Ghana's Exchange Rate Challenge: can we ever get out of it?

Position Paper

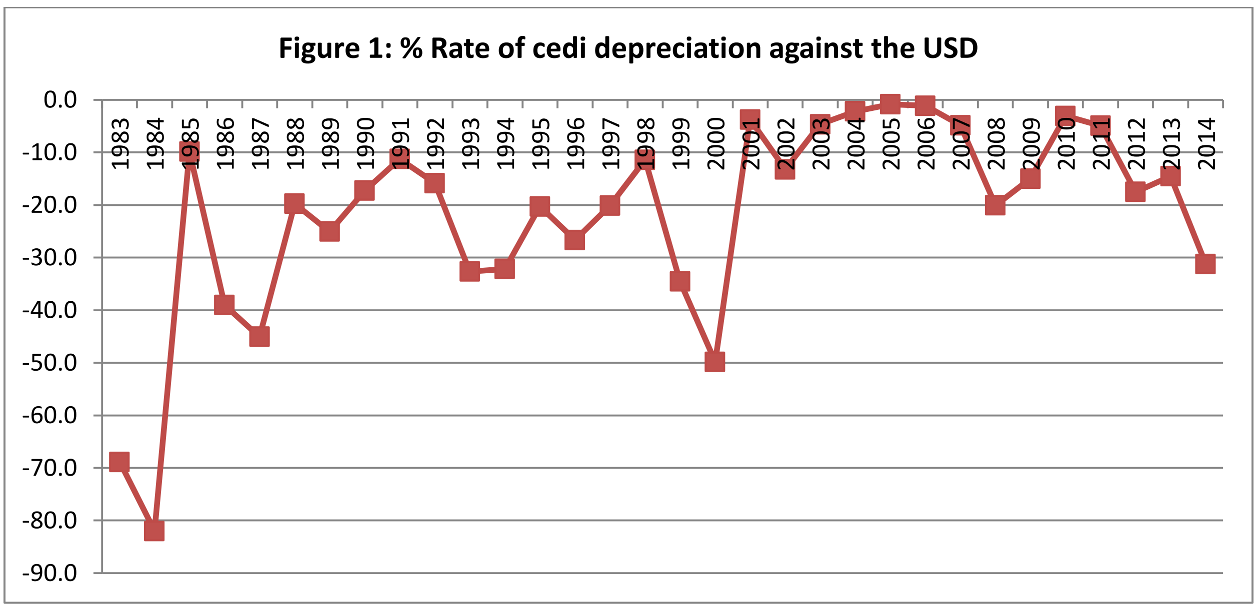
International Institute for the Advanced Study of Cultures, Institutions, and Economic Enterprise

Website: www.interias.org.gh

Email: info.interias@gmail.com

Office: +233-28-107-4256

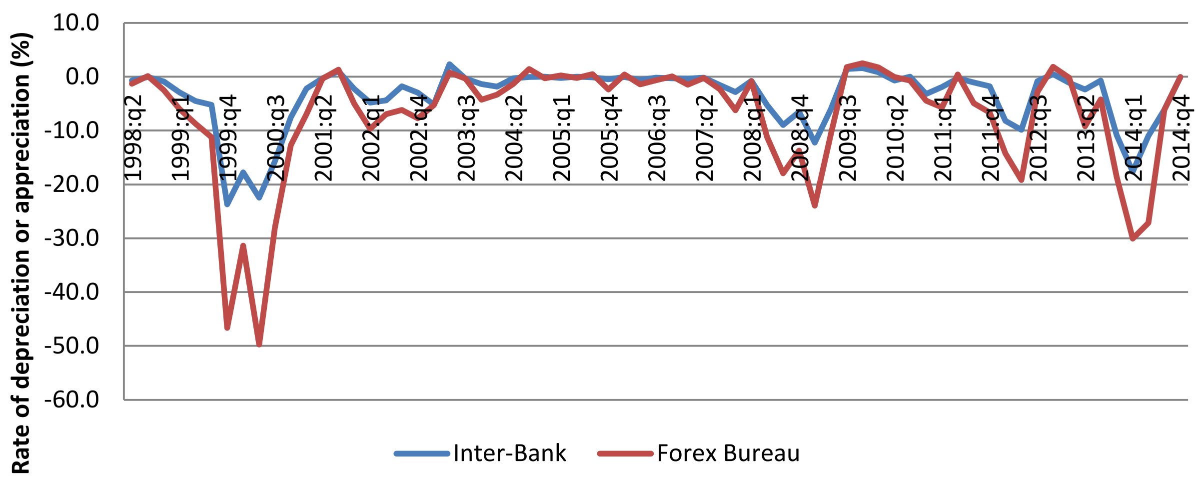
The rapid depreciation of the cedi against other major currencies destabilized the Ghanaian economy in the first eight months of 2014 and raised the economic consciousness of every Ghanaian regardless of his/her level of understanding of economic issues. I was surprised when my illiterate mother insisted that I increase her monthly remittances to account for the rapid depreciation of the cedi. Indeed, this is not the first time Ghana has experienced such turbulence in the exchange rate market. On annual basis, there has not been a single year when the cedi has not lost value since the country moved from the fixed exchange rate regime to the current floating exchange rate system as part of economic reform program embarked on in April 1983. Over the last three decades, the cedi has lost about 99.9841% of its value against the US dollar. The least rate of annual depreciation of 0.9 percent occurred in 2005 while the year 2000 saw the highest cedi depreciation of 49.8 percent since 1984. On average, the cedi has depreciated annually by a rate of 20.3 percent in three decades (see Figure 1). The longest period that saw a slowdown of the cedi's depreciation with a consistent decline in the rate of depreciation was from 13.2% in 2002 to 0.9% in 2005 before ascending to reach 20.1% in 2008.



Source: *Computed from Data from Quarterly Digest of Statistics of Bank of Ghana*

On quarterly basis, the cedi has not been stable either. Between 2007 and 2014, the interbank exchange rate recorded an average depreciation of 3.7% compared with 3.9% at the Forex Bureau. The last quarter of 1999 witnessed the highest rate of depreciation in the interbank market while the second quarter of 2000 recorded the worst depreciation of 27.3% in the foreign exchange market. Indeed, most of the quarters experienced exchange depreciation with few recording some appreciation. The longest period of exchange rate appreciation occurred between the third quarter of 2009 and first quarter of 2010 for inter-bank and third quarter of 2009 and second quarter of 2010. The highest quarterly appreciation of the cedi against the dollar of 2.3% in the interbank market was recorded in the second quarter of 2003 while the forex bureau market saw the best appreciation of 1.5% in the third quarter of 2004.

Figure 2: Rate of quarterly change of cedi in relation to the USD (%), 1998-2014



Source: *Computed from Data from Quarterly Digest of Statistics of Bank of Ghana*

The effects of exchange rate depreciation are well documented in the literature. The one that frequently comes to mind is the fact that depreciation of real exchange rate increases demand for domestically produced goods by reducing their relative prices and more importantly promotes exports which eventually exert expansionary effect on national output. This expenditure switching effects are associated with the Mundell-Fleming-Dornbusch framework. Thus, imports become more expensive relative to domestically produced goods particularly if domestic production does not depend largely on imported raw materials and capital inputs.

However, supply inelasticity of Ghana’s export and our insatiable demand for imported goods for various reasons do not make Ghana achieve higher export and decrease domestic demand in a constant depreciation of her exchange rate over the years. Ghana’s exports are dominated by primary commodities which do not readily respond to any changes in the exchange rate market.

This has often been the motive behind the suggested need to diversify our exports into areas/commodities that are more responsive to dynamics in the exchange rate market.

Even if the country manages to reap the benefits of growth effect of national output effect, it would be reversed on account of high dollar denominated liability of government which is a common feature of the country in recent times. Cedi depreciation raises the domestic currency value of foreign currency debt and debt service burden in view of the fact that domestic revenues are in domestic currency. Indeed, while acknowledging the fact that government liability to foreign entities in dollars have increased substantially over the last few years, the figure hits the roof when it is quoted in cedis. For instance, between September 2011 and September 2014, Ghana’s external debt increased from US$7,103.41 million to US$12,712.02 million representing 79.0% increase but in cedi terms, the increase comes to 275.8% from GH¢10,814.23 million to GH¢40,644.15 million.

The inflationary effect of the depreciation of the exchange rate is uncontestable particularly if, like Ghana, the country’s spending on imports constitutes a considerable proportion of total expenditure. Cedi depreciation against major currencies does not only raise the cedi prices of final goods through imports of such goods but also through increased cedi costs of imported inputs. As alluded to in the 2015 Budget Statement of the Government (see page 14), “while food inflation declined by the end of October 2014, non-food inflation increased significantly underpinned mainly by pass through effects of sharp exchange rate depreciation during the review period”. The speculative effect of exchange rate instability makes it difficult for businesses, government and households to plan. While acknowledging the fact that speculation is not necessarily the root cause of instability in the exchange rate market, it cannot be discounted that any eruption of instability in the market fuels speculation which in turn fuels more instability making it difficult for economic agents to plan. Indeed, the government in the mid-year had to revise its target for 2014 during the mid-year review to Parliament after a turbulent first half of the year and the situation might not differ in the business world.

The underlying reasons for instability in the exchange rate market is directly linked to the demand for and supply of foreign currencies which has been well articulated in the literature. In Ghana, the continued depreciation of the cedi against major trading currencies has often been linked to many factors including heavy dependence on imports and reliance of exports of primary commodities. Admittedly, fixing this fundamental concern is a long term issue, but that cannot be the only cause of the exchange rate instability problem. The high fiscal deficit, which was about 12% of GDP in 2012 mainly due to high election related expenditures and the apparent indecision by -- or perhaps inability of -- the Central Bank to ignite its intervention measures when necessary cannot escape blame in the rapid cedi depreciation that occurred in the first half of 2014. The “dollarization” of local transactions including government’s own decision to index import duties to the dollar tend to put pressure on demand for dollars by economic agents to avoid potential losses for holding domestic currency to pay import duties at the port. The exchange rate control measures introduced by the central bank in February 2014 in a desperate attempt to halt the rapid depreciation of the cedi exacerbated the problem, as many people decided to hold onto their foreign currency or divert it. Additionally, the regulation and monitoring mechanism in the exchange rate market particularly in the Forex Bureaux is very relaxed and porous, to say the least, to the extent that an individual buying from or selling foreign currency to a Bureau does not require to produce any identification to facilitate the capture of the records of the individual and also trace transactions of the Bureau during a period. In such circumstances, how can the regulator monitor the possible flow of foreign currency into the parallel/underground/black market?

As the structure of Ghana's international trade remains as it is with the dominance of primary commodities in export and high imports, culminating in constant trade deficit, the local currency would continue to decline in value against the major trading currencies. The slowdown of the cedi's depreciation in the last quarter of 2014 has triggered debate about whether this is just a flash in the pan after the turbulence of the first nine months of the year. It is important to note that the $1 billion EURO bond and $1.7 billion COCOBOD trade finance facility for the 2014/15 cocoa purchases with the intended purpose of reversing the speculative behavior of agents in the exchange rate market and coupled with the slowdown of imports in August–September largely explain the slowdown in the declining value of the cedi. In the medium-to-long-term however, the redemption or payment of these facilities could put a downward pressure on the cedi against other foreign currencies if these facilities are not prudently invested in economic sectors that would yield better returns in the future.

A long period of stability of Ghana's exchange rate market in the current structure of the economy is difficult to predict. What one can envisage is a possible slowdown of the rate if pragmatic measures are adopted in the fiscal and monetary section of the macro-economy as well as the adoption of better regulatory and monitoring mechanisms in the exchange rate market. Rather than repeating the unpopular exchange rate control measures introduced in February 2014 to address the rapid depreciation of the cedi, the Bank of Ghana could introduce measures (or activate those that already exist) that would ensure that transactions at forex bureaux in particular require proper identification to facilitate movement of foreign currency in the system and reduce potential involvement of some of these bureaux in the parallel market. Monitoring systems in the banking sector also need to be strengthened to minimize loopholes that could facilitate unorthodox exchange rate transactions. To boost regular supply of foreign currency in the banking sector, measures to encourage Ghanaians in the diaspora to operate accounts in foreign currency at a marginal rate above what they would have obtained in their country of residence could be explored. In the USA, Canada and Europe, interest rates on savings and other deposits are very low to the extent that a 2% rate above the rates in these countries could entice Ghanaians abroad who have surplus income to invest elsewhere to direct them home, which could be a better alternative than the issuance of EURO Bond at 8%. Additionally, it is more appropriate to use financial and other monetary instruments to combat rapid depreciation of the cedi rather than to resort to rigid control measures that have the effect of weakening public confidence in the financial and the exchange rate system.

Finally and more appropriately, the use of financial and other monetary instruments to combat rapid depreciation of the cedi as against the adoption of rigid exchange rate control measures that have the effect of weakening public confidence in the financial and the exchange rate system should be explored.