IFS
INSTITUTE FOR FISCAL STUDIES

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The State of the Economy and the 2017 Budget Performance

1.0 Introduction

1. In line with the new Public Financial Management Act (Act 921), the Minister for Finance is required to present a mid-year review of the 2017 Budget Statement to Parliament before the close of July. The IFS has undertaken a review of the state of the economy and the Budget and wishes to submit that the prospects for the economy in the remaining half of 2017 look promising. However, based on current challenges and risks confronting the budget implementation, more needs to be done to achieve progressive fiscal adjustment, sustained macroeconomic stability and high non-oil economic growth.

2.0 Performance of the Economy and the Budget

2. Developments in the real sector of the economy during the first quarter of 2017 was mixed. Although the economy witnessed a strong overall GDP growth during the period, the growth of non-oil GDP was subdued. Real GDP grew by 6.6% year-on-year in the first quarter of the year, compared with 4.4% recorded in the same period last year. Crude oil production from the Jubilee field and the coming on stream of the Tweneboa, Enyenra and Ntomme (TEN) fields together increased oil production by as much as 58.9% year-on-year, which helped boost the overall GDP growth. Non-oil real GDP, however, grew by only 3.9% against 6.3% growth recorded in 2016, due largely to low activity in the

services sector, which grew by 3.7% in the first quarter of this year compared with 6.6% in the same period last year.

3. The fiscal performance during the first four months of 2017 was also mixed. Revenue fell short of the budget estimate by GH₵2.3 billion or 17.1% during the period, due largely to the slow growth of the non-oil sector of the economy. Total government expenditure was also lower than budgeted by GH₵3.6 billion or 20.5%. Thus while revenue fell short of the budget estimate, expenditure was cut more severely than the revenue shortfall, causing the budget to record a deficit of 1.5% of GDP, lower than the budget estimate of 2.2% of GDP. The worrisome aspect of this development is that the expenditure cut affected the much needed capital spending, payments to statutory funds, clearance of arrears as well as spending on goods and services. The deficit was also financed entirely with cedi-denominated bonds, of which non-residents bought almost all of them.

4. Public debt stock increased from GH₵122.6 billion in December 2016 to GH₵137.2 billion in May 2017. Total domestic debt increased from GH₵53.4 billion in December 2016 to GH₵63.9 billion in May 2017. External debt similarly increased from US$16.5 billion to US$17.1 billion over the period. Thus, between December 2016 and May 2017 total domestic debt increased by GH₵10.5 billion while total external debt increased by US$600 million. In relation to GDP, the public debt dropped from 73.3% at end-December 2016 to 67.5% in May 2017, caused largely by the use of a new higher projected GDP figure for the year.

5. Inflation continued its downward trend during the first half of 2017. The inflation rate, which started dropping from 17.2% in September 2016 to 15.4% in December, continued its downward trend, reaching 12.1% in June 2017. The drop in the inflation rate was due partly to the relative stability in the exchange rate and partly to the tightness of fiscal and monetary policies. The exchange rate of the cedi to the U.S dollar increased from GH₵4.20 in December 2016 to GH₵4.48 in February 2017 and thereafter dropped steadily to reach GH₵4.24 in May 2017. During the first half of 2017, therefore, the exchange rate of the cedi to the U.S. dollar depreciated by 3.7%, after coming down from a peak of 8.8% depreciation through early March, compared to the 3.3% depreciation experienced during the first half of 2016.

6. Interest rates generally trended downwards during the first half of 2017, caused mainly by the declining inflation rate. The Bank of Ghana policy rate, which declined by 300 basis points from 25.5% to 22.5% also contributed to the downward trend of interest rates. The biggest drop occurred in government short-term securities rates, with the 91-day Treasury bill rate falling from 16.8% in December 2016 to 11.9% in June 2017. The 182-day Treasury bill rate similarly dropped from 18.5% to 12.9% over the same period. Yields on other government securities declined, implying a fall in the cost of borrowing for the

government. The average lending rate of commercial banks, however, continued to remain high at 30.8% in June 2017, from 31.7% in December 2016.

7. The performance of the external sector during the first half of 2017 was generally encouraging. Total exports receipts increased to US$4.9 billion in the first four months in 2017 from US$3.4 billion in the same period in 2016, driven mainly by increased production volumes of gold and crude oil. Total imports, however, dropped sharply to US$3.8 billion in the first four months in 2017 from US$4.3 billion in the same period in 2016, with both oil and non-oil imports declining. Consequently, the trade balance moved from a deficit of US$935.7 million in April 2016 to a surplus of US$1.1 billion in April 2017. In relation to GDP, the trade account moved from a deficit of 2.2% in April last year to a surplus of 2.5% in April this year. The current account similarly recorded a surplus throughout the first four months of 2017. The capital and financial accounts however recorded a net outflow during the period due to low official inflows, offsetting the current account surpluses. Consequently, the overall balance of payments improved slightly during the first half of 2017. Gross international reserves increased from US$4.9 billion in December 2016, representing 2.8 months of import cover, to US$5.9 billion in June 2017, representing 3.4 months of import cover. The increase in the gross international reserves was due to the inflow of the proceeds from the GH₵9.7 billion (US$2.25 billion) domestic bond issued in April 2017, the bulk of which was bought by non-residents.

3.0 Some Observations

8. The IFS shares the view that the steps taken by the government during the first half of the year are yielding some positive results. However, much more is required to achieve fiscal sustainability, sustained macroeconomic stability and high non-oil GDP growth. As the Institute has pointed out before, the policy of the government to limit earmarked funds, control of exemptions and tax evasion, and the pursuance of improvements in public financial management to instill discipline in government spending are laudable. Together, these measures have generated positive investors’ response.

9. The overall real GDP growth of 6.3% projected for 2017, reflecting largely increased production of crude oil, is encouraging. Nevertheless, the IFS finds the rate of growth of non-oil GDP very disappointing. This unfortunate development is partly due to the government’s spending retrenchment, which has severely hit expenditure on goods and services, capital expenditure and arrears payment. Together, the size of the expenditure cut was GH₵3.6 billion during the first four months of the year. We know that payment of arrears helps to improve private sector liquidity and spending, while capital spending helps to support projects and also provide the much needed infrastructure, such as roads and power. Cutting back capital spending and not paying valid arrears thus hold back economic activity, with serious consequences for domestic revenue mobilization.

10. The IFS' observation in its review of the 2017 Budget that the projected revenue increase of 33.5% was on the high side, given the slower projected nominal GDP growth and wide range of tax reliefs being granted, has been proved right. From developments so far, it is obvious that the projected revenue for the year will be difficult to achieve in 2017 unless new measures are introduced to grow the non-oil economy and enhance revenue administration.

11. Without doubt, the shortfall in revenue seriously constrained government expenditure during the first half of the year, including spending on critical capital projects, payments to statutory funds and clearance of arrears. Adherence to the deficit target seems to have become an overriding goal of the government. While we recognize government's efforts to stay within the projected deficit, the danger is that the much-depressed spending could seriously constrain economic growth and job creation, and thus domestic revenue mobilization.

12. The state-owned enterprises in the energy sector continued to experience weakness in their financial positions during the review period. Their debts continued to accumulate despite efforts to restructure them. This has the potential to undermine fiscal adjustment and add to the public debt.

13. The Bank of Ghana also lowered the monetary policy rate by 300 basis points during the period under review, which together with the reduced borrowing by the government from the domestic banking system led to sharp reductions in the 91-day and 182-day Treasury bills rates. Despite this, banks' lending rates in the credit market have remained sticky downward, making the cost of credit high and private sector credit to remain around GH₵31 billion since the beginning of the year. The ratio of non-performing loans in the banking industry was also high and increasing, forcing banks to absorb the implied losses in their operational costs, thereby contributing to the high lending rates that prevailed.

14. The observed macroeconomic stability during the first half of 2017 is encouraging. Inflation is on the decline, and according to the 2017 Budget it is projected to drop further to 11.2% by the year-end. The exchange rate of the cedi stabilized, albeit at a slower pace than expected and is expected to remain so in the coming months.

15. The macro-stability achieved during the first half of 2017 was mainly the result of the tight fiscal and monetary policies pursued by the government during the period. The exchange rate stability, in particular, was supported by substantial inflows of foreign exchange from government bond issued in April this year. However, we note that the bond was issued predominantly to non-residents, creating a potential risk of future capital reversal should the exchange rate deteriorate, which will bring serious pressure on foreign reserves and the exchange rate.

4.0 Policy Measures to Address the Challenges

16. Given that the objective of the 2017 Budget to achieve strong revenue mobilization is not likely to be achieved, at least for now, there is the need for the government to introduce additional measures to enhance the revenue mobilization effort. Serious reprioritizing of spending in favor of payment of valid arrears, increasing capital spending, dealing with the budget rigidity caused by the wage bill, and interest payments would also help. The government should also enforce strictly the provisions of the Public Finance Management Act (Act 921) to deal with unauthorized, irregular and fruitless spending as well as strengthening fiscal transparency and accountability.

17. Government's objective to issue bonds to pay the energy sector enterprises debt of US$2.4 billion is welcome. It is surprising, however, that the energy sector debt has escalated to the level it is now. In fact, as at end 2012, government indebtedness to the energy sector companies was estimated to be US$1.20 billion. This was projected to reach US$1.31 billion in 2013, of which a provision for cash payment and securitization of a large part of it were planned to take place in 2013. These actions were expected to help solve the problem of arrears accumulation to improve the financial position of the companies. Unfortunately, it seems that this did not happen. Going forward, therefore, any plans to deal with the energy sector debt must be supported with measures to ensure financial viability of the enterprises in the sector.

18. To rein in non-performing loans, the government is urged to expedite action in paying regularly for goods and services supplied to public institutions as well as the payment of arrears. With inflation trending downwards, the Bank of Ghana may have to consider reducing the reserve requirement ratio from the current level of 10% to reduce the cost to banks.

19. Government should introduce measures to sustain the current macroeconomic stability and market confidence. This should involve measures to sustain the declining inflation rate, relative stability of the cedi and strengthen the foreign reserve position. Measures to ensure transparent and effective communication and strengthen ownership of policies will also help to maintain the momentum to sustain the market confidence.

20. In conclusion, the IFS submits that given the challenges and risks associated with the implementation of the 2017 budget, a lot more needs to be done at both the fiscal and macroeconomic fronts in order to achieve the objectives set for the budget. The journey has just commenced and we are yet to see how far the government would navigate its way through.

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