



CENTRE FOR POLICY ANALYSIS

**THE CURRENT STATE OF THE
ECONOMY**

2004

I. Introduction and Background

Assessing the overall outlook of the Ghanaian economy in an election year has always been difficult because of the uncertainties in fiscal behaviour. Our analysis suggests that the macroeconomic stability in terms of nominal interest and exchange rates in 2004 may be maintained. The fiscal, balance of payments, and monetary outcomes are less certain as also their repercussion in 2005.

These are considerable concerns. The key assumptions upon which the 2004 programme had been anchored have been overtaken by events notably by the external oil price increases and the renegeing on the deregulation policy in the petroleum sector. Consequently, unless adequate remedial policies are instituted, a fiscal-induced resurgence of macroeconomic instability may dominate 2005. Issues related to this outcome have to be addressed in Budget (2005) to maintain the macroeconomic conditions required for growth and poverty reduction.

II. Review of Agric Performance (2003)

Generally good rainfall is reported to have resulted in better-than-average performance of the agricultural sector in 2003 even though some regions recorded only average performance. Moreover, the overall above average performance was across all categories of crops — cereals, roots and starchy foods, vegetables and tree crops.

Agricultural performance continues to be adversely affected by low agricultural productivity as a result of outdated technologies and cultural practices. Ghana produces only 33 percent of what she could produce in maize, 31 percent in rice, just above 40 percent in millet and better though below 50 percent in sorghum. Levels of productivity compared with what could be achieved however, are higher for roots, tubers and plantain, but even in these activities considerable increases could be realized for the same amount of area cultivated, for example, with modernization.

Modernizing the agricultural sector would involve intensive farming, improved biological and chemical technologies and cultural practices. It would also require introducing acceptable and

risk-minimizing water management systems. Several studies have identified vagaries of the weather, particularly poor rainfall patterns, as the single most important risk factor making rural households vulnerable to poverty, food and job insecurity.

According to the Ghana Meteorological Services Department, total rainfall in 2003 was higher than the 30-year long-term average in most Ecological Belts. Compared to 2002, however, rainfall in 2003 was lower in almost all ecological Belts. These comparisons illustrate the vagaries and uncertainties in rainfall patterns in the country.

Marketing continued to be seen by farmers as a major problem affecting their decisions. The inability of farmers to organize, and lack of storage and processing facilities (indicating weak sectoral linkages) worsen the marketing problem and generate big price changes over the course of the typical year and from year to year.

III. Fiscal Performance (2003)

The 2003 Budget was anchored on the elimination of reliance on domestic borrowing to finance the budget. This was seen as important to achieve the target set in the GPRS for the domestic debt for end-2005. High debt burdens discourage investments in both physical and human capital necessary for robust and sustainable high economic growth employment creation and poverty reduction. In order to achieve this key fiscal objective, the Budget contained two substantial new revenue measures: a National Health Insurance Levy (NHIL) and a Debt Recovery Levy (DRL).

The NHIL of 2½ per cent on value added was to be administered on the same base and with the same technical features as the VAT and collected by the VAT Secretariat. Aside from the fiscal benefits, the NHIL was expected to have a strong positive distributional impact. The direct burden on lower income groups was projected to be limited. This was on account of the fact that a high proportion of their consumption expenditures fall outside the VAT base – which is what the levy is placed on. Moreover, the poor are expected to benefit from the extra poverty-

reducing expenditure by Government to be financed from the additional budget resources expected to be collected from the NHIL.

The Debt Recovery Levy (DRL) on petroleum products, was set at ₪640 per litre (or kilogram in the case of LPG) across the board. The decision by Government to implement the DRL across-the-board was rationalized on the grounds that the structure of petroleum product prices already includes significant cross subsidization in favour of products – kerosene and LPG – consumed primarily by low-income households. The problem with this rationalization, is that it did not reflect the reality. As the Fund staff would concede; the present system of implicit cross-subsidisation of those petroleum products consumed mainly by the poor has not worked well – and the resulting subsidies not pro-poor.

Other revenue measures to help finance the 2003 budget included:

- the extension of the National Reconstruction Levy (NRL) – which had expired at the end of 2002 – with an expected yield equivalent to 0.2% GDP;
- an increase in the Road Fund Levy on petroleum products – from ₪230 to ₪400 per litre included in the January 17, 2003 price adjustments without Parliamentary approval – with a projected yield equivalent to 0.9% GDP; and
- in the timber sector, an increase in stumpage fees with an estimated yield of 0.5% GDP.

On the expenditure side, a key objective in 2003 was to bring the wage bill under control. For the first time ever, a “hard budget constraint” was to be applied to wages. A ceiling of ₪5,450 billion for the overall wage bill was imposed by the IMF.

The stock of statutory payment arrears to the DACF and the GETF (outstanding at end-2002) was to be cleared in five equal installments of ₪97 billion each during 2003-2007. Furthermore, no new arrears were to be countenanced; Government would remain current on its statutory obligation. The Finance Committee of Parliament was to hold the Executive to this commitment.

The historical experience shows a recurring phenomenon of payment arrears resulting in distortions in the picture of performance from year to year. This manifests itself in subsequent arrears clearances much larger than projected. Furthermore, such government proxy borrowing could raise difficulties for the private sector, especially the indigenous small and medium enterprises (SMEs) in accessing banking sector credit as well as raising the cost of such credit – developments that do not augur well for private sector growth.

Whenever credible estimates are possible and certainly in respect of statutory obligations – to SSNIT, DACF, GETF, Road Fund, TOR and public Utilities – CEPA provides the necessary adjustments. These enable CEPA to provide accounts of performance, as much as possible, on accruals basis.

The official provisional actual shows an OBB (before arrears clearance) of ₺2,298 billion deficit in 2003. This was ₺257 billion – equivalent to 0.4% GDP – higher than the ₺2,041 billion deficit projected in Budget (2003). Correcting for payment arrears, CEPA estimates show an even larger deficit of ₺2,745 billion. Thus, after due note of their new payment arrears (including quasi-fiscal losses), the slippage amounted to ₺704 billion equivalent to a little over 1% GDP for that year.

The Net Domestic Financing target for the year set in Budget (2003) of zero originated from the medium-term debt management strategy of bringing the domestic debt burden to half of the level at end-2002 by end-2005. The official account of the provisional outturn indicated that the target was overachieved by a slight margin. As noted above, however, the official estimates of the deficit excluded the quasi-fiscal losses of TOR and the public Utilities, significant payment arrears to contractors and other suppliers of goods and services to the state as well as payment vouchers issued after December 15, 2003 which did not pass through the bank accounts by end-December 2003.

Once these payment arrears are adjusted for, however, there was in fact net domestic borrowing by Government of about ₵1,369 billion equivalent to 0.6% GDP. Payment arrears serve only to distort the performance path, overburdening subsequent years when the arrears are cleared.

IV. Money, Credit and Prices

2003 started on a rather uncertain note regarding the pricing of petroleum products. This issue had dogged the economy for some time. The cutting loose of this fiscal albatross unleashed on the general price level tremors that culminated in a 12.8 percentage jump in the rate of inflation for the month of February. This set the tone for the “restrictive” stance of both fiscal and monetary policy, particularly for the first half of 2003.

In light of these developments, macroeconomic targets set for the end of December 2003, were revised. In particular, the target for end-of-year inflation was revised upwards to 22% from 9%. Fiscal policy was programmed to end the year with zero net domestic borrowing by Government, thus giving impetus to the tight monetary stance bent on bringing the rate of inflation down. In the meantime, the central bank continued to build up foreign exchange reserves to appreciable levels.

The Government received a pat on the back as the country received its first-ever sovereign credit rating. Standard and Poor (S&P) rated Ghana B+ while another international rating agency, Fitch, gave Ghana a B, with a positive outlook. These ratings were important, given earlier speculations about the country’s creditworthiness being hurt by the signing on to the HIPC Initiative. Some of the factors considered in arriving at the ratings included sovereign default, good governance, socio-economic and political stability and risks associated with financial transactions in the country.

The Bank of Ghana commenced the year committing itself to achieving the Government’s inflation target of a single digit (9%) by year-end and minimizing the volatility in the exchange rate. It also decided to pursue policies to ensure that adequate bank credit was available to

support the growth of the real sector. Theoretically, the pursuit of such multiple objectives is said to weaken central bank “independence”, in as much as other policies could have more inflationary bias. For a developing country such as Ghana, and specifically in a growth and poverty framework, however, it will be foolhardy for a central bank to simply concentrate on fighting inflation to the exclusion of other important real sector objectives.

By May 2003, it was clear that inflationary pressures had begun to ease, as the monthly change in the rate of inflation slowed down substantially. In spite of the pressure abating, the Bank of Ghana maintained its “restrictive” monetary stand; oblivious of the other objectives it set itself before the inflation debacle. The prime rate was kept unchanged at 27.5 percent for the whole of the first half of the year.

The interest rate and fiscal developments affected credit to the private sector. After dipping in the first quarter, credit to the private sector increased gradually ending the year almost 50 percent above the end-2002 level. Much of the increase went to the services sector with domestic trade taking a large chunk. Credit to import trade was also greater than that to export trade. Although the service sector can be an important sector in the generation of economic growth, it is doubtful, however, if the current direction of credit can produce the type or rate of growth of the economy needed to underpin the poverty reduction targets we have set for ourselves.

The monetary targets were not met primarily because the prime rate cannot have immediate and direct impact on the money stock. If a change in the prime rate elicits a change in other interest rates, then credit will be the first to be directly affected. However, if the changes in credit result in only portfolio shifts between government and the private sector, then the net effect on the money stock may be muffled. In 2003, credit to Government fell but was replaced by increased credit to the private sector. There was significant proxy borrowing by the Tema Oil Refinery, Volta River Authority, Electricity Company of Ghana, the Ghana Water Company Limited and other suppliers to state institutions. Another source of the increase in the money stock was on account of the large build-up of international reserves. The cedi value of this build-up was over ₵4 trillion – a growth of about 140%.

V. Trade and Payments

Ghana recorded a large surplus in the balance of payments on account of substantial capital inflows and net private and official transfers. This surplus allowed the Bank of Ghana to increase its gross international reserves holdings from less than three months of imports cover in 2002 to almost five months of imports cover by the close of 2003.

The reserves accumulation, accompanied by better fiscal and monetary management and debt relief for the public sector, resulted in a relatively stable exchange rate. Thus, in spite of declining interest rates, the cedi depreciated in nominal terms by about 6 and 5 percent against the US dollar in the Interbank and Forex Bureaux markets respectively. Such levels of nominal depreciation compare only with 1998 when the cedi depreciated by 4.2 percent in nominal terms in the Interbank market and by 4.4 percent in the Forex Bureaux market. Part of the low level of depreciation against the US dollar was due to the dollar's own weakness in international markets in 2003. The US dollar, however, depreciated against the Euro, the Pound Sterling and other major international currencies in world markets.

Overall export earnings in 2003 increased by 19.3 percent above the total registered in 2002 — second only to the almost 22 percent increase of 1998. As in 1998, the increase was due to sterling performances in cocoa and gold exports - Ghana's leading traditional exports. Cocoa exports increased in value terms by 71 percent in 2003 following a 24.5 percent increase in 2002. This was the result of a 16.0 percent increase in the volume of cocoa beans exports and a 51 percent increase in the Ghana realized price.

Following almost three years of mass spraying of cocoa farms, increasing productivity and increasing real producer prices, creating incentives for replanting, better maintenance and adoption of new varieties in some cases, one can expect domestic production to increase. CEPA's estimates show that the farmers' share of the world market price of cocoa increased from 43.5 percent in 1999/2000 to peak at 63.3 percent in 2001/02 before declining to 60 percent

in 2002/2003. It is expected to rise above 60 percent in 2003/04. Similarly, the real producer price of cocoa, (defined as the farmers' cedi price deflated by the Consumer Price Index (CPI)) increased by 65 per cent over the period of administration of the present government though not in a uniform pattern – with the peak in the 2002/3 crop year.

In the case of gold, exports increased by 2.6 percent in volume terms while the Ghana-realized price increased by 17.4 percent, resulting in an overall increase in export values of 20.4 percent in 2003.

On the demand side, merchandise imports increased by 19.4 percent causing the external trade deficit to widen by almost 20 percent. Merchandise imports increased from US\$2,707 million in 2002 to US\$3,232.7 million in 2003. This was caused, to a large extent, by a substantial increase in non-oil imports. Non-oil imports increased by 21.5 percent in 2003 compared with a 10.4 percent increase in oil imports. Lack of a detailed breakdown of imports will not allow us to determine the driving force behind the increases in non-oil imports.

Net private transfers increased from US\$680 million in 2002 to US\$1,017.2 million in 2003, representing the largest net private transfers over the last five years. Similarly, the increase in official transfers from US\$220.2 million to US\$393.0 million was the largest net official transfers over the last five years.

VI. Economic Outlook

Agricultural Outlook

The outlook for the current (2004) agricultural cycle varies according to the ecological belt. In the Sahel and Guinea Savannah the rains came early and farmers expected a good agricultural outcome. However, it has been pointed out that land preparation costs tend to increase when the rains start early and weed control becomes difficult and expensive. Moreover, rising prices of compound fertilizer and sulphate of ammonia could reduce the levels of application of these supplements - developments that could have adverse consequences for productivity. Agricultural

output for 2004 would therefore depend on acreage expansion. The dominant opinion is an increase in response to better prices in both 2004 and 2005.

Fiscal Outlook

The evidence available suggests that the outlook for 2004 is most likely to differ significantly from what was projected in Budget (2004). This is because the key assumptions upon which the programme had been anchored have been overtaken by events. They include the following:

- i. Large unbudgeted-for transfers to the Tema Oil Refinery (TOR) and the oil marketing companies (OMCs) to finance subsidies on petroleum products. The Government agreed with the IMF to deregulate both the importation and pricing of petroleum and petroleum products. This policy was contained in this year's Budget. Subsequently, however, the Government reversed policy, freezing price levels for the rest of the year.

The result is the need to transfer substantial resources to finance the unplanned subsidies. CEPA had estimated a monthly average of ¢100 billion for a total of ¢1,200 billion for the year. World oil price hikes in the second half of the year point to an average monthly requirement of ¢200 billion. Thus on current indications, the total subsidy for 2004 could be ¢1,800 billion equivalent to about 2.3% GDP. And unless credible remedial measures could be found, this would wipe off the projected 2.2% GDP net repayment by Government with the domestic economy.

- ii. Large payment arrears and delayed payments on account of issuance of payment vouchers totalling about ¢444 billion after December 15, 2003, which were neither acknowledged nor provided for in the Budget (2004), are scheduled for clearance this year. These payments are in respect of road and non-road expenditures as well as subsidy transfers to the public Utilities.
- iii. Compliance with the ceiling on the public sector wage bill of ¢6,632 billion is proving problematic. The ceiling was set consistent with an average nominal wage increase of 15.8% effective March 1, 2004. It is clear from the statements of the Finance Minister and his top officials that the package agreed to at the Tripartite Committee – of

Government, employers and labour representatives – was inconsistent with the parameters of the wage bill ceiling.

- iv. There is widespread evidence that election year 2004 would not be much different from previous election years in terms of government giving in to election year spending pressures – the problem of use of incumbency.

In the face of these developments, it is clear that the 2004 economic programme needs to be carefully repackaged, agreed with the IMF, and presented for consideration and approval by Parliament before the end of the year to give it legitimacy.

In the Memorandum of Economic and Financial Policies of the Government of Ghana, attached to the letter of June 15, 2004 to the Managing Director of the IMF, the Government of Ghana committed to this:

Within the overall fiscal framework, we are undertaking some adjustments to accommodate the decision to maintain retail petroleum prices at their current level for the rest of the year.

The key assumptions include the following:

- ◆ Limiting the public sector wage bill to the ₵6,632 billion in the Budget (2004)
- ◆ Cutbacks in expenditures—both recurrent and capital—while protecting GPRS—designated poverty-related spending
- ◆ Mobilize the potential cocoa export tax windfall as well as the import duties on higher than planned imports
- ◆ Increase the net domestic borrowing to finance the budget keeping in mind the domestic debt target set for end-2005 and
- ◆ Transfer of profits from key SOEs on the basis of FAA.

There is without doubt room to project higher tax revenue collections on account of higher cocoa purchases and exports, higher non-oil imports—first half non-oil imports this year were 50 per

cent higher compared to last year—and higher consumption of petroleum products especially in the transport sub-sector. Efforts have also been stepped up to raise non-tax revenue through the enforcement of the new Financial Administration Act (FAA). Quantifying the additional revenues, however, is problematic given that some of the sources were already anticipated in Budget (2004).

The CEPA assessment of the current situation and outlook for the rest of the year and into 2005 is that given the realities of an election year, the government is most likely to opt for building on the “steady as she goes” approach of the second half of 2003.

This approach, it must be noted is realistic. Indeed the IMF itself has recognised that, the scope to make additional cuts would be very limited without cutting into poverty-related spending and hence the programme allows for most of any overrun in the subsidy bill to be accommodated by an easing of the domestic debt repayment target.

What happens to key monetary aggregates and macroeconomic indicators such as the rate of inflation, interest rates, exchange rates, and in the stock and bond markets would depend on how these fiscal problems and supply side shocks – the National Health Insurance Levy (NHIL) and the deregulation of the petroleum sector are handled by the monetary authorities.

Monetary Outlook

The requirements to

- finance the larger than planned budget deficit,
- finance both the record cocoa purchases for 2003/2004 harvest and the expected large cocoa harvest for 2004/2005 and
- provide for private sector credit needs, pose a “threat” to monetary management.

Financing the cocoa harvest by external borrowing will raise the need for mopping up by the monetary authorities to minimize the impact of the external injection.

The Current State of the Economy

The foregoing developments may, severally and jointly, have an adverse impact on future inflationary trends. The introduction of the National Health Insurance Levy could exert upward pressure on the cost of living.

Following the historical inflation cyclical trends, with the last trough occurring in September 2002, 18 months of rise would have the rate of inflation peaking in March 2005 after which there would be 18 months of decline to September 2005 in the absence of any shocks.

Using this information, and assuming there is no major shock to the economy in either direction, the year is likely to end with inflation in the neighbourhood of 14 percent. After this, again if there is no shock, then inflation will be heading towards single digit by May 2005 and down to a trough in September 2005.

It should however be remembered that the country has committed itself to de-regulating the petroleum sector early in 2005. This is likely to have a major impact on inflationary trends. Although much smaller likely impact, the NHIL introduced in August could push up the cost of living based increase of inflation from September onwards.

Trade and Payments Outlook

Some projections of cocoa production into the medium term expect continued increased output and export volumes into the medium-term. This is attributed to the incentive effect of the producer price increases and mass spraying, leading to increased productivity, replanting and adoption of the high-tech improved husbandry package developed at the Cocoa Research Institute of Ghana (CRIG). Ghana's traditional exports are expected to increase in value terms in 2004.

Gold prices have dipped below the December 2003 price of US\$408.0 per ounce since the beginning of year 2004. Market analysts suggest that gold prices will firm up in the last quarter of 2004 and strengthen in the first quarter of 2005.

Substantial increases in imports perhaps to accommodate the 2004 elections in terms of the import requirements of the political parties and the effect of increased spending by the government have been projected. Even though the government has indicated that it will not inflate expenditures because of the elections, infrastructural expenditures and arrears clearance could increase overall expenditures significantly. A large part of the impact of the increase in government spending on our foreign trade could spill over into 2005. Such spending tends to have lagged effects.

The foreign exchange market is programmed to remain stable with very low levels of nominal depreciation and continuing real appreciation of the currency in 2004. Things could however change in the first half of 2005. The Budget for 2004, while expecting that the exchange rate will be determined by supply and demand for foreign exchange, expects the Bank of Ghana to intervene to “smoothen” wide fluctuations in the rate. There is the added expectation the cedi might be allowed to appreciate in nominal terms. This, however, could threaten the build-up of international reserves and the use of the exchange rate to promote Ghana’s exports. An important caveat for any intervention in the market is that it must be subject to the maintenance of the competitiveness of Ghana’s exports and the international reserves target. The exchange rate must be seen as an instrument of external sector adjustment. We must therefore normally avoid using the exchange rate as an instrument of disinflation policy.

To conclude, the current situation and near-term outlook depend critically, in the first place, on having peaceful elections whose outcomes are widely accepted. This is important to create the requisite environment to tackle together the fiscal malaise – the trio of the wage bill, transfers to finance subsidies in the petroleum, utilities and social services (education, health and sanitation) sectors as well as the public investments in infrastructure necessary for accelerated economic growth and poverty reduction targets in the GPRS and the Millennium Development Goals.