Policy Brief

Understanding Exchange rate regimes and influence on Macro-economic stability in Ghana.

Executive summary

Maintaining a relatively stable exchange rate is important in boosting economic growth and development. Yet flexible exchange rate, which is often employed by central banks is accompanied by fluctuation in exchange rate. In Ghana both the fixed and flexible exchange rates regimes have been employed at different times and the results have not been one sided. Thus this has become a major focus in exchange rate volatility debates also due to its impact on macroeconomic stability and therefore growth. Volatility in the exchange rate has varying economic consequences, one of which is its negative impact exchange rate volatility has on confidence as it makes investment planning and decision making. In an environment where exchange rates are so volatile, prices of goods and services become unstable, and thereby introduces instability in equity prices. This affects the rate of inflation, interest rates, investments and savings among other macrto-economic and growth varables. This puts a lot of stress on the general economy and therefore a challenge for governments. A prudent economy demands that certain measures should be put in place to ensure stability in exchange rates and prices. This is crucial since negative changes in these variables would have serious repercussions on development and economic growth. While volatile exchange rates may be common in developing economies, it is suggested that intervention measures should be quick to address the situation if exchange rates are believed to be extremely volatile. Similarly, since interest rates affect both inflation and exchange rates, the monetary policy division of the central bank, should institute measures, such as mandatory compliance with interest rate signals provided by the central bank rate (CBR), to ensure stability in interest rates.

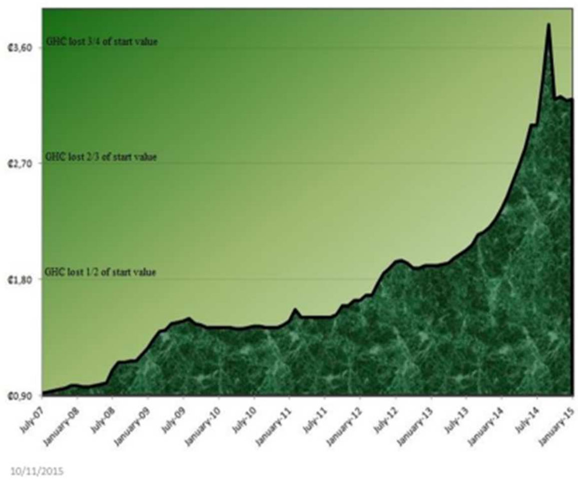
Introduction

Exchange rate defined as the price at which a counry’s currency will exchange for nother country’s is among the most important prices in the global economy. They affect the price of every country’s imports and exports, as well as the value of every overseas investment. A critical preoccupation of governments all over the world, is the search for an exchange rate regime that is able to support the stabilization of their economies. This is because a free fall exchange rate has a serious deleterious effect on economic development and welfare of the population.

In Ghana, the volatility of exchange rate has often been attributed to macro-economic instability. In this direction, discussions relating to fluctuations in exchange rate, focuses on public discourses without any recourse to empiricism. While this may be good, they do not offer any practical solutions to the challenges of the nation. Understanding the trend and causes of exchange rate volatility and channels of expressions, as well as its historical pathways is an important step towards formulation of practical policies that fixes the country's financial sector instability in Ghana. This brief attempts to look at the exchange rate regime and how it has been allowed to operate in the country as a way of examining options available to the country.

Country Evidence

In the wake of exchange rate flight in Ghana, government is considering a range of policy options as a way to curb or minimize ballooning of the cedi against other foreign currencies, especially the dollar and euro. This has become necessary because of the repercussions of exchange rate flight on the economy. It has been observed that typical exchange rate of a developing country like Ghana, relies on either a fixed regime or flexible regime and that the choice of any of these depends on the direction of the economy at any particular point in time. Interestingly, Ghana's experience suggests that over the years both regimes have been operating in the country but at different periods. This suggests that understanding how Ghana fared during the two periods should be of interest to policy makers.



Ghana's history of exchange rate began with the change of the currency from the British pound to the Cedi after independence. Typically the fixed exchanged rate was applied before the 1980s and thereafter Ghana decided to operate with a flexible exchange rate. This rates have been predisposed to the direction of the various political administrations since the time of independence. Ghana adopted the fixed exchange rate regime under the Bretton Wood agreement from 1957 to 1982. Throughout that period, the cedi was fixed to the British pound up to 1966 and the American dollar up to 1982 by decree. The liberalization of the economy in 1983 and for that matter the exchange rate has followed a very slow trajectory until 1992 when inter-bank exchange rate system was embraced. Ghana is currently pursuing the managed float exchange rate system where the forces of demand and supply are allowed to determine the exchange rate, but with some intervention from the monetary authorities.

This stepwise and slow liberation of the currency and creation of forex bareau started with a scheme of bonuses on exports and surcharges on imports, and then followed by an auction system and finally by the licensing of private foreign exchange bureaus. Through this process, the Cedi was substantially devalued to bring its value closer to parallel market values. The process of change finally culminated in the interbank foreign exchange market operating alongside the foreign exchange bureaus, particuallry from the 1992. In the process the central bank was found to have played a key role in the market by starting with a scheme of bonuses on exports and surcharges on imports, followed by an auction system and finally by the licensing of private foreign exchange bureaus.

Subsequently, the real foreign exchange cost in purchasing power parity (PPP) was introduced. It became necessary therefore to adjustment exchange rates on quarterly basis in conformity with comparative inflation rates of the country’s main trade partners. By December, 1984 the government of Ghana adopted a policy of intermittent foreign exchange devaluations to replace the adjustments made on quarterly basis because the exchange rate was perceived to be overvalued. Thus, the cedi was specifically devalued consecutively by the government from 1983 until the interbank system was initiated in 1992. Statistics show that, the cedi depreciated from ₵2.75/US$1.00 in 1983 to ₵390.00/US$1.00 in January, 1992. The cedi has since been depreciating against the dollar.

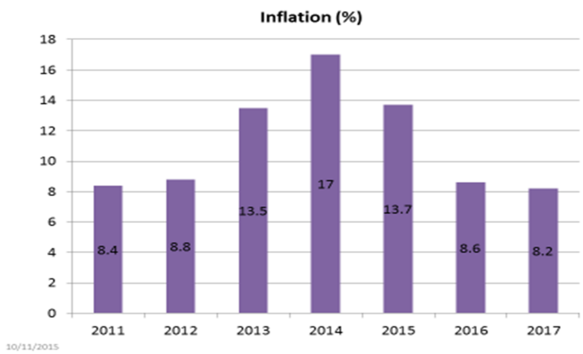
After decades of high inflation had eroded the value of the cedi, the policy was phased out in July 2007. This was then replaced by the Ghana cedi (GHs) at an internal exchange rate of 1 Ghana cedi to 10,000 cedis. During this time, the cedi exchanged at cedis 9,700 = US$1.00, implying an exchange rate for the Ghana cedi of GHs0.97 to US$1.00. This was achived by removing four digits from the actual value of the cedi. This made the Ghana cedi of a higher in value than the US dollar.

It is on record that since the adoption of a flexible exchange rate regime from 1983, the cedi has followed a perpetual downhill, with only brief periods of stability in exchange rate. In 2015, the cedi has shown considerable volatility, moving from 3.24 in January to 3.47 in February to 3.75 in March to 3.85 in April to 4.00 in May to 4.33 in June to 3.45 in July and to 4.05 in August.

Regime	Period	Policy
1	1957 – 1966	Fixed to British pound
2	1966 – 1982	Fixed to American dollar
3	1983 – 1986	Multiple exchange rate system auction
4	1986 – 1987	Dual exchange rate system-auction determined dual retail auction system
5	1987 – 1988	Dutch auction system
6	1988 – 1989	Foreign exchange bureaux
7	1990 – 1992	Wholesale and inter-bank systems
8	1992 – date	Inter-bank market. The bank of Ghana selling and buying rates were determined by the average daily retail rates of the commercial banks.
9	2007	Redenomination of the cedi

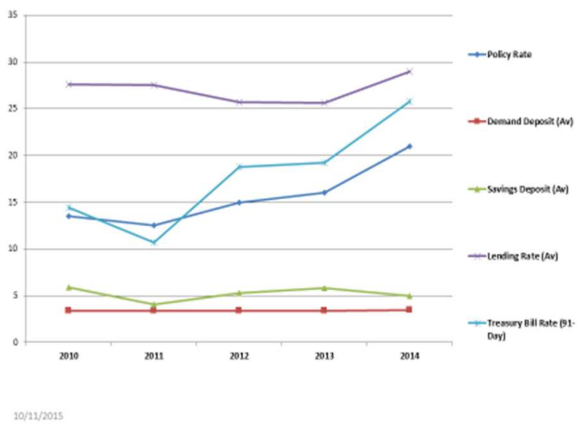
Source: Bank of Ghana

In very simple terms, the cedi's persistent depreciation is due to relatively high domestic inflation, which erodes both the internal and external values. This suggests that the Ghana cedi depreciated cumulatively by over 50% between 2013 and 2015. Therefore, the official rate became GHc4 = US$1, making the cedi is overvalued currency (1/4=US$0.25).



This pattern of volatility has impacted on a number of macroeconomic variables. These include inflation debt sustainability, interest rate, fiscal stability, and external imbalances. In terms of depreciation, we see import prices in domestic currency rising and therefore consumers having to pay more for the products they buy.

This high exchange rate on domestic prices has often been confirmed in studies. The figure on the left indicates how the exchange rate affects some macro-economic variables. This includes the central Bank of Ghana policy rate, lending and savings rate as well as demand deposit and Treasury bill rates in the country. The movement of the exchange rate actually influences the movement of the variable shown and the



complex interactions that take place between and among these variables actually determine the direction of the economy. Specifically these changes especially depreciation of the cedi as a result of rising domestic prices resulting from high exchange rates, can erode investments values and therefore the confidence of foreign investors. This can bring a huge loss to the economy and therefore the need for policy makers to understand this and put in measures to correct any mishap in the economy.

Another question that is often asked in relation to the exchange rate is whether Ghan's exchange rate has been out of line with its long term equilibrium and how has this affected the economy. This is critical because mainting a wrong exchange rate equillibuim or misalignment of the exchange rate creates a situation of high welfare costs. It generates incorrect signals to economic agents and thereby leads to economic instability. In a study conducted by Amarquaye et al (2016), it was realized that since 1983, when the Ghanaian currency was overvalued with an official rate of 2.75 to 1 USD, Ghanaian economy suffered from the following;

- A 30% decrease in per capita income
- Import volumes fell to one third of their previous level
- 52% decline in real export earnings and exports fell from 21% of GDP to 4%
- Fall in domestic savings rate from 12% to about 3%
- 80% decline in real wages and
- A fall in rate of investment from 14% to 2% of GDP

Two things to do in order to correct such situation or ensure aligment of the exchange rate with its long term equilibrium point are to;

1) allow the exchange rate itself to normalize or come back to the equilibrium point or
2) remove inconsistencies between macro-economic policies and exchange rtaes is another possibility.

Since none of these mechanisms easily settles the exchange rate, any effort aimed at keeping the exchange rate as close as possible to the long term equillibuim in the long. It has been proven by evidence in other countries that norminal devaluation can produce real depreciation and improve a clountries position externally if it is accompanied by approaprate macro-economic policies (see. Sebastian, 1989).

Conclusion and recommendation

The policy brief seeks to suggest a strong need to have stability in exchange rates as against other macro-economic variables including inflation mentioned earlier. This underscores the reality that any intervention strategy by the country's central Bank monetary committee should be considered in the management of floating foreign exchange rates. Through this the country might be able to manage any unexpected fluctuations in the economy. Similarly, some stabilization policies as deemed fit by the monetary policy group must be put in place to deal with any economic shocks that might arise due to changes in the exchange rate. This will help stabilize in the short-run, pressure on factors that drive exchange rates and inflation up.

As a result of other global trends which are able to influence local economies, it is recommended that since issues such as the recent global financial crisis, are subject to breeding and encouraging speculative activities, and thereby raises volatility in the financial markets, it is important for government to attempt to do risk hedging and price discovery. This must be implemented in tandem with strong regulatory measures to discourage potentially disruptive speculative uses of derivatives.

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