# OIL DISCOVERY AND FISCAL DISCIPLINE IN GHANA: OIL CURSE BEFORE THE OIL?

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An excessive fiscal expansion in the run-up to the December 2000 Presidential and Parliamentary elections had tipped the Ghanaian economy into a vicious cycle of intense inflation and currency depreciation, and this coincided with a sharp deterioration in the commodity terms of trade. In the short span of one year ending December 2000, the national currency, the cedi, virtually collapsed, losing 50 percent of its value vis-à-vis the US dollar. The country's gross international reserves were so depleted that it could not cover a month's imports and external payments arrears were building up.

Against this background, peaceful democratic elections in 2000 resulted in a change in government from the ruling National Democratic Congress (NDC) to the New Patriotic Party with John Agyekum Kufuor elected as President. This was a landmark election because it was the first change of Government through the ballot box since a military government transformed into an elected one in a democratization process that began in 1992. The new Government espoused good governance, freedom of the press, respect for the rule of law, transparency and accountability, and a liberal economy based on a private-sector-led growth strategy for wealth creation and poverty reduction.

The immediate focus was to restore macroeconomic stability. This meant a major shift in macroeconomic policies from one of considerable fiscal relaxation and monetary accommodation to one of fiscal stringency and monetary. A major pillar of the macroeconomic stabilization process was old-fashioned fiscal consolidation. The central government budget was cast in a medium term framework right from the start, and to set public finances on the course of fiscal consolidation to cut the budget deficit and stabilize the domestic public debt. This called for robust revenue mobilization (to increase the flexibility of the revenue base and reduce fiscal vulnerability) and prudent spending, indeed the fiscal program for 2003 set a target of zero net domestic financing of the public sector borrowing requirement for 2003.

The Government's fiscal policy strategy from 2001 was underpinned by a debt reduction path aimed at ensuring the availability of enough financial resources into the economy for the private sector to access for increased economic activity. Ghana therefore built a track record of good governance, growth and poverty reduction underpinned by macroeconomic stability that made it eligible for HIPC debt relief. Under the Multilateral Debt Relief Initiative (MDRI) Ghana's debt relief amounted to $4.2 billion in nominal terms. After reaching the completion point of the enhanced HIPC initiative and also qualifying for the Mutli-Donor Relief Initiative (MDRI), Ghana's external debt was significantly reduced from a level of 156 percent of GDP in 2000, to 17.2  percent of GDP by 2006 (Table 1)

Monetary policy was underpinned by the adoption of an inflation-targeting framework for the conduct of monetary policy; with the central bank, taking advantage of the statutory independence that Parliament has enshrined in the Bank of Ghana Act (2002).

The fiscal and monetary policy framework that was put in place resulted in a decline in inflationary expectations and a strengthening external payments position. Headline inflation declined from 40.5 percent in 2000 to 12.7 percent by 2007 and the overall balance of payments was in surplus between 2001 and 2007 (except for the deficit of $10.5 million recorded in 2004). Gross international reserves increased from $233 million (less than one month of import cover) in 2000 to 2,836 million by 2007 (some three months of import cover).

*Table . Ghana: Selected Economic Indicators – (2000-2008)*

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | (Annual percentage change unless otherwise stated) | | | | | |
| Real GDP | 3.7 | 4.2 | 4.5 | 5.2 | 5.7 | 5.8 | 6.4 | 6.3 | 7.3 |
| Inflation | 40.5 | 21.3 | 15.2 | 23.6 | 16.4 | 13.9 | 10.9 | 12.7 | 18.1 |
| Broad Money | 46.5 | 41.4 | 50.0 | 35.8 | 25.9 | 14.3 | 39.1 | 36.3 | 37.0 |
| Reserve Money | 52.6 | 31.3 | 42.6 | 28.2 | 18.5 | 11.2 | 32.3 | 30.6 | 34.1 |
| ExRate Deprectn | 49.8 | 3.7 | 13.2 | 17.3 | 2.2 | 0.9 | 1.1 | 4.8 | 20.1 |
| 91-Day TBill | 38.0 | 27.0 | 26.6 | 19.6 | 17.1 | 11.8 | 9.6 | 10.6 | 24.7 |
| BOG Prime Rate | 27.0 | 27.0 | 24.5 | 21.5 | 18.5 | 15.5 | 12.5 | 13.5 | 17.0 |
| Gross Reserves ($m) | 233.4 | 364.8 | 640.4 | 1425.6 | 1732.4 | 1894.9 | 2269.8 | 2836.7 | 2036.0 |
| Months of Imports | 0.84 | 1.2 | 2.2 | 3.2 | 3.3 | 3.5 | 3.0 | 2.7 | 1.8 |
| Overall Bal. ($m) | -116 | 8.6 | 39.8 | 558.3 | -10.5 | 84.3 | 415.1 | 413.1 | -940 |
| Crude oil ($/barrel) | 25.93 | 25.5 | 29.9 | 29.5 | 41.7 | 56.8 | 58.1 | 94.1 | 98.5 |
| NPLs % | 11.86 | 19.6 | 22.7 | 18.3 | 16.1 | 13.0 | 7.9 | 6.9 | 7.6 |
| External Debt ($m) | 6021 | 6025 | 6131 | 7548 | 6447 | 6347 | 2172 | 3590 | 3871 |
| Debt Serv/Exports | 28.1 | 16.4 | 10.1 | 4.9 | 7.2 | 7.7 | 4.5 | 4.6 | 4.3 |
| | | | | (In percent of GDP) | | | | | |
| Budget Deficit | 8.6 | 7.7 | 4.9 | 3.2 | 3.2 | 2.0 | 7.8 | 8.1 | 14.5 |
| External Debt | 156.3 | 115.9 | 105.9 | 101.0 | 73.1 | 59.6 | 17.2 | 24.9 | 27 |
| Debt Service | 14.1 | 5.9 | 3.5 | 1.7 | 2.2 | 2.0 | 1.3 | 1.3 | 0.4 |
| Ext debt ser($m) | 544.8 | 306.6 | 204 | 126 | 194.9 | 215.2 | 166.7 | 192.5 | 52.2 |
| Cur A/c Bal | 10.16 | 10.7 | 4.3 | 1.3 | 9.7 | 12.6 | 13.1 | 16.1 | 24.2 |

Ghana’s overall debt profile was significantly improved with the debt burden well within the threshold of sustainability, unlike its previous HIPC status. Ghana’s external debt (thanks to HIPC relief) had declined from some $6.1 billion in 2000 to 3.59 billion by 2007 (including the sovereign bond of $750 million issued in 2007).. Furthermore, the debt service/exports ratio, i.e. the proportion of exports used to service Ghana’s debts declined from 28.0 percent in 2000 to 4.6 percent by 2007.

These developments resulted in the return of relative stability to the foreign exchange market. After depreciating by some 50.0 percent against the US dollar in 2000, relative exchange rate stability was restored in 2001 with a depreciation of just 3.7 percent in 2001. After depreciating by 13.1 percent 17.3 percent in 2002 and 2003, the cedi depreciated against the dollar by 2.0 percent in 2004, 0.9 percent in 2005, 1.1 percent in 2006, and 4.8 percent in 2007, anchored by declining inflation expectations. Between 2004 and 2007, the cedi depreciated by an average of 2.25 percent against the U.S. dollar. Placed in the context of the historic instability of the cedi and the 2000 experience of some 50.0 percent depreciation, this level of stability of the cedi was remarkable. On the basis of the fundamentals, the real effective equilibrium exchange rate in 2006 was close to its equilibrium level.

Ghana therefore had put in place sound economic policies to underpin its macroeconomic policy framework.

**THE DISCOVERY OF OIL**

In June and August 2007, United Kingdom-based firm Tullow Oil and its U.S. partners, Kosmos Energy and Anadarko Petroleum, announced two significant offshore oil discoveries in the Mahogany field off Ghana’s Coast. The initial estimate was that this discovery could yield recoverable reserves in excess of 1.3 billion barrels. The two discovery wells are 5.3 kilometers apart on adjacent licensed fields, but straddle a single geological structure. The government was optimistic that it will have a significant positive effect on the economy and reduce Ghana’s reliance on oil imports. Initial production of oil was projected to begin in 2010.

The discovery of oil also coincided with a number of factors:

- By the end of 2006, there was what can be termed as "stabilization fatigue". Politicians wanted to move from stability to growth through major investments in infrastructure – roads, power, water, railways, ICT, etc.
- The Completion of Ghana's PRGF program with the Fund was an opportunity to pursue the growth agenda without having to worry about IMF conditionalities.
- The hosting of the African Cup of nations in 2007 which required the building and rehabilitation of four stadia
- A fiftieth anniversary of independence which was celebration.
- A global food crisis which resulted in increases in the price of food and government sought to protect consumers through removal of taxes.
- A global unprecedented increase in oil prices reaching $147/barrel which the government did not pass through to consumers but absorbed.
- The country was hit with a major energy crisis in 2007 as a result of low water levels (with low rainfall) at the hydroelectric Akosombo Dam , the country's primary source of energy supply. Emergency power supply was contracted which proved to be very expensive given the very high oil prices.
- An impending election in December 2008
- Expenditure of the $750 million proceeds from the sovereign bond issue (3.5% of GDP).

The economic environment in 2007/2008 had therefore turned for the worse, underpinned by both domestic and external developments. In the face of these developments government faced the choice of fiscal contraction, full-cost recovery for utilities, postponement of committed expenditures or continued fiscal expansion.

Government was unable to bite the bullet and allow full-cost recovery in petroleum and electricity prices in the presence of rising food prices for political reasons. There was also the economic argument that as the world was heading towards a recession, what was needed was countercyclical policies and therefore aggregate demand needed to be increased in the interim. The public finances would then be balanced when the crisis was over, and when the oil started flowing in 2010. For a government facing an imminent election, this was a persuasive arguments. The was an apparent decision not to sacrifice growth and jobs on the altar of macroeconomic stability in the short-run. The Government was convinced that the economic difficulties being experienced would be abated soon through a reversal in the price trends (of oil in particular) and the forthcoming oil revenues. More importantly, the government faced an election in 2008 and did not want to hand the opposition a political gift by increasing the economic hardships faced by the population. The natural resource discovery only served to give a false sense of greater fiscal space that was the case. In this environment, 2008 became a very difficult year for economic management.

For Government, the dash for growth boiled down to finding sufficient resources. The problem was not one of expenditure but one of revenue and resource mobilisation to meet the expenditure increases. There was to be no compromise on the growth agenda. The fiscal policy stance of Government in 2007/2008 however had consequences, and the economy, which had all the prerequisites for a successful take off (good governance, sound economic management, institutions, etc.), suffered a setback with inflation increasing from 10.9 percent at the end of 2006 to 18.1 percent at the end of 2008 and the exchange rate depreciating by 20.1 percent in 2008, compared with 1.1 percent in 2006. The budget deficit increased from 7.8 percent of GDP in 2006 to 14.5 percent of GDP, by 2008. The current account deficit at similarly increased from 13.1 percent of GDP in 2006 to 24.2 percent of GDP by end 2008. Gross international reserves declined from $2.26 billion (3.0 months of import cover) in 2006 to $2.03 billion (1.8 months of import cover) in 2008. Oil production was expected in the last quarter of 2010 at the earliest.

The beginnings of the oil curse in Ghana were thus evident before the first drop of oil was exported. Unfortunately, this lesson does not appear to have been learnt by the new Government of the National Democratic Congress which won the 2008 Presidential and Parliamentary elections. In an attempt to fulfil its campaign promises, the Government has embarked on a major increase in borrowing with an eye on the newly discovered oil resources. Ghana's domestic debt has more than doubled from GHC4.8 billion (the equivalent of $3.3 billion) at the end 2008 to GHC10.8 billion at the end of June 2011. External debt on the other hand has increased by over 50% from $4.03 billion to $6.33 over the same period. What is more worrying is that Ghana's Parliament has approved loans totalling over $10 billion over this same period (i.e. within two and a half years) including loans for 200,000 houses from South Korea and a $3.5 billion loan from China for infrastructure projects, some of which are yet to be evaluated. While the discovery of oil has provided Ghana with the fiscal space to borrow, there is a clear and present danger flowing from a lack of value for money assessment, debt sustainability and lack of adequate preparation on how these loans would be spent, and a lack of transparency in the terms of the loans. These major borrowing commitments would inevitably require cuts in expenditures in the near future to maintain fiscal sustainability but the record in Ghana, as in many countries, does not offer much hope that the politicians are able to take these tough spending decisions.

The major issue from the experience of Ghana thus far with its natural (oil) discovery is that there is no institutional mechanism to check unsustainable fiscal expansion. The recent passage of a Petroleum Revenue Management Act has not provided the required fiscal anchor. It is conceivable that a *Fiscal Responsibility Act* with hard limits and penalties on Government over-expenditure (including the use of natural resource proceeds) would have forced some of the difficult choices on government. Looking back, Ghana's experience also speaks to the need for a cross-party consensus on the use of natural resource revenues backed by parliamentary oversight. This is because of the temptation of any political party to put current electoral imperatives ahead of future needs of the country when they make decisions about the use of natural resource proceeds, sometimes even before the proceeds are realised. A cross –party consensus on the use of actual or potential proceeds of a natural resource discovery would make these resources less subject to political attacks.