

**GHANA ECONOMIC REVIEW AND OUTLOOK, 2005**  
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**CENTRE FOR POLICY ANALYSIS (CEPA) ACCRA**

## **INTRODUCTION**

This report presents a review of economic performance in 2004 and an outlook for 2005. Similar to the Centre's previous reports it contains an analysis of the Ghanaian economy under the following headings – Public Finance and Fiscal Operations; Money, Credit and Prices and International Trade and Payments.

Data for the analysis are mainly drawn from the Bank of Ghana, Ministry of Finance and Economic Planning, Controller and Accountant General's Department, Ghana Statistical Service, Ghana Stock Exchange, Customs, Excise and Preventive Services, Ghana Export Promotion Council and the Bretton Woods institutions.

## **PUBLIC FINANCE AND FISCAL OPERATIONS**

The chapter on Public Finance and Fiscal Operations presents key elements of the revised 2004 programme. It is against this programme that the assessment and analysis are conducted. As has now become the CEPA tradition, the assessment of fiscal performance is conducted using three measures of the overall broad balance and domestic primary balance. Conclusions regarding the fiscal stance depend very much on what measure is used. In 2004 the overall broad balance improves compared to 2003 when it is estimated on a cash basis. It is slightly worse than 2003 when calculated on a payments basis and exceeds the 2003 value by 2 percentage points as a ratio of the Gross Domestic Product when estimated on a commitments basis. Similar patterns are observed for the domestic primary balance. Thus on a cash basis one may conclude that the fiscal situation was fairly favourable even though the target for the domestic primary balance was missed by

0.8 percentage points. However, on a commitments basis, the domestic primary balance was clearly unsatisfactory since it registered a deficit rather than a surplus.

From a growth and poverty reduction perspective the concern should not only be about the size of the fiscal deficit, but also must include the pattern and effectiveness of public sector spending. There was a real increase in poverty reduction spending in 2004 compared to 2003. However, it is important that to fully assess whether spending on poverty reduction has increased over time, the definition of what comprises poverty reduction spending must be consistent. For spending on programmes and activities deemed to be poverty reducing to have the intended impact, the appropriate mix of resources – i.e. wage versus non-wage spending – should be made available, there should be efficiency in the use of resources –resources must be released on time and in the required quantities- and effective targeting to ensure that the intended beneficiaries are reached. Progress has been mixed in terms of output resulting from spending on poverty reduction and there is not enough information to assess impact. It is hoped that the ongoing fifth round of the Ghana Living Standards Survey will provide the needed data to objectively assess the impact of increased poverty reduction spending.

## **MONEY, CREDIT AND PRICES**

The different measures of money supply registered slower growth in 2004 compared to 2003. Credit to the private sector in 2004 declined by about 50 percent compared to 2003 whilst credit to government increased by almost 40 percent. This pattern contrasts with 2003 when credit to the private sector increased whilst credit to the government decreased. The active borrowing by government subvented agencies such as the Tema Oil Refinery (TOR) with credit to the private sector declining is suggestive of a crowding out of the private sector. The decline in credit to the private sector coupled with estimated arrears in 2004 suggests that the private sector faced a credit squeeze in that year.

Current research and analysis at CEPA of the year-on-year rate of inflation series shows that the series follows a regularity with a statistically robust goodness of fit. Using

monthly data over the fifteen-year period 1986 – 2000, a three-year sinusoidal pattern is evident. This pattern is referred to by CEPA as the “Economic Cycle”. The data over the period 2001-2004 support the view that significant gains have been made in macroeconomic management. Monetary, fiscal and exchange rate policies, positive terms of trade developments, historically high inward transfers of resources including debt relief and remittances from abroad and good harvests led to a considerable shallowing of the inflation cycle. Of particular interest is that the peaks in the inflation cycle have halved from 30 percent to 15 percent, whilst the troughs remain the same at 10 percent.

The year 2004 witnessed the reversal of shocks that hit the economy in 2003 – i.e. the petroleum price shock of January 2003 and the real appreciation of the cedi and the exceptionally favourable food harvest of 2003. These short-term shocks of 2003 worked themselves out of the system and the economic cycle reasserted itself with the observed rate of inflation following a downward path towards the target of about 10 percent in September 2005.

## **INTERNATIONAL TRADE AND PAYMENTS**

A stable nominal exchange rate with an incipient real overvaluation characterized the foreign exchange market in 2004. In spite of the worse trade deficit in absolute terms over the last five years and an imports bill topping 48.5 percent of Gross Domestic Product the exchange rate remained stable in 2004 and even appreciated in real terms. The exchange rate also remained insensitive to deteriorating terms of trade. Low inflationary expectations, a tendency to use the exchange rate as a nominal anchor against inflation to avoid the interest costs of inflation control, and debt forgiveness under the HIPC are the major contributors to this trend.

CEPA has pointed out the dangers of using the exchange rate as a nominal anchor against inflation on a number of occasions. The current policy to use the exchange rate to reduce interest costs generates mixed signals for business and investors. The real appreciation, implying loss of competitiveness by domestic production is a disincentive

to investment by both export-oriented and import-competing firms. This may not be compensated by any real incentives that may come from declining nominal interest rates. One other consequence of such a policy is that instead of using the more efficient and non-discriminatory tool, the exchange rate, to maintain domestic competition and protect industry, the government will –and has - come under pressure to use the less efficient and discriminatory tariff policy. Domestic industries losing their competitiveness to imports as a result of the increasing overvaluation of the currency will demand protection through the use of tariffs. Ghana has in the past experienced the effects of lobby and rent seeking associated with this scenario and could be spared the implied distortions.

Oil imports increased despite the increase in world prices because consumers were shielded from the effects of the price increases by large state subsidies. Non-oil imports also increased largely due to the appreciation of the real exchange rate that makes imports cheaper than what they should be together with election-year spending.

## **OUTLOOK FOR 2005**

On the public accounts, CEPA expects that 2005 fiscal year will be burdened with payments shifted from 2004 as well as arrears clearance in respect of road and non-road arrears from the past.

Preliminary analysis at CEPA suggests that barring any unanticipated positive shocks headline inflation may reach its lowest point of 15 percent per annum by the close of the third quarter of 2005 and begin to rise, reaching 16 percent in December 2005. From thereon headline inflation will continue to rise in line with the established trend, reaching a temporary high of 16 percent in January 2006. Subsequently it will fall sharply in February and March by a total of 5 percentage points to about 12 percent in May 2006.

CEPA has observed a three-year cyclical production pattern around a trend of the cocoa crop in Ghana, which generally reflects a weather cycle. In line with the three-year cyclical trend, cocoa output is expected to fall in 2005 after which a recovery is projected

to follow in 2006 and 2007 at an annual rate of 15 thousand metric tones per annum. The extent to which these levels of production will be sustained, however, will naturally depend on how effectively the cocoa hi-tech package is managed and on the age composition of the tree stock. The expectations of farmers will also matter, and so producer price policy could also affect the observed trend.

In contrast to the official projection in the 2005 Budget Statement, CEPA projects a decline in cocoa production in 2005. CEPA estimates an overall lower cocoa crop of about 573.4 thousand metric tons for calendar year 2005. This translates into negative growth of real Gross Domestic Product originating from the cocoa sector. Agricultural Gross Domestic Product growth performance will consequently be lower than officially projected for 2005. Thus even if the rather optimistic official growth assumptions for the industrial and services sectors were retained, overall real GDP growth will slow down. The overall effect of these developments is a net loss of 1.6 percentage points, implying a real GDP growth of 4.2 percent instead of the 5.8 percent that is projected.

Cocoa volumes and world prices are expected to be lower in 2005 compared to 2004. It is unlikely that developments in the export of gold and other commodities will be enough to compensate for the decline in cocoa export earnings. Oil imports in 2005 are likely to be lower because of the 50 percent domestic price increase that occurred in the early part of the year. The continued appreciation of the real exchange rate, however, will not put a dampening effect on the demand for non-oil imports. The net effect of these developments, therefore, is that the trade balance is not expected to improve significantly in 2005 compared to 2004.