interest and interest

expenditure while capital expenditures consist of domestically financed and foreign financed components.

Compared to its target, the outturn in respect of recurrent expenditure is estimated by CEPA to be in excess by about 16.0 percent. In contrast, CEPA estimates a lower-than-planned capital spending — short of its target by 13.4 percent. Given the fact that the recurrent component is the larger of the two and given the extents of over-spending in respect of recurrent expenditure and under-spending in respect of capital expenditure, the overall outcome for net total expenditure over-spending was to the tune of almost 3.0 percent.

The recurrent expenditure target in 2006 was $\text{¢}21,589.7$ billion representing a share of national income of nearly 20.0 percent. The target for the bigger non-interest expenditure component was the equivalent of 16.0 percent of national income, while that of interest payments was a little above 3.0 percent. In terms of outcomes, CEPA estimates an over-spending in respect of non-interest income of about 20.0 percent. This excess was driven by the wage bill — almost 15.0 percent above its target — and transfers of an estimated $\text{¢}2.0$ trillion to the public utilities to help manage the energy crisis. Consequently, the non-interest expenditure outturn was, according to the CEPA estimates, some 20.0 percent above its target.

In contrast, interest (domestic and external) payments totalled about 6.0 percent lower than the budget had projected. The savings were in respect of external interest payments. The debt relief from the Multilateral Debt Relief Initiative (MDRI) became available in 2006 and involved the cancellation of some debt and interest payments. The combined effect of excess non-interest payments and lower interest payments was a net recurrent over-expenditure of about 16.0 percent — equivalent to a share of 2.6 percent of national income.

As usual, capital expenditures for the year were lower than planned and by a considerable margin — over 13.0 percent. CEPA has drawn attention to the implications for economic growth of the persistent shortfalls in capital spending especially in the context of infrastructural deficiencies. The 2007 budget also refers to low absorption capacity as one of the major implementation challenges. As the Minister of Finance saw it, this has “*resulted in the slower than expected utilization of available project funds*” (paragraph 1385, 2007 Budget Statement).

4.4 Overall Broad Balance (OBB)

The OBB (payments basis) is computed on the basis of current operations. It is defined as the difference between Total Revenue and Grants, and Total Expenditure. OBB (payments basis) exceeded its target by over 63.6 percent according to the CEPA estimates. In terms

of the shares of GDP, the realized deficit was wider than its target by 2.8 percentage points.

On the modified cash basis, that is, when arrears clearance (road and non-road) as well as past VAT refunds are added to OBB (payments basis), the CEPA estimate of ₵8,209.9 billion for the OBB (modified cash basis) was 58.0 percent wider than the target set for 2006. Their respective GDP shares correspondingly showed a 2.5 percentage points difference.

OBB (cash basis), is a third variant of the overall deficit. It is based on cheques that have gone through the Government accounts in the banking system during the course of the year under review, 2006. The difference between OBB (cash basis) and OBB (modified cash basis) is the float. If, in absolute terms, the former exceeds the latter, the float will have a negative sign. This indicates a carryover into the year under review of cheques from the past. The 2006 budget acknowledged some ₵577.8 billion of such cheques carried over into 2006. In the assessment of outturns, CEPA estimates indicate that while these delayed cheques were cleared in 2006, in turn an estimated ₵299.0 billion was carried over into the following year 2007.

4.5 Domestic Primary Balance (DPB)

The Domestic Primary Balance (DPB) is a good measure of the viability of the debt management strategy. It is computed on the basis of domestic revenues and non-interest domestically-financed expenditures. If the DPB is less than interest payments due in the year under consideration, the existing debt management strategy could be called into question. This is because in the absence of sufficient foreign grants, new loans will have to be raised to meet interest payments with the potential for the debt stock to snowball. In 2006, the target was a deficit but this was on account of the debt relief resources that were expected to be more than enough to cover interest payments. The outturn was much worse than planned and resulted in a large unplanned net domestic borrowing and a sharp rise in the domestic debt stock.

Since 2005, government has embarked on a process of tax restructuring and rationalization. As a result, tax reliefs have been granted to both businesses and individuals. These reliefs have been informed by several considerations including:

- a recognition that the current tax burden in Ghana is relatively high, compared with the historical experience and countries in the region; and

- the need to bring the tax structure better aligned with those elsewhere in ECOWAS to ensure Ghana does not lose out on foreign direct investment.

On account of the lowering of the tax burden, in spite of the intensified efforts to increase the efficiency of the revenue collecting agencies — particularly CEPS — the share of government domestic revenues in national income has missed its target since the restructuring exercise commenced. In 2006, the target was missed by as much as an equivalent of 1.8 percent of national income. With the further reliefs and incentives contained in the 2007 budget, the outcome could be worse, and more so, if the impact of the energy crisis is fully taken into account. Pursuit of the Growth with Stability strategy would require that appropriate financing — specifically external borrowing — be found to cover the structural revenue gap over the near to medium term.

On the expenditure side, beyond commitments already made, two new important sources of spending pressure have emerged. These are the energy crisis and the labour unrest in the public sector. CEPA estimates that an unplanned amount of about $\text{¢}2.0$ trillion had to be transferred to the public utilities in 2006 to help manage the energy crisis. The 2007 budget has also earmarked the entire debt relief from the MDRI to the VRA for the procurement of gas turbines and a barge. In addition, the

VRA component of the Emergency Power Programme of the Energy Ministry involves the procurement of generators for the production of 50 MW of power at Tema. For the 38 generators so far installed with a 44 MW capacity, the daily fuel costs have been estimated at about ₵2.8 billion. This was before the recent increase in price of petroleum products. The budget would have to continue to make sizeable transfers to subsidize VRA's production; otherwise upward adjustment of utility tariffs would be unavoidable.

Clearly, the revenue shortfalls and the additional expenditures would mean larger deficits that must be appropriately financed if macroeconomic stability is to be sustained as required by the Growth with Stability goal of GPRS II. In the 2007 budget, government reaffirmed its determination to diversify the sources of financing the development agenda. To quote from the Budget Statement:

While reliance on donor-provided grants and concessional loans has served us well, there is, however, the need to expand the scope and structure of financing if government is to meet its goal of scaling up investment for accelerated growth from the current 6.0 percent to 8.0 percent annually. After achieving stable macroeconomic conditions and winning the confidence of markets as reflected in our B+ sovereign ratings, the Government intends to enter the international capital market in 2007 as a sovereign borrower to diversify and broaden our funding options, including public-private partnerships. In addition, Government will seek more

funding by requesting access to the IBRD window of the World Bank.

Advised by Citigroup, the Government reportedly has successfully issued a sovereign bond in the amount of about US\$500.0 million. This is seen in financial circles as a “hugely important step for a sub-Saharan African country, other than South Africa, to have entered the international capital market since the largely unsuccessful forays by Nigeria and La Cote d’Ivoire in the late 1970s and early 1980s”.

The Government is also reported to be seeking to borrow on concessional terms from bilateral donors. China has already announced that it would provide a loan of US\$600.0 million on concessional terms for the construction of the hydroelectric dam at Bui in the Brong Ahafo Region. Negotiations are reported to be well advanced over the possibility of extending the loan facility beyond the 70.0 percent coverage so far. Other bilateral sources that have been mentioned include India and Japan.

At present, given the B+ (with positive outlook) sovereign rating, mobilizing loan finance on reasonable terms does not appear to pose much of a challenge to Ghana. Indeed, an amount of up to US\$1.8 billion has been suggested as possible between 2007 and 2009. A special fund to be designated the Jubilee Development Fund (JDF) is

proposed for the consideration of Government. All loan proceeds as well as any such identified and dedicated resources mobilized in support of the accelerated growth and development objective would be deposited into the JDF. This is to assure transparency and accountability.

Given the commitment to the Growth with Stability goal of GPRS II, CEPA sees the key challenges over the medium-term (2007-2010) to be the following:

- consolidating macroeconomic stability — (single digit inflation at a level close to the average of major trading partners and continued build-up of international reserves to the equivalent of at least four months import cover);
- decisive resolution of the energy crisis to enable real economic growth at an average of 6.5 percent a year over the period;
- further re-orienting fiscal priorities towards development;
- pursuing structural reforms, particularly in the financial sector to bolster private sector-led growth; and
- human resource development for and domestic retention of professional and technical skills.

Meeting these challenges would, among other things, call for continued complementarity of fiscal and monetary policies. Specifically, the

domestic debt-to-GDP ratio must remain the fiscal anchor over the medium-term. Fiscal policy would therefore continue to make possible net repayments into the domestic economy with the aim of “crowding in” private sector investment with low real interest cost of capital.

5 MONEY, CREDIT AND PRICES

5.1 Background

Over the period from 2003 the Bank of Ghana has had a monetary policy which narrowly considered — separately from fiscal policy — appears to have two competing and partly contradictory objectives. The first and dominant one, which has been the main focus of this policy, has been the objective of achieving single-digit inflation by end-2006 — originally two years earlier. Its principal instrument has been to restrain liquidity growth, including through increased foreign exchange. As a result, the exchange rate of the cedi against the US dollar has been relatively stable. On account of inflation differentials, however, this has implied considerable appreciation of the real exchange rate.

In thus taking advantage of the large inflows of foreign exchange, the real appreciation of the cedi has served as a source of strong dampening pressure on inflation. Large quantities of non-oil imports valued at about US\$5.1 billion were brought into the country providing cheap substitutes for domestically produced goods. On the downside,

however, this disinflation policy appears to be losing markets at home and abroad for locally produced goods, with potentially adverse consequences for production, employment and profits. Increasingly, local producers are complaining of a “lack of buying power” syndrome as they lose out to competing imports.

The focus of Ghana Poverty Reduction Strategy (GPRS I) was to regain and maintain macroeconomic stability. Consequently, the disinflation objective was central to the strategy. Nonetheless GPRS I did have, even if of lower priority, a growth objective as well. Moreover, its successor Growth and Poverty Reduction Strategy (GPRS II) has shifted focus further to accelerated economic growth as the principal instrument for poverty reduction and national prosperity.

In pursuit of the growth objective, the Bank of Ghana has sought to increase bank lending to the private sector. The instrument for this is lowering of interest rates. It is the potentially expansionary consequence of this monetary policy objective that appears to contradict the disinflation objective. To reconcile these otherwise seemingly contradictory objectives, we must turn to fiscal policy. The targets set for the domestic debt-to-GDP ratio — the fiscal anchor — imply net repayments into the domestic economy. This serves to “crowd in” the

private sector by supplementing the credit available in the banking system.

5.2 Monetary Management

Available data show that key monetary aggregates grew in tandem and at generally faster rates in 2006 compared to the previous year 2005. Reserve Money or High-Powered Money growth rates not only exceeded those of the previous year but also followed a generally rising trend. Thus, from the 11.2 percent growth rate of December 2005, Reserve Money growth accelerated over the course of the year reaching an estimated 25.7 percent by end-December 2006. This was more than double the December 2005 rate and over eight percentage points above its target of 17.5 percent.

Annual year-on-year growth rate of total liquidity — measured by Broad Money (M2+) followed a similar upward path as that of Reserve Money (RM). In fact its trend was steeper. Thus, from the December 2005 rate of 14.1 percent, it climbed rapidly over the succeeding months to reach 33.5 percent at the end of the third quarter of 2006. CEPA estimates the end-December 2006 growth rate at 36.5 percent.

Net credit to government by the banking system also increased rapidly. For the twelve months to May 2006, it rose by about 45.0 percent, more

than doubling the 20.0 percent of the corresponding period of 2005. Credit to private and public sector enterprises in the first half-year, however, increased at a slower pace in 2006 compared to 2005. It quickened somewhat in the second half-year, finishing the year with an increase of almost 38.0 percent — about 2.0 percentage points faster than the growth rate recorded in the first half of the year.

Developments over the recent past have seen a steady rise in the share of cedi deposits in total liquidity making it the largest of the three components of overall liquidity (namely, currency, cedi deposits, and foreign currency deposits) — about 56.0 percent in 2006 compared to 52.0 percent in 2005. It is evident that increased mobilization of cedi deposits was the main driving force behind the growth of overall liquidity recorded in 2006. Thus, in comparison, the share of currency fell from 24.0 percent in 2005 to 23.0 percent in 2006; so also did the share of foreign currency deposits — though marginally from 21.5 percent in 2005 to 21.2 percent in 2006.

The higher growth of public holdings of cedi deposits compared to currency has meant a continued fall in the ratio of the stock of currency with the non-bank public relative to cedi deposits. This shift in monetary holdings is a positive development as it represents a preference for financial assets by the non-bank public that favour

investment. Furthermore, it is a phenomenon that would intensify as female participation in the modern sector increases. CEPA research has shown that females have a higher preference for Time and Savings deposits than males.

5.3 Interest Rates and the Money Market

With an eye on the accelerated economic growth objective, the Bank of Ghana has followed a monetary policy of encouraging increased bank lending to the private sector by lowering interest rates. This policy could be considered to have been largely successful with growth in the real stock of credit having soared to peak levels in 2006. The Bank of Ghana induced cuts in interest rates at various times in 2006. The rationale for this has been that inflation was on a downward trend, even when the declines have been modest and the actual rate of inflation has remained above the stated target. Indeed, even when in December 2006 the rate of inflation rose, the Bank of Ghana nonetheless lowered its prime rate by two percentage points from 14.5 percent to 12.5 percent. Adjusted for inflation, the cost of credit is deemed onerous and there is strong pressure on the Bank of Ghana to bring interest rates down by bigger margins and faster.

Developments in the money market in the first half of 2006 reflected generally declining interest rates though the rate of decline slowed in

the second quarter. Rates on the Interbank overnight money market, like the rates on the auction market, all declined “in line with inflationary expectations”, according to the Bank of Ghana.

Interest rates of commercial banks have tended to move in tandem and consequently the spread between average savings deposit rates and average lending rates have remained stubbornly fixed at close to 20.0 percentage points. Taken as a measure of intermediation cost this indicates a disturbingly high cost of mobilizing financial savings in Ghana. As much as two thirds of the cost of borrowing from the banks goes to cover intermediation costs. In these circumstances, pressure to lower bank lending rates invariably has the unfortunate result of leading to a lowering of savings deposit rates and by an equal margin.

The result of this state of affairs is that while lending rates have remained significantly positive in real terms — adjusted for inflation — real savings rates have been negative for most of 2006. The mobilization of deposits nonetheless achieved impressive results in 2006.

5.4 Consumer Price Developments and Inflation

The Bank of Ghana’s policy of disinflation using the exchange rate as a nominal anchor continued into 2006. Nominal depreciation of the cedi

vis-à-vis the US dollar stayed well below 1.0 percent per annum between March 2005 and June 2006, and remained below 2.0 percent per annum during the second half of 2006. Over the same period, headline inflation measured by the yearly changes in the Consumer Price Index (CPI) steadily declined from about 16.7 percent per annum to reach single digits in March and April 2006 — the first time since May 1999.

In April 2006, in line with the adoption of a full-cost pass-through regime, the petroleum oversight authority, the National Petroleum Authority (NPA), announced an increase in petroleum product prices averaging 10.0 percent. Headline inflation subsequently edged upwards in the following three months to reach 11.4 percent at end-July 2006. The petroleum product price impacted directly on transport costs and through that on the market prices of almost all the items in the consumption basket of the average household.

In the second half of 2006, inflation and inflationary expectations appeared relatively subdued, in part because of *downward revisions* in the price of petroleum products, better food harvests relative to 2005, and continued high appreciation of the real exchange rate. It is to be recalled that in late July 2006, the NPA introduced a specific tax to replace the ad valorem tax in the price build-up of petroleum products,

leading to marginal drops in product prices averaging 6.2 percent. Further downward revisions in petroleum product prices, averaging 7.1 percent, were subsequently announced in early September. These downward adjustments in petroleum product prices had the effect of calming down inflationary expectations in the economy. The rate of inflation began slowly to ebb, falling on average by 0.2 percentage points per month, to reach 10.5 percent in December 2006.

5.5 Near-Term Inflation Outlook

As reported in previous CEPA publications, the economy entered the upswing phase of the three-year economic cycle in the latter part of 2005. Being essentially an agricultural cycle, the eighteen-month period from October 2005 to March 2007 saw a pickup in the agricultural sector growth rate. With the productivity gains emanating from the cocoa high-tech package developed at the Cocoa Research Institute of Ghana (CRIG) production surged to an all-time high of 722,163 metric tons in 2005. Moreover, consistent with the phase of the cycle, the indications are that output in 2006 was about 8.0 percent higher with the crop volume reaching an estimated 780,000 metric tons — a new record. Domestic food market price developments provide supporting evidence pointing to a better agricultural harvest in 2006 compared to 2005.

A major achievement of the disinflation policy has been the continued shallowing of the economic cycle. Over the eighteen-month upswing phase (October 2005 to March 2007), leaving aside petroleum and utility price shocks, the amplitude of the underlying cycle appears to have shrunk from the historical 10.0 percentage points to an estimated 2.5 percentage points at present. Similarly, the annual rate of inflation averaged over the cycle was first lowered from 20.0 percent to 10.5 percent and currently appears to have fallen further to about 8.0 percent. Consequently, inflation in the three-year economic cycle is now projected to lie in a rather narrow range — the cycle is practically “dead”. The current peak in March 2007 was about 10.5 percent per annum; barring any cost-push shocks, and assuming a relatively benign counter-cyclical monetary policy, the trough of about 5.5 percent is expected to occur in September 2008.

The CEPA forecast, however, is for headline inflation to hover around the peak level of 10.5 percent over the next eighteen months to September 2008. This is because the commitment to accelerated growth enshrined in GPRS II would call for increased public spending particularly on infrastructure, education, training, health and sanitation. In addition, the work of the Fair Wages Commission charged with, among other things, the rationalization of public sector wage structure involving removal of anomalies and distortions would most likely raise

the government wage bill above the 10.0 percent of national income reached in 2006. Then there are energy-related expenditures, including possibly large subsidies and other transfers to the public utilities. Finally, there are ongoing infrastructural works in preparation for the CAN 2008 soccer extravaganza. Financing the projected budgetary deficit without igniting inflationary fires is the key challenge in the near to medium term.

6 INTERNATIONAL TRADE AND PAYMENTS

6.1 Background

In the Budget Statement and Economic Policy of 2007, the Government of Ghana recognized the need to move from the concentration on macroeconomic stability to the achievement of stability with economic growth. This is a laudable objective if it can be achieved but could prove difficult to achieve.

One way to achieve this is through the judicious use of the substantial development assistance Ghana is receiving from her development partners in the form of debt relief and increased aid. Using these to create infrastructure and other capital investment that ‘crowd in’ the private sector without burdening it with quasi-fiscal roles is important. Two issues emerge immediately. First, the rate of absorption depends on the absorptive capacity of the public sector. Secondly, as the levels

of assistance and expenditures on infrastructure increase, there is a tendency for inefficiency and therefore project costs to increase.

As discussed below, achieving this objective is not helped by concentrating on stabilization by purchasing lower inflation through subsidizing imports with an overvalued exchange rate. The real policy dilemma is how to use the resources in such a way as to achieve a low level of inflation while maintaining the competitiveness and therefore the growth of the domestic economy. Current thinking is that, over the medium term, the key is productivity gains.

In a number of countries with substantial external assistance, there is a tendency to liberalize the capital account of the balance of payments. As the experiences of East Asia and Latin America show, such an approach can increase the vulnerability of the economy to external financial shocks and speculation.

6.2 Constraints to Achieving Competitive Exchange Rates

The export-led growth strategy Ghana has adopted requires her to diversify her export base. There is a need to create micro-level incentives for investment in the tradables sector. The exchange rate is a key instrument in promoting this objective. There is a need, therefore,

for Ghana to maintain a competitive exchange rate to ensure that the micro-level incentives for growth are maintained.

Achieving this, however, is constrained by political economy considerations and aid factors. Politicians see an appreciating currency as an achievement and this can be reflected in official policy. The objectives of the medium-term macroeconomic policy framework in the Budget and Economic Policy Statement for 2007 taken from the Growth and Poverty Reduction Strategy (GPRS II) include a stable exchange rate with the cedi depreciating by less than 4.0 percent per annum. With both actual and target inflation rates higher than this rate, it is expected that the real exchange rate will appreciate continuously.

The availability of aid creates an illusion and a disconnect between the exchange rate, exports and the availability of foreign exchange for development. In the case of Ghana there is also an illusion that there is a permanent increase in external resources and that the real equilibrium exchange rate must have appreciated, justifying an appreciation in the actual real exchange rate. Available literature indicates that sustained growth (SG) countries avoided overvaluation of their currencies even in cases where there were substantial aid inflows.

Aid is good provided it is used in ways that enhance growth and employment. Pro-cyclical exchange rate policy in which aid is used to purchase lower inflation through imports can create long-run difficulties. Experiences of the 1990s suggest that while lower inflation is desirable, the method of achieving it is also important. If it is achieved through overvalued exchange rate, it may be growth retarding.

Reconciling the need for a competitive exchange rate and the constraints facing its achievement in favour of a competitive exchange rate is a challenge Ghana must confront. Absorbing aid and debt relief resources in ways that enhance economic growth can be a strategy. Resolving this tension through capital account liberalization simply increases vulnerability without promoting the growth objective.

While the tension between the need for the competitive exchange rate and the constraints to achieving it persists, the real exchange rate continued to appreciate in 2006. The real exchange rate between the cedi and the US dollar has appreciated continuously since 2004. In 2006, it appreciated by 9.7 percent on the basis of the CPI and by about 20.0 percent on the basis of exporters' costs. This was the result of the stable nominal exchange rate. The nominal exchange rate between the US dollar and the cedi depreciated by 1.4 percent in the Interbank

market and by 2.1 percent in the Forex Bureaus. The real appreciation in 2006 follows upon three other years of real appreciation.

The continuous real appreciation has resulted in overvaluation of the cedi in purchasing power parity terms. CEPA analysis also shows that adjustment for the Balassa effect in which the real equilibrium exchange rate may appreciate with growth and therefore productivity, still reveals considerable levels of overvaluation of the currency.

With an overvalued exchange rate, the only other means to maintain competitiveness is through productivity increases. However, with reduced profitability of exporting through the exchange rate, this route could result in labour displacement. This route also requires substantial infrastructural development, which cannot be achieved in the short run.

Pressures by rice, tomato and poultry farmers for public policy support are only symptomatic of a policy regime that assigns the exchange rate to internal balance and inflation to the neglect of the external sector competitiveness. More of such pressure can be experienced if the real exchange rate continues to appreciate. The manufacturing sector growth rate fell short of its target in 2006 in the face of cheap imports. Unfortunately, the main losers from the policy, the exporters and producers in competition with cheap imports, have no policy influence.

6.3 Balance of Payments

The international payments system in 2006 was characterized by substantial and increased balance of payments surplus and a widening trade deficit driven largely by the appreciating real exchange rate. These were financed by debt cancellation and increased inward transfers. In spite of the surplus, external reserve accumulation was modest, with gross international reserves in terms of months of imports cover declining.

The overall balance of payments recorded a surplus of US\$415.1 million in 2006, up from the surplus of US\$84.3 million in 2005. The improvement was due to debt cancellation and external resource transfers. As a result, the Bank of Ghana accumulated reserves. However, the rate of accumulation was lower than the growth in imports, resulting in the import cover of reserves declining from 3.9 months in 2005 to 3.3 months in 2006. If services are included, imports cover drops from 3.7 months in 2005 to 2.8 months in 2006.

In terms of proportion of GDP, the trade deficit widened from 23.8 percent of GDP in 2005 to 24.2 percent of GDP in 2006. This was on account of a sharp increase in imports over exports. While export receipts increased by 33.0 percent, expenditure on imports rose by 45.7 percent from US\$5.34 billion in 2005 to US\$6.75 billion in 2006, with

the non-oil component representing 75.6 percent of the overall imports bill. All components of exports, except Timber and Wood Products, experienced substantial growth in value terms. The two dominant export commodities — gold and cocoa — mainly because of both increased export volumes and higher world market prices led the overall growth.

The increased trade deficit was financed in part by private transfers, which increased by 11.6 percent from US\$1.55 billion in 2005 to US\$1.73 billion in 2006. Net of official transfers, the deficit on the current accounts amounted to the equivalent of 6.5 percent of GDP in 2006 compared to the 5.8 percent of GDP of 2005.

6.4 Trade in Services

At long last Ghana is recognizing the need to diversify into services exports. The 2007 Budget Statement recognized the need for Ghana to take advantage of globalization and the WTO Agreement, specifically the General Agreement on Trade in Services (GATS). Ghana's services trade regime is more liberalized than that in many least developing countries (LDCs). Ghana is also committed under the GATS to liberalizing more sectors than the average for Africa as a whole. To diversify into services, Ghana needs to provide the same levels of incentives and support to trade in services. Infrastructural development,

particularly in telecommunications and human capital development are essential for meaningful diversification into services. Human capital development is crucial because trade in services tends to be more skill-intensive than trade in goods. Furthermore, financing for exports development must be extended to services exports. For example, the Export Development and Investment Fund (EDIF) currently does not cover activities related to exports of services.

7 ISSUES IN PUBLIC EXPENDITURE MANAGEMENT (PEM)

7.1 Background

The main issues of Public Expenditure Management relate to the credibility, predictability and control over Public Expenditure. At the aggregate level except for 2002 there has been strong correspondence between appropriations and payments. This reflects the demands of fiscal discipline required in the program with the IMF. On the other hand, disaggregated by budget head, economic item and function, the evidence shows that there is a tendency for the predictability and credibility of the budget to be eroded on account of the inability to control spending on the wage bill especially in the priority social sectors of Education and Health. Infrastructural investments have tended to suffer payment shortfalls for these excesses. They also serve to crowd out the private sector in credit markets and increase aid dependence.

An External Review of the PEM carried out by the UK (DFID) and the World Bank in 2006 concluded as follows:

Assuming the Government maintains its present commitment to sound economic and fiscal policies, Ghana can expect similar growth in incomes in the near future. If the business environment can be further improved, and public investments made more efficient, economic growth in the medium term could be in the 6-8 percent range. In turn, this would improve Government revenues, which together with the savings in the fuel subsidy and reduction in domestic debt repayments, should create the fiscal space necessary to accommodate further poverty-reducing expenditures, the pressure for which is growing, particularly in the education and health sectors. Strong growth would also facilitate the Government's program of public sector reform.

The Review considered total Central Government expenditure financed from all sources — the Consolidated Fund, internally generated funds (IGFs), donor disbursements and statutory funds and assessed performance against six objectives as follows:

- Credibility of the Budget
- Predictability and Control in Budget Execution
- Policy-based Budgeting
- Comprehensiveness and Transparency of the Budget
- Accounting, Recording and Reporting
- External Scrutiny and Audit

7.2 Key Findings

The analysis here is restricted only to discretionary expenditures charged on the Consolidated Fund, which amount to about 50.0 percent of the overall total of Central Government expenditures in the yearly Appropriations. The time period covered, 2002-2005, is wider than that in the 2006 External Review by the inclusion of 2002, while the issues discussed are restricted to those concerning credibility, predictability and control of the budget.

Available data confirms the finding of the External Review that over the period 2003-2005, there was close conformity between voted provisions and actual payment releases — the total deviation index for each year remained below 5.0 percent. This outcome can be and is often interpreted as reflecting government policy to control spending in line with the commitment to fiscal discipline and macroeconomic stability objective of GPRS I. The total deviation index of 32.0 percent for year 2002 was much more significant — signalling serious expenditure control and management difficulties resulting in large spending overruns.

The Total Variation Index, which measures variations within aggregates — specifically at the level of budget heads — shows moderately high values for 2003 and 2004 and significantly higher values for 2002 and

2005. Judged by the Excess Variation Index, the performance in 2005 was worse than that of 2002 — which was at comparable levels with 2003 and 2004 — which presages expenditure management problems in 2006 and beyond unless effective action is taken to restore fiscal discipline.

The Budget Deviation Index (BDI) was a high 46.3 percent in the year 2002, which was quite disastrous. GPRS I and its first budget of 2003 instituted a new policy regime with tough fiscal discipline. Consequently, the index fell by 65.0 percent to 16.3 percent. After that the BDI has followed a rising trend reaching 33 percent in 2005. The upward trend is cause for concern since it indicates a tendency of loss in fiscal discipline reaching disturbing proportions in 2005. These concerns are heightened by the values of the Excess Variation Index. Firstly, comparable values are recorded for 2003 and 2004 as was recorded for the problem year 2002. Secondly, and most disturbingly, the Excess Variation Index for 2005 of 32.7 percent was more than double the 14.3 percent recorded in 2002.

In terms of voted provisions, the wage bill has averaged about 70.0 percent of the total provisions. Indicative of the persistent tendency for spending overruns on this item, its share in total payment releases over the 2002–2005 period averaged 73.3 percent — about 3.0 percentage

points higher. In terms of the deviation indexes, the wage bill has recorded, on average, the smallest values, whilst at the other end the investment variation index has recorded the largest. And yet, given its weight, relatively low excess spending on this item is enough to push the total expenditure into excess, which must then be compensated for in under-spending under one or more of the other items, in order to remain within or close to the aggregate ceiling.

The problem of the wage bill is both its size — CEPA estimates it at almost half of government tax revenue, equivalent to 10.0 percent of national income in 2006 — as well as its structural characteristics. The latter arises particularly due to the fact that public sector wage rates are inadequate to attract and retain professional and technical personnel in priority sectors.

According to the External Review, the flow of resources to MDAs and service delivery units over the period has been less than ideal in terms of both quantity and timeliness. Processing of invoices has tended to be very time-consuming, leading to arrears and higher costs through penalty interest (mainly in the area of road arrears). Also, cutbacks in planned services are carried forward into the following year as unpaid commitments.

The 2006 External Review drew attention to the absence of a transparent link between planned and executed budget activities. The result of this could be possible misclassification of expenditures as to priority as well as inefficient use of resources.

The publication *Where did Ghana's HIPC Funds go?* by the SEND Foundation raises a number of searching questions and concerns about the use of public funds even in designated priority areas. In the final analysis, there is a need for caution in the interpretation of the impact of spending. The 2007 budget proposes a reclassification of poverty expenditures to include growth enhancing expenditures in 2007. The proposal will also be in line with the Growth and Poverty Reduction Strategy (paragraph 1238).

In conclusion, the size or growth in poverty-related spending could be illusory. There can be no substitute for monitoring and evaluation of the process of implementation and the development of indicators of the state of affairs. This must be done at not just the national level (important though this may be for international comparisons) but most importantly there is an urgent need for effective decentralization backed by a Districts Programme for monitoring progress which is of even greater importance for the people of Ghana.

7.3 Issues with the Wage Bill

Effective management of the wage bill is the key challenge of PEM in Ghana. It is the largest economic item with a tendency to spending overruns, and is moreover rising. Improvement in the budgetary processes that determine the wage bill is therefore important, given its size and also it being a source of significant budget variance.

The current procedure is to budget on the basis of existing numbers and wage rates, and to provide a contingency for any increase projected for the coming year. Increases in the wage bill during the year, is typically derived from two sources:

- growth in public service employment particularly new hiring of teachers; and
- increases in public sector wage rates that are not considered in the budget.

In the 2007 Budget Statement a Fair Wages Commission was proposed. Among other things, the Commission is expected to address the staffing levels and policy cost drivers of the wage bill as well as to develop a new pay policy that gives greater regard to the local labour market for professionals and skilled technicians.

In addition, it is hoped that the public sector wage negotiation process would be better synchronized with that of budget preparation, so that negotiations are completed ahead of submission of the Appropriation Bill. The wage bill has been about 70 percent of the total vote appropriated for discretionary expenditure from the Consolidated Fund (CF), and because of the persistent tendency for over-spending; its share of the payment release is almost 75 percent.

In summary:

- The wage bill constitutes the largest economic item in discretionary expenditures on the CF;
- The tendency for actual releases to exceed the voted provisions drives total discretionary spending to exceed the budgetary provisions;
- In order for fiscal discipline to conform to expenditure ceilings imposed by the IMF, a wage bill excess often necessitates compensatory shortfalls in releases for other economic items.

The large bill not only crowds out other categories of spending in the domestically financed current budget, it also makes their funding over-dependent on external aid from development partners. Over the longer term, the wage bill is driven by policy decisions on the scope of government and the manner in which services are delivered and this

would be another important agenda item for the Fair Wages Commission.

In the near-term, both budgeting and technical issues influence the wage bill. On the budgetary side, control over the wage bill by the Ministry of Finance and Economic Planning (MOFEP) is complicated by the staffing demands of MDAs. Negotiations over the wage bill for MDAs in respect of the coming year's budget are conducted late in an already tight budget preparation schedule.

There are technical problems that also impede control over the wage bill. Payroll audits since 2000 have made important contributions in the quest to clean up the public sector payroll. Thousands of ghost workers have been reportedly removed from the rolls especially in the GES yet the problem is not yet eliminated, and continual cleaning exercises are still required.

Better control of the wage bill over the longer term requires comprehensive public sector reform through rationalizing of the number of government agencies. It also requires revising the way in which current policies are delivered, and dividing the line between the state and private/community provision. This is necessarily a long-term task.