

## Guarded Optimism

### Economic growth to rebound, but policy will be key driver

#### Overview

GDP growth for Ghana is likely to surge to 6.3% in 2010 (2009: 4.7%), but any resurgence in growth must be supported by an expansionary monetary and fiscal policy during the period. The economy is set to produce crude oil in commercial quantities by October 2010 (with an estimated 120,000bpd), which will change both the structural and growth dynamics of the country. Average GDP growth forecast between 2010 and 2015 is 10.5%, which is significantly higher than the average of 5.5% over the last decade. **Nevertheless, this optimism is guarded by lessons from existing mineral contracts and lack of a coherent national development policy.** In our view, although the oil and gas industry can potentially push output growth above a poverty reducing level of ~8%, we urge the government to press on with strong, enforceable contracts which provides for significant local content.

#### Short Term Outlook

**In our opinion, interest rates will decline (in line with improvements in public sector borrowing requirements), while inflation and currency risk will be minimal over the next 12 months.** Inflation will decline due to improvements in domestic food production, while improvements in gross international reserves will also enhance currency stability. Government policy within the next two years will be targeted at stimulating growth and creating jobs. There are indications that the focus of monetary policy will shift somewhat from inflation targeting to growth. Nevertheless, the extent to which monetary authorities can accommodate fiscal expansion will depend on the country's inflation dynamics. Our expectation is that, inflation will close 2010 within the range of 12.5% and 13.4%.

#### Medium to Long Term Outlook

Crude oil production is likely to result in significant structural changes for Ghana over the medium to long term. We expect oil revenue inflows to account for close to 15% of total revenue by 2015. Characteristically, the major threat of the oil sector to the structure of the economy will be to effect a change in the currency dynamics in a way that will hurt the country's traditional exports. While this will require a proactive external reserve management by the Bank of Ghana to ensure that the currency is not overvalued, it will also provide the platform for the attraction of long-term foreign portfolio investment.

#### Ghana: Key Macro Data

INDICATORS	2005	2006	2007	2008	2009	2010F
NOMINAL GDP (GH¢ 'b)	9.7	11.5	14.0	17.2	21.6	25.4
NOMINAL GDP (\$ 'b)	10.7	12.5	14.6	14.2	15.1	12.7
REAL GDP GROWTH (%)	5.9	6.2	6.3	6.2	4.7	6.1
HEADLINE INFLATION (%)	13.9	10.9	12.7	18.1	16.0	16.8
CENTRAL BANK PRIME RATE (%)	15.5	12.5	13.5	17.0	18.0	16.5
91-DAY TREASURY BILL (%)	15.5	10.2	9.9	17.9	22.5	14.9
1-YEAR TREASURY NOTE (%)	17.7	15.7	12.4	19.0	20.0	16.2
OVERALL FISCAL DEFICIT/GDP (%)	2.0	7.8	8.1	14.9	10.2	9.5
TAX REVENUE (GH¢ 'b)	2.1	2.4	3.3	4.3	5.1	6.0
PUBLIC EXPENDITURE (GH¢ 'b)	3.5	3.9	5.4	9.5	8.7	10.5
CEDI/DOLLAR DEPRECIATION (%)	-0.6	-1.3	-4.1	-20.9	-15.4	1.5
CEDI/DOLLAR EXCHANGE RATE (%)	0.9088	0.9210	0.9599	1.2134	1.4340	1.4120
CEDI/EURO DEPRECIATION (%)	-14.2	-11.2	-14.2	-17.3	-17.3	11.2
CEDI/POUND DEPRECIATION (%)	-10.9	-13.3	-5.6	-9.0	-23.9	9.6

Source: Databank Research, Bank of Ghana, 2010 Budget Statement, Ghana Statistical Services

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## Economic Outlook: 2010 GDP At 6.3%

Economic growth for Ghana is expected to increase to 6.3% in 2010 (2009: 4.7%). **The lower GDP growth outturn was on the back of tight fiscal and monetary policy which led to weak domestic demand. The industry and service sectors felt the brunt of the weak consumption and generally high interest rates that characterised the period.** Growth in the agricultural sector was the main driver of output growth in 2009.

The (world) prices of Ghana's key export performed well in 2009. The year-to-date gains in the prices of cocoa and gold as at the end of 2009 were ~27% (\$3,259/MT) and ~28% (\$1,105.3/t.oz) respectively. This performance, coupled with higher growth in the crop and fishing sub-sectors propelled agricultural sector growth to 6.2% in 2009 (2008: 5.7%). **In our view, further investments in the agrarian sector as indicated in the 2010 budget should support growth above 6% during the period.** We anticipate that cocoa prices will be negatively affected by the acquisition by Kraft (US confectionary manufacturer) of Cadbury International, UK in Q1-2010. Nevertheless, the long term effect of the new capital injection by Kraft could also result in an increase in the production of confectionary products; which in our opinion could lead to increased demand and higher prices for cocoa during the period.

After 2010, we expect GDP growth to increase above 8.0% mainly on the back of commercial production of crude oil. **The revenue from the oil and gas sector is likely to hasten infrastructural projects which are critical for the development of the services and the industrial sectors.** In our view, Ghana's relatively small (but efficient) private sector could expand significantly on the back of the oil and gas industry. Our average GDP growth forecast for the next five years to 2015 is within the range of 9.5% and 10.5%.

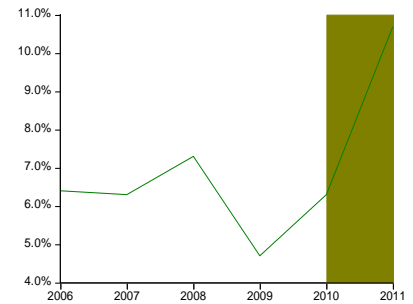
## Sectoral Growth: Oil & Gas Sector Promising

The production of crude oil in commercial quantities for Ghana is likely to alter the structure of the economy when it starts in October 2010. Currently, domestic tax revenue accounts for over half the total planned expenditure. It is also worth mentioning that an estimated 52% of tax revenue is used to finance public sector wage bill. With a projected annual average oil revenue inflow of \$1.0b between 2011 and 2012 (and projection of \$3.0b by 2015); it is likely that fiscal space will improve over the medium term.

Ghana's narrow fiscal space leads to significant aid dependence and high domestic borrowing which usually crowds out the private sector through high real interest rates. Incidentally, revenue inflows from crude oil production is likely to facilitate fiscal relief and further improve fiscal space. **In our opinion, with strong institutions and good contracts, the oil revenue will reduce the borrowing requirements of the public sector and improve external savings which is critical for long term development.**

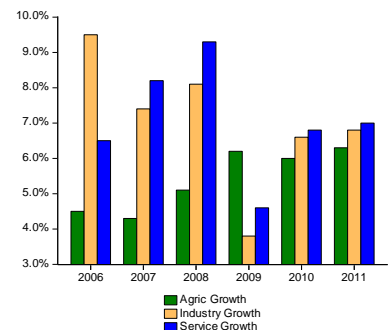
Within the short term, we expect activities prior to the take-off of oil production to lead to FDI inflows and a more stable local currency. Oil production will also lead to renewed confidence in the long term growth of the country. In our view, the Ghanaian economy will benefit from foreign portfolio inflows as the stock market and fixed income returns are likely to remain competitive. The decision by the British oil exploration firm Tullow Oil to list its local subsidiary on the Ghana Stock Exchange is likely to draw attention to the equity market.

Ghana: GDP Growth



Source: Ghana Statistical Service

Ghana: Sectoral Growth



Source: 2010 Budget Statement, Ministry of Finance

## Monetary Policy: Central Bank to Accommodate Growth

The Bank of Ghana has maintained a tight monetary policy stance through the high inflationary periods between 2007 and 2009. Within that period the basic tenet of monetary policy was inflation targeting, which pre-supposes that concerns over inflation were more important than growth and job creation. **Nevertheless, the Governor of the Bank of Ghana, Kwesi Amisah-Arthur, has indicated his preparedness to support economic growth and make credit cheap for the private sector.** We think that this is likely in 2010, but the ability of the central bank to support this policy stance will depend on inflation dynamics. In our opinion, pushing interest rates below inflation for Ghana is not desirable and must be avoided to ensure long term growth and stability.

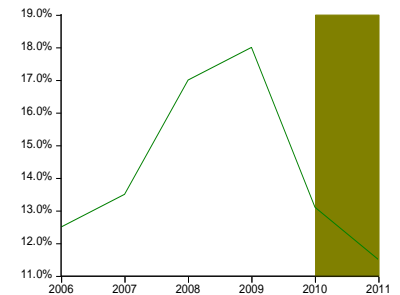
Over the years, transaction interest rates have been sticky in response to prime rate reductions. In this stead, it is difficult to ascertain the likely impact of reductions in the prime rate in 2010 on commercial banks base and lending rates. **But the corresponding declines in benchmark yields in 2010 in addition to the reductions in the monetary policy rate should facilitate notable declines in banking sector base and lending interest rates.** Nevertheless, it is likely that average lending rates will remain above 20% in 2010; although we expect the central bank's Prime Rate to close 2010 below 13.9% from its present level of 16.0%. Overall, with declining treasury yields, anticipated robust economic activity and the recapitalization of commercial banks, we expect the willingness of banks to lend to the private sector to be reinvigorated.

## Fiscal Policy: Government Spending To Increase

Total public expenditure is expected to increase by 40% to GH¢12.13b in 2010 (the comparable figure for 2009 is GH¢8.66b). This expansionary fiscal stance is in contrast to the austerity measures adopted in 2009 (Government expenditure in 2009 was GH¢8.66b compared to a target of GH¢10.05b). **It is likely that fiscal policy will be expansionary over the medium term as the government seeks to honour its electoral pledges and push growth above 8%.** The influx of additional revenue from the oil and gas sector will facilitate increased public sector spending which will be targeted at improving the nation's infrastructure. Overall, fiscal deficit including divestiture receipts closed 2009 at 4.2% compared to 7.8% in 2008; this is, however, expected to increase to 7.5% in 2010 (as per the 2010 budget statement).

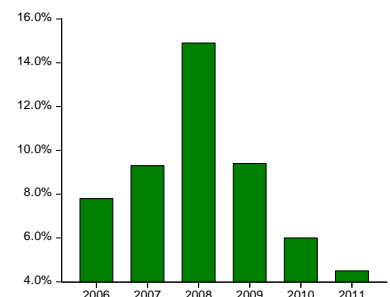
The anticipated increase in the fiscal deficit would be financed mainly through external loans, grants and the issuance of medium term treasury notes. **However, we do not expect this to exert pressure on treasury market yields as the government intends to lengthen the profile of its debt securities and float more medium term treasury notes which are opened for foreign participation.** We expect fiscal policy to stimulate growth over the medium term. This nevertheless requires spending to be targeted at growth catalytic areas of the economy and the monitoring of public projects for effective execution. **Our view is that, the current focus on spending on agriculture, employment creation, youth development projects, education, health, and housing sub-sectors can push growth above 8% over the medium term.** Ghana's fiscal position, however, requires further consolidation (and in particular, there are still potential short term pressures on the fiscal outlay). In 2010, for example, government intends to spend GH¢12.1b while its total revenue estimate is GH¢6.2b, indicating that over 40% of government spending must be raised from non-income generating sources including the treasury market and external creditors. The introduction of the single spine salary structure could also put mild pressures on the wage bill which currently accounts for over 50% of total tax revenue.

Ghana: BOG Policy Rate



Source: Databank Research Databases

Ghana: Fiscal Deficit % of GDP



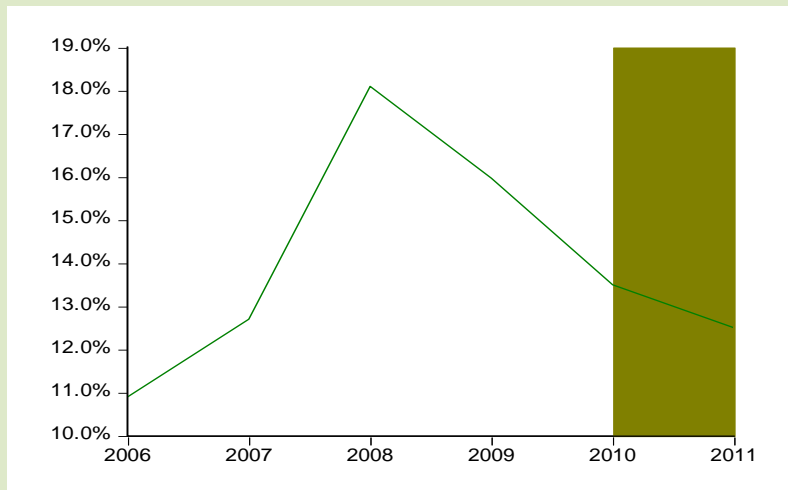
Source: 2010 Budget Statement, Ministry of Finance

## Inflation Risk: Inflationary Pressures to Ease

Our positive outlook on the pricing front is mainly dependent on currency stability, stable crude oil prices (within the range of \$70 and \$85 per barrel, as well as, improved domestic staple production (owing to government investment in the agric sector). Clearly, inflation risk has subsided since the second half of 2009; declining from 20.7% in June 2009 to 15.97% in December 2009. In February 2010 inflation further dipped to 14.23%.

The Government plans to establish a buffer stock agency in 2010. If this is implemented, it will mitigate the seasonal swings in food inflation. In our view, a buffer system will improve the stability of food prices and enhance the credibility of farmers for loans as gluts will not significantly affect farm incomes. This should lead to increased staple production which should positively influence food inflation (the food component accounts for 45% of the CPI basket). It is also likely that the strengthening of the cedi against major trading currencies will also lessen non-food inflation (as import prices are stable). Overall, this should facilitate lower inflation in 2010 compared to 2009.

Ghana: Consumer Inflation Trend



Source: Ghana Statistical Service

Nevertheless, there are inherent factors that could put upward pressure on domestic prices. The 2010 budget has estimated an increase of 40% in public spending to GH¢12.13b, while the Bank of Ghana's policy rate is likely to fall on lower inflation expectations and treasury market borrowing. These developments will facilitate strong domestic demand. The government has also imposed a 20% ad-valorem tax on non-alcoholic beverages (that of alcoholic beverages was 50%) and packaged water, increased road tolls by 950%, and there is the possibility of an upward review of utility tariffs. The implementation of the single spine salary structure could also exert pressure on the public sector wage bill. It is likely that government will not achieve its single digit inflation target of 9.2% for 2010; although inflation for the period will be lower than in 2009.

Overall, we think that the outlook for inflation is positive. In lieu of the weak domestic demand experience in 2009, we believe that strong growth in 2010 will not lead to demand driven inflation. It is also likely that because of the stability of the macro economy, increases in prices will be slower in 2010 than in 2009. Consequently, our expectation is that inflation will end 2010 within the range of 12.5% and 14.0%.

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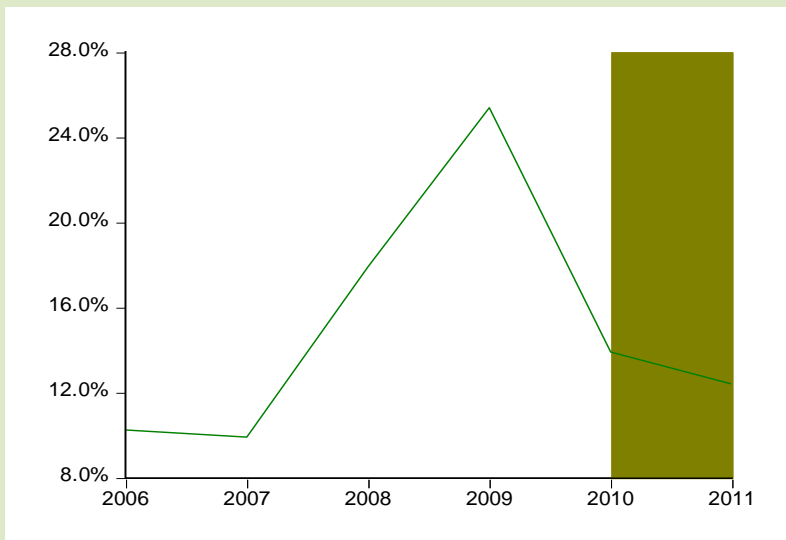
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## Interest Rates: Yield Curve Set To Correct

The Bank of Ghana cut its key policy rate by 200bps to 16.0% in February 2010 after a 50bps cut in November 2009. This indicates the preparedness of the monetary authorities to support the pro-growth agenda of government in 2010. It is likely that developments in the economy such as declining inflation and lower public sector borrowing (especially through the auction market) would support lower commercial bank base and lending rates.

Yields on benchmark treasury securities have trended downwards since September 2009. The yield on the 91-day and the 182-day bills edged down from 25.9% and 28.9% in September 2009 to 22.5% and 25.3% respectively in December 2009. The interest rate on the 1-year and 2-year notes also fell from 21% and 25.5% to 20% and 23.5% respectively during the same period. The decline in treasury yields was in line with reductions in fiscal deficit in 2009, as well as, lower inflation expectations for the year. The government is committed to lengthening the maturity profile of its treasury market instruments and redirecting borrowing to the longer end of the market. In February 2010, the Bank of Ghana issued a 3-year note which was oversubscribed by 97%, and it is likely that more medium term notes will be issued in 2010.

Ghana: Treasury Market Dynamics (91-Day Bill)



Source: Databank Research Databases

We think that interest rates will decline in 2010, with the central bank's policy rate down from 16.0% in February 2010 to below 14% in December 2010. Ghana's interest rates are among the highest in sub-Saharan Africa- the Bank of Ghana's key policy rate is currently at 16% compared to 6% and 7% for South Africa and Nigeria respectively. The main challenge to lower interest rates at the macro level is inflation and excessive public sector borrowing; but improvement in tax revenue and further improvements in fiscal discipline could facilitate lower interest rates over the medium term. Nevertheless, we expect foreign investors to participate in Ghana's fixed income market on the back of the prevailing high interest rates (compared to other African countries) and low currency risk expectations. The local currency is expected to be stable against all the three major trading currencies (the US dollar, pound and euro) in 2010 owing to improvements in the country's capital accounts and expected FDI inflows.

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*Nevertheless, we expect foreign investors to participate in Ghana's fixed income market on the back of the prevailing high interest rates (compared to other African countries) and minimal currency risk expectations.*

## Currency Risk: Cedi on the Upswing

The performance of the cedi against the three major trading currencies was mixed in 2009. For most part of the year, the local currency recorded sharp depreciation owing to speculative buying, low gross international reserves, and reversal of portfolio flows. The year-to-date depreciation of the cedi against the US dollar, pound and euro as at December 2009 were 15.4%, 23.9% and 17.3% respectively. Against the dollar, the depreciation of the cedi was intense in the first nine months to September 2009 peaking at 17.1% before declining to 15.5% in December 2009. **The cedi's recent rise was due to improvements in gross international reserves (IMF balance of payments support of \$145m), the recapitalisation drive of commercial banks, and weak import demand during the festive season.**

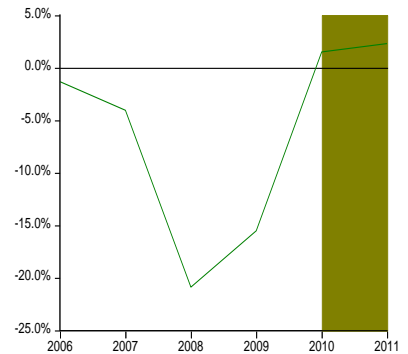
The cedi's performance was sustained in Q1-2010 with the local currency appreciating against all the three major currencies. As at March 4, 2010 the cedi gained 29bps, 750bps and 610bps against the dollar, pound and the euro respectively. The main driver of the better performance of the cedi in Q1-2010 were the improvement in gross international reserves to 3 months of import cover, stable crude oil prices and renewed inflow of portfolio investment. In our view, the cedi will be stronger in 2010 buttressed by **portfolio inflows, with the anticipated onset of crude oil production in Q4-2010 facilitating FDI inflows.** In our view, the cedi could close 2010 with a year-to-date appreciation of 150bps against the dollar.

## External Sector: Terms of Trade to Improve

The external sector has recovered somewhat in 2009 after suffering from the effects of the global financial crisis in 2008. Gross international reserves improved to \$3.2b (Dec-09) from \$2b (Dec-08). The reserve position as at the end of 2009 amounted to 3 months of import cover (the comparable outturn for the same period in 2008 was 2.1 months of import cover). The country's overall balance of payments account recorded a surplus of \$1.2b (2008: A deficit of \$0.9b). The improvement in the economy's external sector is in line with improvements in terms of trade. The prices of gold and cocoa were strong in 2009 with a year-to-date gain of 28.1% (to \$1,105.3/t.oz) and 29.0% (\$3,259/MT) respectively despite weak global demand during the period. It is likely that the country's terms of trade position will remain stable in 2010 as the global economy recovers, which should enhance the prevailing stability of the external sector.

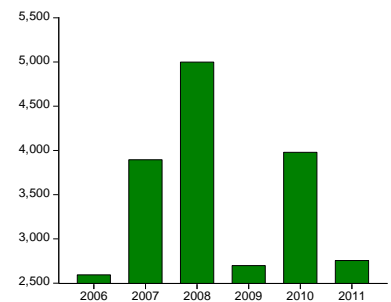
Total trade deficit for 2009 was US\$1.2b which indicates a significant improvement over the \$3.5b outturn for 2008. This was driven by lower crude oil prices in 2009, as well as, improvements in the hydro-thermal energy mix of the country. **In our view, unless crude oil prices exceed US\$85 per barrel in 2010, Ghana's terms of trade will remain favourable during the period.** We anticipate that as growth picks up to 6.3% in 2010 (from 4.7% in 2009) there will be an associated mild increase in imports. Nevertheless, this may be offset by improved domestic rice production which does have a significant burden on the trade account. Overall, the production of crude oil in commercial quantities by Q4-2010 will have a significant impact on the country's trade account. Clearly, the anticipated export volume of \$7.2b could reverse our current deficit into a surplus.

Ghana: Cedi/Dollar Trend (%)



Source: Databank Research Databases

Ghana: Trade Deficit (\$ 'm)



Source: 2010 Budget Statement, Ministry of Finance

## Conclusion: Outlook for Growth Promising

The prospect for higher GDP growth for Ghana remains upbeat over the medium term. We anticipate that GDP growth for Ghana will average above 7.8% over the next five years underpinned by investments in agriculture, the production of crude oil in commercial quantities, and the recapitalization of commercial banks. In 2010, GDP growth is likely to increase to 6.3% (the comparable government forecast is 6.5%) and thereafter increase to above 10.5% in 2011.

Clearly, the onset of commercial oil production will alter the structure of the economy and lead to enhanced fiscal revenue; but the most significant impact for Ghana within the short term will be job creation and a spring-up in ancillary enterprises in the services sector. Thus any desired impact on the fiscal front may be minimal compared to the financing needs of the country. Oil revenue projections (as per the 2010 budget) indicates an annual average inflow of GH¢1.0b between 2010 and 2012 which compares unfavourably with an average financing gap of GH¢6b (total public spending in excess of total revenue) during the period. In our view, this calls for cautious optimism on the medium term impact of crude oil production on the economy. In this regard, unless further discovery are made leading to the realization of fiscal surplus, we think that there is no likelihood for any significant oil savings for Ghana.

There is a renewed hope in the country's financial market in 2010 as currency risk improves and credibility of government policy is enhanced. The recent issuing of 3-year treasury notes in February 2010 and March 2010 (which were oversubscribed with significant foreign participation) supports the assertion that the market views medium term macroeconomic risk as favourable for Ghana. Preserving the current stable macroeconomic environment while at the same time pushing for aggressive growth spending will, however, pose a challenge over the medium term. We think that economic policy must be guarded in a way that will balance the risk between growth and macroeconomic risk (including inflation); but excessive focus on inflation could worsen unemployment and negatively affect social cohesion.

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