

# **AN EVALUATION OF THE SECOND REVIEW BY THE IMF BOARD OF GHANA'S EXTENDED CREDIT FACILITY-SUPPORTED PROGRAM, 2015-17**

## **An Evaluation of the Second Review by the IMF Board of Ghana's Extended Credit Facility-Supported Program, 2015-17**

Prepared by the staff team of the IFS

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The views expressed in this paper are the views of the IFS
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## **Abstract**

This paper evaluates the IMF Board's second review of Ghana's ECF-supported program, which spans 2015-17. The review revised key macroeconomic targets that generally vindicate the Institute for Fiscal Studies' (IFS) earlier view that many of the original targets set under the program were unrealistic, in terms of being overambitious, and needed to be revisited. While most of the revised targets seem more realistic, disappointingly, many—such as growth, inflation, the public debt and current account deficit—indicate that macroeconomic instability will remain heightened for a while, whereas economic growth will be suboptimal, in terms of being below the recent historical average, unbalanced and not generating enough jobs. Achieving a turnaround in the economy will require strengthening of overall macroeconomic management. In particular, re-stabilizing the economy and placing it on a long-term path of sustained growth, job creation and poverty alleviation will necessitate strict adherence to the program's fiscal consolidation path—a task that will be greatly tested in election year 2016—buttressed by implementation of concrete growth-enhancing policies.

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## 1. Introduction

In April 2015, Ghana reached an agreement with the IMF on a financial bailout backed by a three-year (2015-17) economic program under the Extended Credit Facility (ECF). The main objective of the program is to "restore macroeconomic stability and debt sustainability." The program is supported by total financing of US\$916.8 million, representing 180% of Ghana's quota, to be disbursed in eight equal amounts of US\$114.6 million each. The first disbursement was made after the IMF Executive Board approved the program in April 2015 and the second in August 2015 after the Board completed the first review.

In January 2016, the Board completed the second review of the program and approved the third disbursement, bringing the cumulative disbursement to US\$343.8 million. In the review, the Board also approved new program targets for 2016 and 2017. The Board noted that the implementation of the program continued to be "broadly satisfactory." However, it considered the economic outlook to remain difficult, "with risks tilted to the downside." The Board expressed its satisfaction with the fiscal consolidation efforts (which it considered to be on track) and the gradual increase in electricity production capacity. The Board, however, had to grant a waiver for the nonobservance of the performance criterion regarding accumulation of external arrears, noting that corrective measures were being taken by the authorities to avoid reoccurrence.

The Institute for Fiscal Studies (IFS) has been following Ghana's ECF-backed program closely and has commented on it extensively.<sup>1</sup> The Institute's interest in the program is motivated by its mandate to contribute to shape intellectual discourse on macro-fiscal policies in order to promote better economic management in Ghana. This report is the Institute's evaluation of the second review of the program completed by the IMF Board in January 2016.

## 2. IMF Board Review

### 2.1 Revisions to Economic Targets

Key economic targets have been revised in the review, ostensibly to take account of unanticipated developments. Revisions have been made to economic growth, inflation, the fiscal deficit, public debt, the current account deficit and international reserves.

As Table 1 shows, real GDP growth has been revised downwards to 5.4% in 2016 (from 6.4%) and 8.6% in 2017 (from 9.2%). The downward revisions were informed by lower prices for export commodities and anticipated extension of the energy crisis. End-of-period inflation has been revised upwards to 10.0% for 2016 (from 8.6%) and downwards to 6.3% for 2017 (from 8.2%). The new figures suggest that inflation will remain elevated in 2016 before coming down more quickly in 2017. The overall fiscal deficit target has been reduced to 5.3% in 2016, from 5.8%, while the original figure of 3.7% for 2017 has been maintained, pointing to a more front-loaded fiscal consolidation than originally envisaged. Public debt, on the other hand, has been

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<sup>1</sup>See, for instance, The Institute's Occasional Paper No.2, "Ghana's 2015-17 IMF Program."

Table 1: Revised Economic Indicators, 2016-17

Indicator	2016		2017	
	Original Target	Revised Target	Original Target	Revised Target
Real GDP Growth (%)	6.4	5.4	9.2	8.6
Inflation (%)	8.6	10.0	8.2	6.3
Fiscal Deficit (% GDP)	-5.8	-5.3	-3.7	-3.7
Public Debt (% GDP)	67.5	72.4	62.6	69.6
Current Account Deficit (% GDP)	-6.2	-7.4	-4.9	-6.0
International Reserves				
a) US\$m	5,822	5,834	7,544	6,875
b) Month of imports	3.5	3.1	4.2	3.4

Source: IMF (Jan. 2016)

revised upwards with wide margins to 72.4% of GDP in 2016 from 67.5%, and 69.6% in 2017 from 62.6%. The revisions show a much worse debt profile than originally envisaged, resulting from more borrowing along with slower real GDP growth. The deterioration in the debt profile is confirmed by the Debt Sustainability Analysis (DSA) embedded in the program, which suggests that Ghana faces “a high risk of debt distress.”

The current account deficit has been significantly revised upwards from 6.2% to 7.4% in 2016 and from 4.9% to 6.0% in 2017. The upward revisions are driven largely by higher trade deficits resulting from lower exports due to depressed commodity prices. Imports have also been revised downwards, but the drop is not large enough to offset the decline in exports. Gross international reserves have been revised slightly up to US\$5,834 million from US\$5,822 million in 2016. In months of imports cover, however, it declines to 3.1 from 3.5. The reserves for 2017 have been sharply reduced to US\$6,875 million from US\$7,544 million and, in import cover terms, to 3.4 from 4.2. The downward revision in 2017 reflects the lower projected exports as well as downward revision to donor support.

## 2.2 Fiscal Policy

The 2016 budget has been directed at strengthening fiscal consolidation by targeting a lower deficit than envisaged in the original program, following the call by the IMF Board for a resolute continuation of the fiscal consolidation efforts. The Board points out that strict expenditure controls will be required by reining in discretionary spending while protecting priority spending.



## 2.3 Debt Sustainability

The DSA conducted by IMF-World Bank staff, and incorporated in the program document for the second review, concludes that Ghana “continues to face a high risk of debt distress.” The DSA projects the public debt as a ratio of GDP to peak at 78.3% in 2016 and thereafter drop gradually to reach 59.5% in 2020, which, in principle, could be regarded as sustainable based on the 60% threshold.<sup>2</sup> It will take up to 2035 for the debt-to-GDP ratio to drop to 40.3%. Debt service-to-revenue ratio is also projected to be as high as 77% in 2015 and then drop to 38% by 2035. The projections are based on assumptions on real GDP growth, fiscal balance, inflation, exchange rates and interest rates. The staff report that, since 2014, the World Bank has downgraded Ghana under its Country Policy and Institutions Assessment (CPIA) ranking from a high performer (with a score of 3.61) to a medium performer (with a score of 3.37).<sup>3</sup>

The Board calls for debt management to be strengthened. The IMF staff also note that sticking to the fiscal consolidation path and achieving an appropriate financing mix will be key to ensuring debt sustainability.

## 2.4 Monetary Policy and Exchange Rate Issues

With inflation closing at 17.7% in 2015 compared with the program forecast of 13.5% and the Bank of Ghana's (BoG) own medium-term target of 8.5% (+/- 2%), the Board of the IMF suggests that BoG should be prepared to tighten policy further to help bring inflation down towards its medium-term target. The Board believes that an amendment of the Bank of Ghana Act to phase out the Bank's lending to government will help make the inflation targeting (IT) framework more effective.

On exchange rate management, the review proposes reforms, including gradual phasing out of compulsory surrender requirements, which could help “deepen the market” and thereby contribute to reduce volatility.

## 2.5 Economic Growth and Poverty Reduction Policies

The ECF is essentially a financial program with the primary objective “to restore debt sustainability and macroeconomic stability,” which, in principle, should foster long-term growth,

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<sup>2</sup>In the DSA, the staff define the external debt component of public debt to cover not only central government debt (defined in Table 1 above) but also the debt of SOEs and the central bank's liabilities contracted for a reserve management purpose.

<sup>3</sup>The CPIA consists of 16 criteria grouped in four equally weighted clusters: Economic Management, Structural Policies, Policies for Social Inclusion and Equity, and Public Sector Management and Institutions. For each of the 16 criteria, countries are rated on a scale of 1 (low) to 6 (high).

job creation and poverty reduction. However, the program does not devote much attention to growth and poverty reduction policies.

## **2.6 Structural Reform Agenda**

The ECF program contains a range of structural reforms to support the fiscal consolidation process. These relate to tax, payroll, public financial management and state-owned enterprises. Various tax reforms have been proposed under the program, including strengthening tax administration and streamlining tax exemptions. The reform of the payroll is also being strengthened, including data clean-up, biometric registration, human resource audit and migration of sub-vented agencies onto the mechanized payroll system. A public financial management (PFM) law has been proposed to address some of the problems indicated above. The law provides for a strong sanctions regime for any financial malfeasance by public officials. Poor financial performance of key SOEs, in particular VRA, ECG and Ghana Water Company, poses major risks to the budget, the financial sector—to which the SOEs are heavily indebted—and the economy as a whole. The poor financial performance of the SOEs is the result of inefficiencies in their operations coupled with the prevalence of cross-debts and below-cost tariffs. The IFS therefore welcomes plans to seek World Bank assistance to address these issues, including by strengthening monitoring, evaluation, governance and accountability frameworks of the SOEs. On the issue of tariffs, while the IFS sees the economic need to allow utility providers to recover their costs, it is also important to make sure that the costs are purged of inefficiencies to acceptable industry standards in order not to pass on unjustified costs to already over-burdened consumers. The Public Utilities Regulatory Commission (PURC) should therefore work with the service providers to ensure that they operate efficiently so that justifiable cost-recovery tariffs can be determined for them.

## **2.7 Risks to the Program**

The IMF staff indicate that the program faces a number of risks, including tight financing conditions, global financial market volatility, sustained decline in key commodity prices and prolongation of the energy crisis. The Fund also contends that the government faces tight financing conditions, both externally and internally. Externally, the deterioration in the domestic economic situation that has led to the downgrading of Ghana's sovereign rating by credit rating agencies implies that the country can borrow only at very high cost. Globally, financial markets face considerable volatility, arising from uncertainties in the Euro area, unfavorable economic conditions in China and the likely policy responses to address them, withdrawal of liquidity from the markets by oil-exporting countries affected by the tumble in oil prices, and the start of US Federal Reserve policy tightening and associated higher interest rates. These factors are likely to affect capital flows to emerging market economies, with Ghana not being an exception.

Ghana's key export commodities—cocoa, gold and oil—have also seen a sustained decline in their



prices, emanating from the economic slowdown in trading partner countries, particularly China. Continuation of the low prices will pose an important risk to the program. The energy crisis in the country has also inflicted considerable harm to the economy, leading to collapse of businesses, labor lay-offs and a slowdown in growth. The timetable for the resolution of the crisis has continually delayed, and the fear is that any further prolongation could derail the program, which would be damaging to the economy's prospects for stability and eventual recovery.

### 3. Comments and Observations

The revision of key economic targets, ostensibly to take account of new developments, is not surprising to the IFS. In earlier comments we made on the program (See IFS Occasional Paper No.2), we noted that some of the targets, including growth and the fiscal deficit, were unrealistic in terms of being overly ambitious, and needed to be re-examined. The revised indicators for 2016-2017 are presented in Table 2 and discussed below.

Table 2: Selected Economic Indicators, 2011-2017

Indicator	2011	2012	2013	2014	2015	2016*	2017*
1. Real GDP Growth (%)	14.0	8.0	7.3	4.0	3.0	5.4	8.6
2. Nonoil Real GDP Growth(%)	8.4	7.3	6.7	4.0	3.0	4.5	5.5
3. Inflation (y-y) (%)	8.4	8.1	13.5	17.0	17.7	10.0	6.3
4. Fiscal Deficit (% GDP)	-4.0	-11.6	-10.5	-10.0	-7.2	-5.3	-3.7
5. Public Debt (% GDP)	42.6	49.1	56.2	69.0	74.0	72.4	69.6
6. Current Account Deficit (% GDP)	-9.0	-11.7	-11.9	-9.6	-8.2	-7.4	-6.0
7. Gross International Reserves							
a) US\$m	5,382	5,348	4,587	4,349	4,660	5,834	6,875
b) Month of imports	2.9	2.9	2.9	2.6	2.7	3.1	3.4

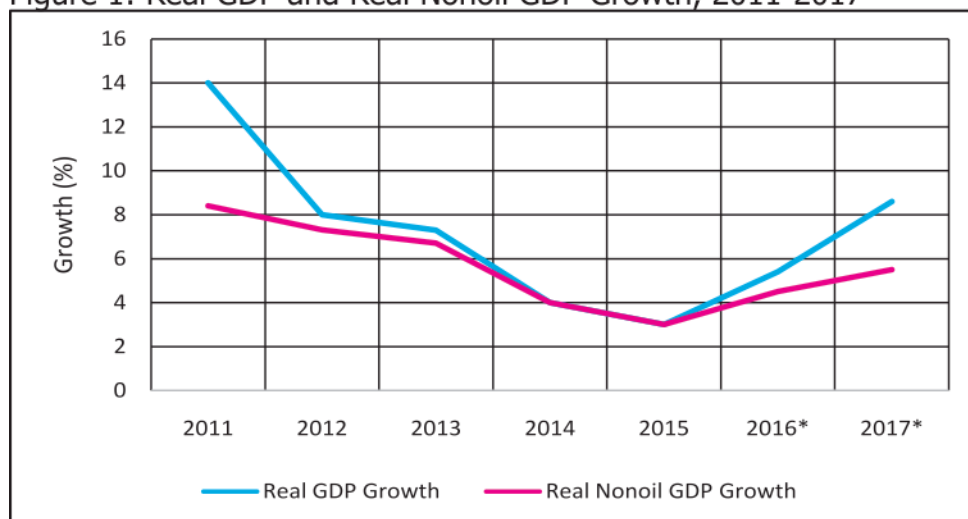
Source: IMF (Jan. 2016)\*Projections

#### 3.1 Economic Growth

The downward revisions to economic growth in 2016 and 2017 vindicate IFS's doubts about the achievability of the original estimates, given uncertainties about the energy situation, the continuing unfavorable macroeconomic environment, persisting high input costs, and subdued business and consumer confidence. The new growth figures look realistic and indicate a welcome turnaround after the sharp and progressive decline since 2012 (see Table 2).

Nonetheless, the growth is driven largely by a projected increase in oil and gas production (see Figure 1). Because they are capital-intensive activities, however, oil and gas do not generate many jobs. With no significant growth projected for agriculture and manufacturing, which have the potential to create more jobs, the unemployment situation is bound to remain dire. The situation will be further compounded by the freeze in net employment (except in education and health) imposed on the public sector under the ECF program.

Figure 1: Real GDP and Real Nonoil GDP Growth, 2011-2017



Source: IMF(Jan. 2016) \*Indicates projections

The ECF's primary objective is "to restore debt sustainability and macroeconomic stability." While recognizing that economic and financial stability, in principle, is a prerequisite for long-term growth, job creation and poverty reduction, the lack of attention to these key goals represents a major deficit in IMF-supported programs. This is the more reason why the broader government fiscal policy, which the ECF supports, should pay due attention to growth and poverty-reduction issues. The envisaged fiscal consolidation path in the ECF program should not jeopardize growth and poverty-reduction prospects. To avoid this undesirable outcome, expenditure should continue to be reprioritized in favor of development and social spending. Unfortunately, we see the brunt of fiscal consolidation as being increasingly borne by development spending. This trend is not in the interest of long-term growth and should be reversed as a matter of urgency. There is also a need to adopt borrowing strategies that avoid crowding out the private sector but rather create room for affordable credit to the sector to boost growth.

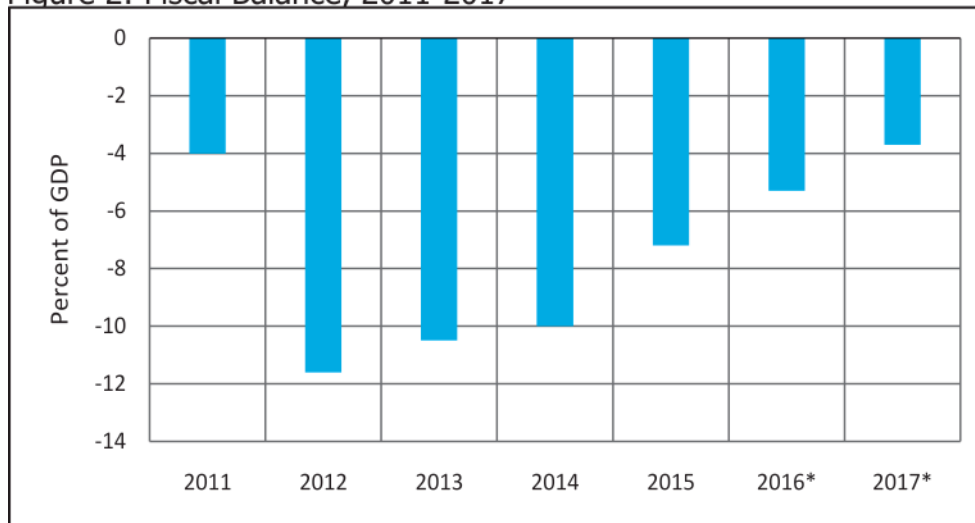
We call for the IMF program to be juxtaposed alongside the budget so as to pay due attention to rebalancing growth by addressing bottlenecks facing manufacturing and agriculture, including, as relevant, energy constraints, poor infrastructure, high cost of credit, high and multiplicity of taxes, high cost of public services, and unfavorable international trade policies.

### 3.2 The Fiscal Deficit

The downward revision of the fiscal deficit in 2016 (from 5.8% to 5.3%) implies a more front-loaded fiscal consolidation than originally envisaged (Figure 2). The IFS had suggested that the original highly-frontloaded fiscal consolidation path appeared "too optimistic," given uncertainties and rigidities in revenue and expenditure. For these same reasons, the new stronger fiscal adjustment trajectory would be even more difficult to achieve. Revenue is likely to be affected by the slowing economy and low oil prices. Meanwhile, apart from the inherent inflexibilities, expenditure faces additional election-year uncertainties, including possible pressures from labor and other constituencies. One is tempted to suggest that the apparently unusual decision to front-load fiscal consolidation and even-load financial disbursements was

possibly motivated by the envisaged political risk to the program in terms of overspending in election-year 2016, with the hindsight of such occurrences in previous election years.

Figure 2: Fiscal Balance, 2011-2017



Source: IMF (Jan. 2016) \*Indicates projections

Fiscal policy is the centerpiece and the key driver of the program. The IMF Board is therefore right in calling for resolute continuation of the fiscal consolidation efforts. The 2016 budget has appropriately been directed at strengthening fiscal consolidation by targeting a lower deficit than envisaged in the original program. The IFS has stressed the importance of a strong fiscal consolidation effort in steering the economy back on course. We therefore encourage government to stick strictly to the envisaged fiscal path.

As the Board points out, strict expenditure controls will be important in reining in discretionary spending while protecting priority spending. Appropriate measures are also required to increase domestic revenue, including the broadening of the tax base, reducing the spate of tax exemptions, strengthening tax compliance, and reinforcing tax collection efficiency. Recent measures to introduce new taxes and increase existing tax rates may however be ill-advised, as they will impose an additional burden on households and businesses that are already heavily taxed. For example, the recent increase in petroleum taxes, which has resulted in higher pump prices at a time of exceptionally low world prices and a stable exchange rate, would appear to be misplaced. Imposing taxes indiscriminately without giving due consideration to their incidence seems misdirected.

Apart from their misdirected incidence, higher taxes tend to encourage evasion and also contribute to dampen economic activity, thereby reducing government's overall revenue. Utility tariffs have also been substantially increased recently, bringing an added burden to households and businesses. While it is important that the utility companies recover their costs to remain viable, the problem is that their costs exceed, by far, industry standards and reflect high inefficiencies in the companies' operations. Asking consumers to pay for costs laden with high inefficiencies is ill-conceived.

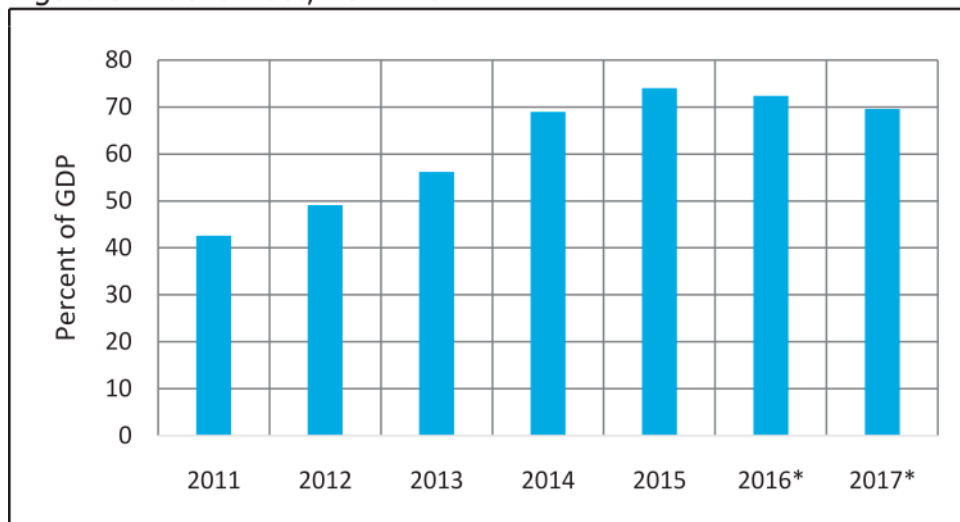


### 3.3 Public Debt

The upward revisions to the public debt-to-GDP ratio are appropriate and clearly show a much worse debt profile than originally envisaged (see Figure 3). This is the result of more borrowing along with lower real GDP growth. The deterioration in the debt profile is confirmed by the DSA embedded in the program, which suggests that Ghana faces “a high risk of debt distress.”

Ghana's public debt has risen sharply in recent years as a result of borrowing to finance high fiscal deficits, and the IFS has expressed serious concern about the country's debt and its dynamics. As of end-2015, the debt was reported to have reached GH¢99.9 billion, about 71% of GDP (Bank of Ghana, May 2016). While no single indicator of debt is a sufficient determinant of its sustainability, the debt-to-GDP ratio is often used as an international benchmark. Even this measure does not have a fixed sustainability threshold for all countries, as sustainability depends on the stage of development or structural characteristics of a country.

Figure 3: Public Debt, 2011-2017



Source: IMF (Jan. 2016) \*Indicates projections

Generally, advanced countries can carry higher debts sustainably compared with developing countries, because they have a greater resource-capacity to service the debt. For the Euro area, a reference value of 60% of GDP is set for members' debt. If this is taken to be the “sustainable threshold” for the Euro area, less developed countries, including Ghana, would have lower thresholds. Therefore, Ghana's debt-to-GDP ratio, which was reported to be around 71% in 2015, could be said to have crossed the “sustainable threshold.” This has raised concerns, including the high probability of Ghana returning to a Heavily-Indebted Poor Country (HIPC) status if serious steps are not taken to rein in the debt. It is also for this reason that the DSA in the ECF program review points to Ghana facing “a high risk of debt distress.” The DSA shows that the debt-to-GDP ratio will peak at 78.3% in 2016 before decreasing to reach 59.5% by 2020, when, by the “60% standard,” the debt could be said to have returned to a “sustainable level.” The projected decline in the debt would appear ambitious, however. Indeed, the projected trajectory is based on a number of macroeconomic assumptions relating to real GDP growth, inflation, real foreign

interest rate, current account balance and primary fiscal balance (see Table 3). The real GDP growth projections look achievable, with key drivers assumed to be higher oil and gas output and improved energy supply. Nonetheless, projected growth may not be high enough to ensure appreciable improvement in the standard of living or significant reduction in poverty over the projection horizon, which extends as far as 2035. Ghana has the potential to grow at higher rates, just as many emerging market countries have been able to do. The economy does not have to be limited to achieving growth rates averaging only 5.8 percent over a 20-year (2015-2035) horizon. In fact, Ghana has achieved higher rates of growth before in recent years even without oil, at an average of 7.5% in 2011-2013 (see Table 2). What is needed to achieve higher rates of growth are the right policy initiatives. The fact that the projected growth is largely driven by capital-intensive mining activities also implies that the impact on unemployment would be minimal. Boosting growth and generating enough employment to absorb the increasing labor supply calls for far-reaching policy interventions, especially in support of agriculture and manufacturing.

Table 3: Key Baseline Macroeconomic Assumptions Underlying DSA

Indicator	2015	2016	2015-2020	2021-2035
Real GDP Growth (%)	3.0	5.4	5.8	5.8
Inflation (GDP Deflator) (%)	14.2	12.7	9.6	7.1
Real Interest Rate (foreign debt) (%)	4.5	3.5	2.7	2.7
Current Account Balance (% GDP)	-8.2	-7.4	-6.4	-4.5
Primary Fiscal Balance (% GDP)	-0.2	1.3	1.8	0.8

Source: IMF (Jan. 2016)

The projected inflation rates also appear achievable. They do not, however, look sufficiently ambitious, given that it will take a long time to reduce inflation to high single digits. Sustaining low inflation has long been a challenge, and this has undermined economic growth prospects. Both supply-side interventions and policies to keep demand under control will be important in ensuring enduring price stability as a basis for long-term sustainable growth.

The projected current account balances embody a narrowing of the trade deficit. This trajectory is desirable, since persistent large current account deficits have undermined Ghana's external position, increasing the country's indebtedness and eroding the purchasing power of the national currency. Narrowing the external gap, however, requires increasing exports and reducing imports, a scenario that calls for major transformation of the economy through strong diversification and industrialization drives.

The projected primary fiscal balances reflect a strong consolidation trajectory. Indeed, the IMF staff point to the overriding importance of "strong fiscal adjustments and an adequate financing package" in bringing the public debt "back to a sustainable path." This will require sustained improvement in revenue generation and rationalization of expenditure, buttressed by



far-reaching reforms in budget preparation, implementation and oversight.

Regarding the financing package, we wish to stress the importance of managing accruing debt in a manner that reduces roll-over risks and vulnerability to global financing conditions. In this vein, the increasing resort by government to external borrowing through Eurobonds raises some concerns. External borrowing is being carried out at a high cost because of the current poor domestic economic conditions that have led to the downgrading of Ghana by the credit rating agencies—and also in terms of the World Bank's CPIA, as noted above. Further, the bullet feature of Ghana's Eurobonds, requiring one-time payments on maturity, increases default risks. As an alternative, domestic borrowing is equally costly, given the high rates of interest, while it also risks crowding out the private sector. There is merit in deepening the domestic debt market, and we support the IMF Board's call to step up efforts in that direction. This requires active development of the relevant institutional and legal framework. The IMF and other development partners have expertise in this area, which we encourage the government to tap.

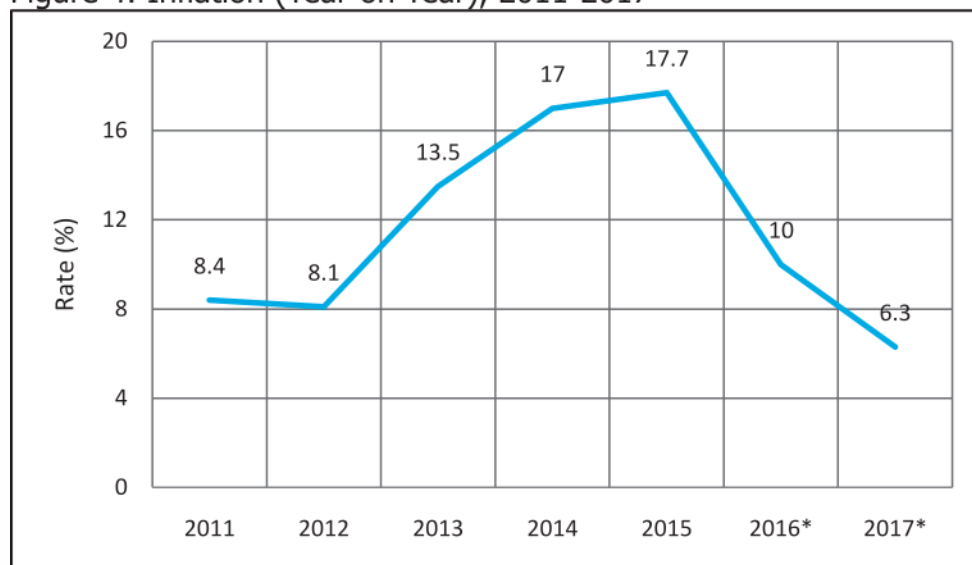
### **3.4 Monetary Policy, Inflation and Exchange Rate Issues**

The new inflation figures of 10.0% for 2016 and 6.3% for 2017 extend the horizon for inflation to move toward the medium-term target of 8.0% (+/-2%). This is generally in line with the view of IFS that the original estimates were going to be difficult to achieve. Achieving the new inflation figures would still be challenging as the underlying pressures might persist. In fact, future exchange rate movements and deregulation of fuel and utility prices may continue to put pressure on inflation. Indeed, the Monetary Policy Committee (MPC) considers these factors as representing upside risks to the inflation outlook. If changes in these factors are sufficiently large, they could further extend the horizon for inflation to fall to reach the Bank of Ghana's target.

The conduct of monetary policy by the Bank of Ghana continues to face major challenges. In 2015 alone, the Bank raised its policy rate by 500 basis points from 21% to 26%. One would have thought that this would have had a significant effect on inflation. Yet, inflation rates remained intractably high, closing the year at 17.7%. Not only was this way above the forecast of 13.5%, but it was also more than double the Bank's own medium-term target of 8.5% (+/- 2%). In January 2016, inflation rose further to 19.0%, the highest rate since September 2009, when it was 18.4%.

The persistence of inflation in spite of sharp increases in the policy rate has raised doubts about the effectiveness and credibility of the Bank's Inflation Targeting (IT) framework, which has been in place since 2002. Ironically, in the program review, the Board suggests that the Bank of Ghana should be prepared to tighten policy even further to help bring inflation down towards its medium-term target. The question we ask is: how much farther should the policy rate go before inflation can be reined in? And what will be the consequences for long-term economic growth if interest rates remain this high? The economy is actually being strangled under the weight of astronomically high interest rates that cannot even deliver official inflation targets. This points to a dilemma in the conduct of monetary policy.

Figure 4: Inflation (Year-on-Year), 2011-2017



Source: IMF (Jan. 2016) \*Indicates projections

The problem is that inflation is being driven largely by supply-side and cost-push factors relating to fuel, utility price adjustments, food prices and currency depreciation. The IT framework that is essentially designed to use the policy rate to control the cost and availability of credit and, eventually, aggregate demand cannot effectively deal with the supply-side drivers of inflation. Even on the demand side, the IT framework is further constrained by the low transmission of interest rate impulses through the economy. The program review rightly notes that further reforms will be necessary to improve monetary policy transmission, although no details are provided in the report. A sufficiently-developed and efficient financial sector will be an important factor in the transmission of monetary policy, but this will take time to materialize. Fiscal dominance and its effect on aggregate demand have also worked to frustrate monetary policy and inflation control. The Board review duly recognizes the role of fiscal dominance in undermining monetary policy. The review notes that it is for this reason that the newly-proposed Bank of Ghana Act seeks to eliminate the Bank's direct financing of the budget. However, this is a suggestion that we beg to differ with for reasons stated below.

Given the range of factors that affect inflation—both supply and demand factors—Bank of Ghana needs to broaden its arsenal of instruments for managing inflation. Furthermore, there is the need to ensure better coordination of monetary policy and government's overall economic policy. In particular, policies involving large-scale discretionary adjustments in administered prices, which frustrate monetary policy, should be avoided. We should not wait too long, often out of political expediency, before effecting these large-scale, damaging price adjustments. Making small incremental adjustments would be less harmful.

The fight against inflation should also not just focus on headline inflation, since this contains items that monetary policy, which relies on interest rates, cannot effectively control. For instance, while headline inflation in January 2016 was 19.0%, the two broad components, food and

non-food, recorded markedly different rates of inflation of 8.2% and 25.5% respectively. Food inflation has been relatively lower than non-food inflation for a long period of time. However, as a single item out of the 12 major aggregated items in the CPI, food alone carries the highest weight of 43.9% of the CPI basket. On the other hand, all the eleven non-food items carry weights ranging from 1.7% to 9.0% and totaling 56.1%. Thus, despite the fact that food has a relatively lower rate of inflation, as an individual item, it makes a disproportionately high contribution to overall inflation. Thus, the fight against inflation cannot succeed without paying attention to food supply. In more developed economies, food will not have a weight greater than 10% in the CPI. If we were able to stabilize food prices in Ghana, the cost of living would be cut by nearly half. The solution lies in a range of policy interventions, including modernization of agriculture; provision of extension support services; provision of requisite subsidies (such as improved seeds and fertilizer); improvement of supportive infrastructure, including adequate irrigation projects; improvement of marketing facilities; and provision of storage and preservation facilities to ensure availability of food all year round.

The fight against inflation should also recognize the variations in inflation in the CPI components. For instance, with headline inflation of 19.0% in January, inflation of the CPI components ranged from 8.2% and 13.5% for food and communications to 30.8% and 45.5% for transport and housing, electricity, gas & other fluids respectively. The question to ask is: what is responsible for the extremely high inflation of 45.5% for housing, electricity, gas & other fuels? If we are able to determine the reason, then instead of relying on a demand instrument such as the policy rate to fight headline (overall) inflation, we should be finding solutions rather to the high pockets of inflation through policy interventions directed at those pockets.

Apart from item variations in inflation, there are also marked differences in regional inflation. For instance, in January 2016, Upper East Region (UER) inflation was as low as 14.1%, whereas Greater Accra Region (GAR) inflation was the highest at 23.1%. The question is: what accounts for these large variations in regional inflation? In particular, we should identify the items that contribute to such low inflation in UER and such high inflation in GAR and identify policy interventions that are necessary to bring down national inflation.

The IMF Board believes that an amended Bank of Ghana Act, which will eliminate the Bank's lending to government, will make the IT framework more effective. While in theory, this should contribute to the effectiveness of the framework, it must be reiterated that as long as inflation continues to be driven by supply-side factors, the reliance on the policy rate alone, which is geared to containing aggregate demand, will not be effective in delivering low inflation. The point being made is that Bank of Ghana has to be more innovative in its choice of instruments in fighting inflation rather than resorting to the use of traditional instruments that do not seem to work.

In this vein, we are essentially proposing a "micro approach" to fighting inflation, targeting the real sources of the problem, such as food supply, administered prices and the exchange rate. This is important because the macro approach of targeting overall inflation does not appear to be working.



On the new Bank of Ghana Act, it is our view that the independence of the Bank should be carefully balanced with its accountability, in line with international best practice.<sup>4</sup> Thus, while we agree with the need to strengthen the Bank of Ghana's monetary policy autonomy, it is important that monetary policy supports the overall policy of government as the elected manager of the economy. Further, in a developing country context such as Ghana's, where the domestic debt market is underdeveloped, it is necessary for the central bank to be ready to provide some, albeit limited, financial accommodation to government when needed. Therefore, in our view, the proposal in the new Act to eliminate completely Bank of Ghana lending to government starting from 2016, except in extreme emergency cases, is premature and counterproductive and should be revisited.<sup>5</sup> In fact, we want to go as far as proposing a new lending limit of 5% of government revenue (compared with the previous limit of 10%, which also included government borrowing from the rest of the economy).

On exchange rate management, we are in favor of any reforms that will help deepen the market and thereby contribute to reduce volatility. However, we are concerned that the proposal by the IMF to phase out compulsory surrender requirements could increase the pace of foreign exchange leakage (or outflow) through the financial system, especially in light of substantial foreign ownership of the banking sector. The question is whether Bank of Ghana has the necessary supervisory capacity to prevent these leakages. We suggest that the Bank seeks technical assistance from the IMF, as needed, to strengthen its capacity in this area. It is when all the loopholes for foreign exchange leakage have been plugged that the surrender requirements can be safely eliminated.

While on surrender requirements, we wish to point out that whereas Ghana's annual balance-of-payments accounts usually show substantial amounts of proceeds earned from the traditional export commodities, only a small fraction of the proceeds accrue to Bank of Ghana. This is because of the high retention of export earnings enjoyed by the mining companies. In fact, the gold mining companies retain overseas over 70%, on average, of their earnings, with just about 30% accruing to Bank of Ghana in exchange for cedis for the internal operations of these mining companies. Comparatively, about 98% of cocoa proceeds are compulsorily surrendered to Bank of Ghana. For oil, about 18% of the total production accrues to Ghana, with the rest going to the partner companies. These figures generally point to the constraints in ensuring adequate foreign exchange supply domestically to prevent the perennial depreciation of the cedi. To turn the situation around, there is a need to revisit the agreements on foreign exchange retention by mining companies to correct any anomalies.

We also want to emphasize that managing the foreign exchange market alone cannot bring lasting solution to the perennial pressure on the cedi. The issue is how to generate enough foreign exchange to meet the high and growing demand. The problem—and the solution—lies in the structure of the economy that produces low-value-added primary products, whose prices are dictated in world markets, coupled with overreliance on imports due to the low domestic

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<sup>4</sup>The IFS has presented its views on the proposed Bank of Ghana Act for the consideration of the authorities in a paper: **"Amending the Bank of Ghana Act, 2002 (Act 612)?"**

<sup>5</sup>We made this point strongly in both our Occasional Paper No.2 and in proposals regarding Amendment of the Bank of Ghana Act.

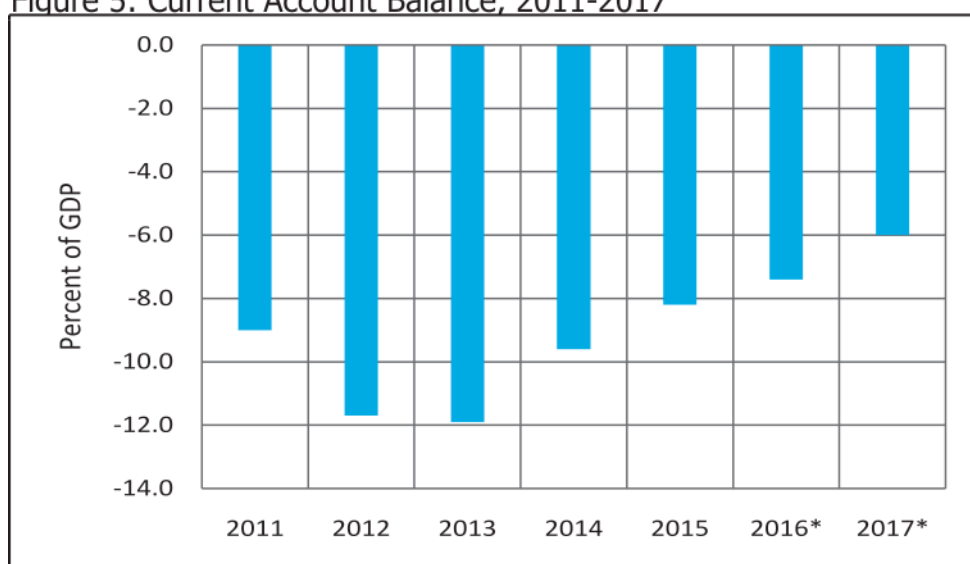
industrial production capacity. Addressing the exchange rate problem on a durable basis calls for transformation of the economy from its “colonial structure” through export diversification and value addition in conjunction with a strong domestic industrialization drive to foster production of wide-ranging import substitutes.

### 3.5 Current Account Deficit and Gross International Reserves

The upward revision in the current account deficits is driven largely by higher trade deficits resulting from lower export earnings due to depressed commodity prices (see Figure 5 below). Since 2014, commodity prices have remained generally depressed. During the period, cocoa prices have fluctuated between US\$3,400 and US\$2,700 per ton, gold prices between US\$1,325 and US\$1,050 per ounce, and crude oil prices between US\$105 and US\$30 per barrel (See Figures 6-8).

Although imports have been revised downwards, the drop is not large enough to offset the decline in exports. The projected impact of low commodity prices reveals Ghana's vulnerability to export price shocks as a result of underlying structural weaknesses of the economy, and which call for a strong transformation drive to diversify the economy and add value to the country's exports.

Figure 5: Current Account Balance, 2011-2017



Source: IMF (Jan. 2016) \*Indicates projections

The sharply reduced reserves figures for 2017 to US\$6,875 million from US\$7,544 million reflects the lower projected export earnings as well as downward revisions to donor support. The projected lower reserves imply that the cedi could come under some pressure. If this happens, it will feed into domestic inflation. It is partly for this reason that we noted above that the inflation outlook may be less optimistic than projected.



Figure 6: Cocoa Prices, 2014-2016



Source: NASDAQ, New York

Figure 7: Gold Prices, 2014-2016



Source: NASDAQ, New York

Figure 8: Crude Oil Prices, 2014-2016



Source: NASDAQ, New York

Revisions to program targets are commonly made to take account of unanticipated developments. However, if the revisions become widespread and more frequent, they may be seen as a sign of weak commitment to the program. This will not only compromise the integrity of the program, but it will also send a wrong signal to the markets and potential investors. Therefore, to the extent possible, changes to key variables, especially those that are seen to be reasonably under the control of government, should be kept to the minimum.

### 3.6 Structural Reform Agenda

a) Tax reforms: Ghana's tax effort, estimated to be 17-18% of GDP, is still low by middle-income country levels (which average around 25%). There is room to increase this effort. The low tax effort is the result of the narrow base, low compliance, high level of exemptions and deficiencies in administration, among others. We welcome the various measures proposed to address, specifically, tax administration and exemptions. Efforts are also required to broaden the tax base. That should help avoid the indiscriminate resort to increases in existing taxes and introduction of new ones without due regard to their incidence and, in particular, the further hardship they place on already-overburdened taxpayers and the poor.

b) Payroll reform: It is known that the public sector wage bill consumes a disproportionate share of government revenue. As such, payroll reform should be an important component of fiscal

reforms and fiscal consolidation. Therefore, we welcome the attention accorded payroll reform in the ECF. However, in all this, what gets relegated to the background is overall public sector reform, without which the sector will continue to overburden the budget. Public sector reform has been on the drawing board for a long time but has been stalled by successive governments because of lack of political will to implement it. In particular, there is a need to downsize the public sector to make it more productive. When this is done, it will make it possible to improve remuneration in the sector so as to attract the best skills while avoiding the perennial agitations for improvement in service conditions.

c) Public financial management reforms: Public financial management (PFM) in Ghana has been characterized by serious shortcomings. Spending overruns have become commonplace and serious financial leakages occur through misappropriations, payment of dubious judgment debts and other financial malpractices. In other words, fiscal indiscipline has become an entrenched practice. These problems have festered amid severe weaknesses in PFM legislations and oversight institutions. In the light of these shortcomings, we welcome the proposed PFM law and hope that it will address some of the problems indicated above. Our information is that the law provides a strong sanctions regime for any financial malfeasance. We very much welcome this because a major loophole in existing PFM legislations is lack of strict sanctions, allowing breaches to occur regularly with impunity. Our only concern is that the drafting process appears to have been rushed (it was a structural benchmark in the ECF for end-2015) and, as such, it did not benefit from widespread consultations with, and inputs from, key stakeholders.

d) SOEs-related reforms: Poor financial performance of key SOEs, in particular VRA, ECG and Ghana Water Company, poses major risks to the budget, the financial sector—to which the SOEs are heavily indebted—and the economy as a whole. Their difficulties are the result of inefficiencies in their operations coupled with the prevalence of cross-debts and below-cost tariffs. We therefore welcome plans to seek World Bank assistance to address these issues, including by strengthening monitoring, evaluation, governance and accountability frameworks of the SOEs. On the particular issue of tariffs, while we see the economic need to allow utility providers to recover their costs, we also see the need, as we noted above, to make sure that the costs are purged of inefficiencies to acceptable industry standards in order not to pass on unjustified costs to already over-burdened consumers. The Public Utilities Regulatory Commission (PURC) should work with the service providers to ensure that they operate efficiently so that justifiable cost-recovery tariffs can be determined for them.

### **3.7 Program Financing**

All along, IMF staff have described the ECF as “front-loaded.” This would seem to apply to the disbursements under the program. However, the total financing of SDR664.200 million approved for the program is scheduled to be disbursed in eight equal tranches of SDR83.025 million each between April 3, 2015 and March 15, 2018.



The “front-loading” in this context rather refers to the fiscal adjustment schedule. During the program period (2015-17), the overall fiscal deficit is scheduled to be reduced by 3.0 percentage points to 7.2% of GDP in 2015 from 10.2% in 2014; by 1.9 percentage points in 2016 to 5.3%; and by 1.5 percentage points in 2017 to 3.7%. This confirms that the fiscal adjustment schedule is front-loaded. The problem with this front-loaded adjustment, however, is that it necessarily entails initial significant increases in taxes and/or cuts in expenditure. These adjustments usually bring hardships to both households and businesses and tend to slow down economic growth. As we suggested in our Occasional Paper No. 2 on the ECF, the fiscal adjustments should have been supported by front-loaded financial disbursements. That would have cushioned the associated pain while ensuring reasonable economic growth under the program.

### **3.8 Risks to the Program**

First, the government faces tight financing conditions both externally and internally. Externally, the deterioration in Ghana's domestic economic situation that has led to the downgrading of Ghana's sovereign rating by credit rating agencies implies that Ghana can borrow only at very high cost. The issuance of a US\$1.0 billion (out of a planned US\$1.5 billion) Eurobond late last year at a high yield of 10.75% attests to the low investor appetite for Ghana's debt. Internally, interest rates are prohibitively high, implying that government can only borrow at a high cost. This problem is compounded by what we consider to be an ill-advised proposal by the IMF to eliminate totally government borrowing from Bank of Ghana, which means that future government debt will be issued only to the rest of the economy. This restriction will not only put further pressure on the yields but could also crowd out private sector borrowing. As we suggested elsewhere in this report, rather than abruptly eliminating government borrowing from the central bank, the borrowing should be phased out gradually over several years.

Second, global financial markets face considerable volatility. This is likely to affect capital flows to emerging market economies, with Ghana not being an exception. In the circumstance, Ghana may have to turn to the domestic market for most of its financing needs, a scenario that could push up interest rates further and crowd out the private sector.

Third, the sustained decline in the prices of Ghana's key export commodities and the risks it poses to the program highlight Ghana's long-standing vulnerability to shocks to commodities on which the economy heavily depends. As we mention variously in this report, the answer is to transform the economy from its “colonial structure” by diversifying exports and promoting domestic industrialization.

Finally, the energy crisis has inflicted considerable harm to Ghana's economy, leading to collapse of businesses, labor lay-offs and a slowdown in growth. The timetable for the resolution of the crisis has continually delayed. At the time of the program review, the future of the energy crisis was still uncertain and the Board saw it as a potential risk to the program. Subsequently, there has been some improvement and the energy situation has somewhat stabilized. It is hoped that this will be sustained, otherwise the economy's prospects for stability and eventual recovery could be jeopardized.

## **4. Conclusion and Recommendations**

### **4.1 Fiscal Consolidation**

The program is designed with front-loaded fiscal consolidation and even-loaded financial disbursements. This scenario must have been motivated by the need to elicit early government commitment to the program in an election year usually characterized by spending overruns. Frontloading austerity measures such as tax increases, (net) employment freeze and elimination of consumer subsidies without an adequate financing cushion, however, increases the economic burden on the citizenry. That said, we urge government to adhere strictly to the fiscal path as this is critical to the achievement of the program's overall objectives. This requires measures to sustain improvement in revenue generation (without necessarily increasing the incidence-burden on already-overtaxed households and businesses) and rationalize expenditure (by reducing waste and increasing capital and social spending), buttressed by strengthened budget preparation, implementation and oversight.

### **4.2 Debt Sustainability**

Debt sustainability is one of the principal objectives of the program. Two key ingredients for bringing the public debt back to a sustainable path are strong fiscal adjustment and an appropriate financing package. The importance of fiscal consolidation for the overall success of the program has been sufficiently stressed, and it is even more relevant for debt sustainability. Regarding the financing package, there is a need to carefully balance the use of external and domestic resources so as to reduce the overall cost of borrowing. There is merit in deepening the domestic debt market to ensure ready availability of affordable financing. This requires active development of the relevant institutional and legal framework, tapping the expertise of the IMF and other development partners.

### **4.3 Inflation Management**

Inflation management by Bank of Ghana has been generally ineffective. This is largely because the Bank has solely relied on a policy rate, essentially a demand-management instrument, to tackle current inflation that is largely supply-driven. To be effective, the Bank needs to broaden its arsenal of instruments and adopt a "micro-approach" that directly targets the primary sources of inflation, such as food supply, administered prices and the exchange rate. This approach should be employed in tandem with overall government policy also tailored to addressing the problems associated with these primary drivers of inflation.

### **4.4 Foreign Exchange Management**

Reforms that will deepen the foreign exchange market and reduce volatility are to be welcomed. However, the proposal to eliminate surrender requirements should be carefully considered. In



particular, steps should be taken to equip Bank of Ghana to be able to check potential foreign exchange leakages through the financial system before the new mechanism becomes operational. Measures should also be taken to reduce retention of export proceeds abroad, especially by mining companies. Ensuring that export proceeds are repatriated into the country is important in deepening the domestic foreign exchange market and thereby reducing exchange rate volatility. Also, it has to be emphasized that the answer to the perennial exchange rate depreciation does not lie in the effective management of the foreign exchange market alone, but requires fundamental transformation of the economy to increase and diversify exports while also increasing domestic production of import-substitutes.

#### **4.5 Economic Growth and Poverty Reduction**

The ECF program, as is typical with IMF programs, does not, in and of itself, incorporate adequate policies to promote growth and reduce poverty. In fact, the brunt of fiscal consolidation is increasingly borne by development spending. This trend is not in the interest of long-term growth and should be reversed within the context of overall government policies. Overall government policy, which the ECF supports, should pay more attention to harnessing the full growth potential of the economy. In particular, direct policy interventions are required to support the backbone agriculture and manufacturing sectors that have greater potential to increase growth, generate employment and reduce poverty.

#### **4.6 Risks to the Program**

The program faces risks that could affect it one way or another. Tight financing conditions at home and abroad imply that borrowing costs may be high. That is the reason we suggest that government borrowing from the central bank should not be abruptly stopped as planned, but that limited borrowing should be in place for a while as the domestic capital market is being developed. The possibility of a sustained decline in the prices of commodities also poses a risk to the program. This highlights Ghana's long-standing vulnerability to shocks to primary low-value export commodities. There are no short-term solutions to this problem. But we must begin to take steps now to transform the economy from its "colonial structure" by diversifying exports and promoting domestic industrialization. The energy crisis has inflicted considerable harm to Ghana's economy, leading to collapse of businesses, labor lay-offs and a slowdown in growth. While supply has somewhat stabilized, it needs to be sustained through diversification of generation capacity and promotion of consumption conservation methods, otherwise the economy's prospects for stability and eventual recovery could be jeopardized.

The greatest risk to the program is probably the election-cycle factor, which entails spending overruns every election year since 1992. The government has given its strong commitment that this syndrome will not reoccur this time around. We wish to take government by its word and to urge strict adherence to the program so as to avoid plunging the economy into another major crisis that might necessitate an unwarranted post-election return to the IMF for another bailout.