**IFS’ Review of the Economy Ahead of the Mid-Year Budget Presentation**

**(Press Summary)**

**Key Findings**

**Economic growth**

* The Ghanaian economy has had a decent run of growth since 2017 to the first quarter of 2019. Annual economic growth averaged 7.2% in 2017-18, the highest for any two-year period since 2012-13. First-quarter 2019 growth was also strong, coming in at 6.7% year-on-year.
* The main driver of economic growth has been extractives (mineral and petroleum) production. Although the extractives sector amounts to less than 15% of the size of the economy, it accounted for 46.7% (3.4 percentage points) of the 7.2% average growth rate in 2017-18. On the other hand, services, which provides 46% of nominal GDP, contributed 16.3% (1.2 percentage points), while agricultural production, which makes up around 20% of the economy, contributed 15.0% (1.1 percentage points) to average growth in 2017-18. In the first quarter of 2019, extractives production provided 47.5% (3.2 percentage points) of the 6.7% year-on-year GDP growth in the period. The contribution of services stood at 40.6% and of agriculture at 6.7%.
* The implication of extractives-driven economic growth is that its direct and indirect effects on employment and incomes will tend to be limited relative to growth driven by, say, services, agriculture or manufacturing. The key challenge for the government, therefore, is to improve growth in the non-extractive sector to ensure more diversified overall economic growth that significantly boosts employment and a broad range of incomes.

**Macroeconomic stability**

* The macroeconomy has enjoyed greater stability since 2017, with decreasing inflation, relative currency stability, and falling nominal interest rates—although the latter picked up in the first half of 2019 due to an increase in domestic government borrowing, especially in the first quarter of the year.
* Despite relative exchange rate stability, a few episodes of sharp surges in the exchange rate have occurred. The last of these occurred in December 2018 and persisted through January-February 2019. This was attributed largely to a sudden sell-off of domestic government bonds held by foreign investors. It appears the exchange rate has not fully recovered from this shock, as it depreciated by 8.3% in just the first half of 2019. The episode highlights the exchange-rate risk associated with the increased uptake of government securities by foreign investors. It further underlines the need for a robust policy response to the tendency for the exchange rate to depreciate rapidly at the beginning and towards the end of each year.
* Real (inflation-adjusted) interest rates are generally higher today than three years ago. For instance, the average real 91-day rate was 5.0% during the first half of 2019 as compared with 3.9% in 2016. The real average one-year Treasury rate also rose from 4.6% to 5.2% in the period. One implication of this is that nominal interest rates have potentially more room to fall, if price stability holds and government borrowing is contained. For the average real bank lending rate, it climbed from 11.7% to 16.9% over the period. Thus, after adjusting for inflation, the cost of credit from banks was higher in the first half of 2019 than three years ago. This to a large extent reflects the challenges in the banking sector, including the high rate of nonperforming loans, which stood at 18.1% in June 2019.

**Fiscal performance**

* The budget deficit—the gap between how much the government spends and how much it collects in revenue—fell to GHc12.2 billion or 4.8% of GDP in 2017 from GHc13.9 billion or 6.5% of GDP in 2016. It further contracted to GHc11.7 billion or 3.9% of GDP in 2018. Despite the appearance of fiscal consolidation, these figures do not reflect the true state of the public finances, due to the incurrence of expenditure and liabilities by the government that are outside the framework of the budget approved by Parliament. Examples are the bonds that were issued to bail out the financial sector and extra-budgetary borrowing through the Ghana Education Trust Fund (GETFund).
* Revenue collection has consistently undershot the budget targets since 2017. As revenue expectations were not fulfilled in 2017-18, budgeted capital spending was increasingly sacrificed to safeguard the government’s deficit targets. The same situation is playing out again in 2019, as the government reacted to the revenue undershoot of 17.6% (GHc10.3 billion collected against a projection of GHc12.4 billion) in the first quarter of the year by spending 4% less than budgeted (GHc16.6 billion spent versus GHc17.3 billion budgeted), with investment expenditure falling by 28.7% relative to target and bearing the brunt of the cuts. This means that, for a third straight year, central government investment spending is at risk of severe retrenchment due to underperforming fiscal receipts.
* Over the last two years, the weak-performing areas of tax revenue were the same areas that experienced most of the tax cuts enacted by the government in 2017. This suggests that the tax cuts have contributed to the government’s failure to realise its revenue expectations, as their adverse short-term impact on revenue mobilisation was underestimated.

**Public debt**

* Fiscal consolidation and relative exchange rate stability helped to reduce the debt-to-GDP ratio in 2017 to 55.5% from 56.8% in 2016. Twenty-eighteen has seen a reversal, however, of the fall in the debt-to-GDP ratio which occurred in 2017, with the growth of the nominal debt by 21.4% in that year (to GHc173.1 billion) being accompanied by a rise in the debt burden to 57.9% of GDP. The increase in the debt-to-GDP ratio in 2018 was due to the debt incurred to bail out the financial sector as, without it, the ratio would have decreased for a second straight year to 54.6% of GDP.
* Reflecting the fiscal expansion in 2019 and additional debts incurred by the government in the financial sector intervention, the debt stock rose to GHc200.0 billion in May 2019, equivalent to 58.1% of GDP. The International Monetary Fund (IMF) has forecast the debt-to-GDP ratio to worsen to 60.5% by the end of 2019.

**Key Recommendations**

* To reinvigorate nonextractive sector economic growth, especially services sector growth, which has been most negatively affected by the financial sector crisis, a robust financial sector recovery is needed. This implies, crucially, that the government must pay its outstanding bills to private sector contractors and service providers quickly to resolve the arrears overhang that has contributed to the high rate of nonperforming loans in the banking sector and limited lending. The government needs also to step up the fiscal revenue effort to protect growth-inducing investment spending from being slashed further in a bid to attain deficit targets.
* The recurrent bouts of exchange rate depreciation, especially at the beginning and towards the end of each year, require a robust and pre-emptive policy response, and steps must also be taken to limit the country’s exposure to fickle foreign investors in the domestic debt market.
* The government should strengthen the administration and mobilisation of non-direct taxes, where most of the tax revenue undershoot has been concentrated since 2017, as a way to improve revenue performance. To increase non-tax revenue, it should revise those user fees and charges levied by public agencies whose real values have declined due to little or no adjustment for extended periods. Revenue gains stand also to be derived by following through rapidly with the envisaged reform of the tax exemptions regime, in respect of which the government submitted a bill to Parliament in early 2019.
* To prevent the debt burden from persisting on an upward trajectory, the government must come forward with a strategy to set the debt ratio on a reducing course as soon as possible. The strategy should incorporate strong revenue policies, in particular, to enable critical expenditures, such as investment spending, to be protected while debt is reduced.
* The surge in extra-budgetary borrowing activities is worrying, as it hinders effective fiscal control, weakens fiscal policy credibility and transparency, and conceals the government’s true fiscal position and indebtedness. Furthermore, indulgence in extra-budgetary expenditures compromises the credibility and effectiveness of the recently-legislated budget deficit ceiling (5% of GDP) in ensuring fiscal discipline, since the ceiling is applicable only to fiscal operations covered by the budget. We believe it is time the coverage of the budget and the government’s financial statement was extended from central to consolidated general government level to fully capture all expenditure and borrowing by statutory funds, local government units, and all other institutions performing the activities of government. Presently, the narrow budget and financial statement coverage hinders a comprehensive analysis of overall fiscal policy and its macroeconomic impact, and also limits accountability.