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Ghana: Impact of the Falling Crude Oil Prices

Introduction

This paper looks at the impact of the recent falling crude oil prices on Ghana's economy. Oil production affects Ghana's economic growth while revenues from oil exports and costs of oil imports affect the government budget and macroeconomic performance. Oil thus plays a complex role in Ghana and therefore a careful look at the implications of commodity's price swing on the economy is very necessary.

The Oil Price Slump

Crude oil prices have been falling since June 2014 when it stood at US$111.8 per barrel. By the second week in January 2015, the price of the Brent crude had plunged by about 57 percent as stockpiles mounted with no sign of contraction in production. Prices recovered in May and June, suggesting that the previous severe drop was temporary. However, the downswing in prices resumed thereafter, and by the third week of August, the Brent crude had hit a six-year low of US$42.23 a barrel. Prices recovered somehow towards the end of August, with the Brent crude price reaching US$50.60 a barrel.

Oil analysts believe that the oil price recovery was a short-term relief rally after the markets had stabilized and traders had lowered their expectations for the September interest rate rise by the US Federal Reserve. Oil prices are therefore expected to remain weak in the short run as the market works off the surplus in the second half of the year.

Four reasons have been advanced to explain the oil price slump since July 2014. First, demand is low because of weak economic activity, increased efficiency, and a growing switch away from oil to other fuels. Second, the market is more sanguine about geopolitical risk. For example, the turmoil in Iraq and Libya—two big oil producers with nearly four million barrels a day combined—has not affected their output. Third, the USA has significantly increased its oil production to about 9.6 million barrels per day. Though the USA does not export crude oil, it now imports much less, creating a lot of spare supply. Fourth, the Saudis and their Gulf allies have decided not to sacrifice their own market share to restore the oil price. Saudi Arabia, for instance, ramped up its production to an all-time high of 10.6 million barrels per day in June 2014.

Oil and Ghana's Economy

Crude oil was discovered in commercial quantities in Ghana in 2007 but actual production came on stream in December 2010, with 55,000 barrels produced per day. In 2011, the structure of the economy changed dramatically as the commercial production of oil led to a significant GDP growth of 14.0 percent, making the country the highest growing economy in sub-Saharan Africa. Currently, Ghana produces about 103,000 barrels per day, and production is expected to more than double to 250,000 barrels per day by the year 2021 as output rises at the Jubilee field and other sites start production. Ghana also imports both crude and refined oil for domestic consumption since its own crude oil cannot be refined locally at the moment due to some technical reasons. Oil is thus not only an export commodity for the country, it has long been a major import commodity, requiring a careful look at the commodity's price swings.

Since 2011, Ghana has been receiving oil revenues which may continue for the next 20 years and beyond. Crude oil exports increased from US$2.8 billion in 2011 to US$3.9 billion in

2013 but dropped to US$3.7 billion in 2014. Correspondingly, total government oil revenues (comprising carried and participating interest, royalties, surface rentals and taxes) increased from US$444.1 million (16.0 percent of total oil exports receipts) to US$978.8 million (26.3 percent of total oil exports receipts) over the period. In 2011, when crude oil began to be exported, it added to cocoa and gold as Ghana's major export commodities, which together accounted for more than 80% of the country's total export revenue. Having trailed behind gold and cocoa in 2011, oil became the second biggest export revenue earner from 2012, when it contributed 22 percent of the country's total export revenue. In the first two years that Ghana exported oil, it was a net importer of the commodity. In 2013, however, the country became a net exporter of oil, exporting US$3.9 billion worth of crude oil and importing US$3.4 billion of crude and refined oil products. It is important to point out that this took place despite the fact that the country has increasingly relied on imports of refined oil products which cost a lot more than crude oil because of value addition. Not only that, but also the country has been importing crude oil at significantly higher prices than it exports in each year since 2011.

To ensure that the country was properly positioned and adequately prepared to manage the new oil boom the government prepared and placed before Parliament a Petroleum Revenue Management Bill, one month before the first oil production in commercial quantities came on stream in December 2010. The Bill was passed into law on April 11, 2011, giving birth to the Petroleum Revenue Management Act (PRMA), 2011 (Act 815). The Act provides for a portion of the oil revenue to be used for budget support, designated the Annual Budget Funding Amount (ABFA) and portions for Petroleum Funds (comprising the Stabilization Fund and a Heritage Fund). The objective of the Ghana Stabilization Fund (GSF) is to cushion the impact on or sustain public expenditure capacity during periods of unanticipated oil revenue shortfalls while the Ghana Heritage Fund (GHF) is an endowment for the benefit of future generations.

Impact of the Crude Oil Price Fall

The crude oil price fall since July 2014 has serious negative implications for Ghana's economic growth, fiscal management, and macroeconomic stability. These issues are discussed below.

Economic Growth. Ghana's real GDP growth is set to decline substantially as fiscal adjustment in response to the oil shock dampens economic activity. The projection is that real GDP growth will decline to 3.5 percent in 2015 from 4.0 percent in 2014 and 7.3 percent in 2013 before recovering over the medium term. The lowered prospects for real GDP growth will act as a disincentive for private investment and weaken the country's capacity to diversify away from oil-related sectors. This will reinforce the direct effect of lower investment in the oil sector stemming from the continuous depressed oil prices as well as the impact of the exchange rate depreciation on private sector balance sheets, and hence on investment.

Fiscal Management. The fall in crude oil prices also presents serious fiscal challenges to the government. Although the country's oil output is expected to remain unchanged at 102,033 barrels per day in 2015, the government has been forced to revise down substantially the oil revenues indicated in the 2015 Budget as a result of the oil price slump. Total oil revenues for fiscal year 2015 have been dropped by a whopping 58 percent, from GH₵4.2 billion to GH¢1.8 billion. Apart from the direct impact on oil revenues, the decline in oil prices is also likely to impact negatively on revenues from petroleum taxes announced in the 2015 Budget. For these revenues, an amount of GH¢1.25 billion (comprising GH₵1.13 billion from company taxes and GH₵124 million from the special petroleum tax imposed in 2015) is projected to be lost as a result of the fall in oil prices. Domestic-financed capital expenditure has also been revised downwards by GH₵722.8 million in the revised Budget as a result of the oil price fall. Consequently, government capital spending has fallen from 26 percent to 17 percent of total expenditure since oil production began in 2011. The cut in domestic-financed capital expenditure was the result of the expected drop in oil revenues and the ABFA, from which a minimum of 70 percent is expected to be used to support investment expenditures in line with the PRMA. The estimated transfer to the national petroleum corporation, GNPC, from the government's carried and participating interest in oil is also reduced drastically in the revised Budget. Based on the revised estimates, the fiscal deficit for 2015 has been revised upwards to 7.3 percent of GDP from the original target of 6.5 percent of GDP.

When oil production came on stream in December 2010, it was expected that the additional revenues would help reduce government borrowing from the open market (which tends to increase interest rates), thus making more funds available to the private sector. This expectation has been undermined by the falling oil prices and rather has necessitated increased borrowing by the government. As a result Ghana's public debt situation has worsened in recent years in spite of the coming on stream of oil revenues, and the country now faces a high risk of debt distress and increased overall debt vulnerability. Total public debt service-to-revenue ratio has not only assumed a rapidly increasing trend but has breached its indicative long term threshold. Debt service now absorbs a large part of domestic revenues, leaving the country vulnerable to shocks. All other debt indicators have deteriorated owing to tight domestic and external borrowing conditions, weak fiscal consolidation and weakening of the domestic currency, pointing to a greater risk of sovereign debt default over the medium term.

As a result of the oil revenue losses resulting from the continuous price fall below the projected domestic benchmark prices, the Ghana Petroleum Fund received a zero allocation during the first half of 2015, while allocations to GNPC and the Annual Budget Funding Amount were drastically cut. In addition, in early 2014, the government, already aware of the debt and debt sustainability challenges confronting the country, took a decision to cap the GSF. This allowed the government to use savings above the designated level and any future excess amount to fund the growing budget deficit. In March 2015, the government indicated that an amount of GH¢487.2 million will be withdrawn from the Ghana Stabilization Fund on a quarterly basis during the year to close the revenue gap in the Budget. In tabling the 2015 revised budget in July, the government again proposed to reduce the cap on the Ghana Stabilization Fund further down for the rest of the year. In the absence of detailed provisions in the PRMA for managing the GSF, the decision to cap the GSF and also withdraw money from it risks turning future petroleum revenues into a lifeline for an unsustainable fiscal deficit and thus increases the budget's overall vulnerability to oil price falls. The zero allocation to the GPF is also set to reduce the Funds' size and ultimately when oil prices fall there will be a larger hole to manage than would have otherwise been the case.

Macroeconomic Stability. Besides the fiscal implications, cheaper fuel helps the country to contain inflation by keeping import costs down. For consumers therefore, the fall in fuel prices is beneficial as it implies an increase in disposable income. Unfortunately, the current setup of the country's downstream petroleum sector, i.e., the oligopolistic market structure which is reinforced by the imposition of taxes and levies, is such that crude oil price downswings are unlikely to lead to any significant drop in petroleum product prices at the pump. The 2015 budget also staked the country's receipts from oil on higher prices, so with the prices falling, the expected foreign exchange inflows and thus the country's foreign reserves are set to reduce. This development is already having a serious impact on the exchange rate of the cedi which was tumbling even before the oil prices started dropping in July 2014.

The oil price fall since June 2014 presented a golden opportunity to Ghana. On the consumption side, the resultant drop in oil imports bill should help the government to end fuel subsidies and also reduce petroleum product prices at the pump. On the production side, the government could have taken a "put option" to protect the risks of oil revenue losses resulting from the price fall. On both sides therefore, there could have been a positive impact on the national budget. Unfortunately, the country missed the opportunity as the hedging program that was implemented in

2010-2012 was discontinued since January 2013. Meanwhile, a benchmark oil price of US$99.38 per barrel was factored in the 2015 national budget and with prices falling to below US$50 per barrel with no "put option" in place, this has exposed the country to huge risks.

Policy Recommendations

Oil revenues are expected to create important fiscal space for Ghana to meet its development objectives of accelerated growth and poverty reduction. There is therefore the need to pursue fiscal policy rules that ensure fiscal sustainability to cushion the economy against revenue volatility and economic underperformance. For this reason, the rules governing the use of the GSF should be reviewed to make the Fund operate as savings for the country that can only be used during national emergencies. The view here is for the government to adopt a countercyclical fiscal policy stance, viz. save the windfall oil revenue during price upswings and use these buffers during downswings. The passing of the Petroleum Revenue Management (Amendment) Act, 2015 to incorporate a lower benchmark price should indicators point towards a downward price trend over the course of the fiscal year regardless of the seven-year moving average, and also secure a revenue stream for the GSF and GHF is in the right direction.

While for fiscal reasons it is very tempting to increase taxes on petroleum consumption during periods of oil price fall, the government should not lose sight of the fact that the private sector can easily be frustrated and discouraged, and thus economic growth undermined by continuous high petroleum products prices despite the low crude oil prices. The government should therefore consider reducing taxes on petroleum products so that the private sector can take advantage of the lower oil prices and play a more active role in propelling the economy to increase its pace of growth.

Strong institutions and discipline are required to implement fiscal policies to achieve success. To this end, the government needs to improve the public financial management system, especially with regard to the budget processes. A strong and open public financial management system which ensures that citizens are well informed about the size of oil revenues, the rate of its spending and the composition of spending is very necessary. It will also introduce sound budget procedures and accountability systems and improve expenditure planning. The development of a sound institutional framework is also very important if the country is to avoid the fiscal challenges that accompany oil booms. The government also needs to amend the Financial Administration Act (FAA) and its accompanying Regulations (FAR) to address some of the institutional weaknesses and introduce some fiscal rules, discipline, accountability and sanctions in the management of public resources. There is also the need for a more transparent process in the management of oil revenues and the budget. In addition, the government needs to enact a legislation to prohibit oil-backed and forward loans. The danger with these transactions is that oil is exhaustible and its prices are volatile, therefore a commitment of oil to commercial transactions subjects the country to serious future fiscal challenges, particularly when oil prices become volatile.

Since the country's hedging program has not resumed, the economy is unable to withstand the impact of the external shock, which is exacerbating macroeconomic instability and slowdown of economic growth as oil prices continue to fall. Given that crude oil price may not recover to US$80.00 before the end of 2015, the government should move quickly to resume the hedging program to help mitigate the risks associated with future oil price swings. The government also needs to undertake the required adjustments now to ensure that its fiscal consolidation objectives are not undermined. The decision to set up a Mitigation Fund to hedge the pump price when oil prices start to rise is a good initiative which should be implemented without delay.

Since Ghana imports crude oil at higher prices than it exports its own crude oil despite the perception that the country produces higher grade oil, arrangements should be made so that crude oil importers can buy the country's own oil and save costs. But before this can work, the necessary steps should be taken to enable local refining of the crude oil produced in the country to be undertaken to serve the nation, minimize cost and help save foreign exchange.

The slump in oil prices is also a fleeting window of opportunity for the country to grab. It is now a buyers' market and importers (consumers) of oil should experience considerable savings on their oil import bills. Government should therefore exploit the opportunity and build more strategic reserves against a future rise in price. It is time to build underground storage tanks filled with crude oil across the country. Perhaps, the government may rise to the challenge by taking a cue from some countries such as South Africa and the USA where huge strategic oil reserves are maintained.

Conclusion

The fall in crude oil prices poses both a serious threat and opportunity to Ghana. On one hand, the oil price fall is leading to significant reduction in oil revenues, with serious negative implications for fiscal management, macroeconomic stability and economic growth. As a primary commodities exporting nation, the resultant decline in foreign exchange inflows and lower corporate tax receipts from the lower oil prices will reinforce the weaknesses of the domestic currency relative to the major international currencies. This has the potential to significantly affect the country's gross international reserves and balance of payments.

On the other hand, cheaper oil prices have positive macroeconomic implications. They help to contain inflation by keeping imports costs down, which is beneficial to consumers as it implies an increase in disposable income. Cheaper oil prices also affect the country's trade balance by trimming import costs, thereby providing fiscal relief to the economy. However, this requires sound fiscal policies to ensure prudent and sustainable utilization of windfall gains. The optimal approach is to adopt a countercyclical fiscal policy response that will see windfall oil revenues being saved during price upswings and spent during downswings to ameliorate the macro-fiscal volatilities induced by the commodity price cycles. The country also needs to strengthen its institutions and enhance transparency in the management of public resources to establish public confidence in the overall public financial management system and reduce governance risks associated with managing natural resource wealth.

There is also the need to take measures to mitigate the impact of price swings in a regime of market-driven oil prices. Hedging is one such effective mechanism to deal with oil price volatility risks as has been done effectively by Tullow Oil and Kosmos Energy, the two giant oil producers in the country. Government should follow Tullow and Kosmos' footsteps and pursue a hedging program to help mitigate the risks associated with future oil price swings.

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