Exchange Rate Development and the Macroeconomic Economic Performance in Ghana: An Overview

Lordina Amoah

Meshach Aziakpono

Abstract

This study provides an analyses of the interaction between the various exchange rate policies and key performance indicators in Ghana since the launch of the economic recovery programs. Important observations are made. There has been substantial changes in the structure and performance of the Ghanaian economy since independence in 1957. For the period in which the country maintained the fixed exchange rate regime, the average growth rate of GDP from 1960 to 1970 was 3.04 percent, but between 1973 and 1983, the economic fortunes of Ghana took a turn for the worse. GDP growth rate decreased to 1.78 percent, inflation increased from 3.03 percent to about 122 percent. The economy was plagued with persistent high unemployment rates, huge balance of payment deficits coupled with low production in the manufacturing sector resulting in shortages. After the Economic Recovery Program (ERP) was adopted in 1983, the policy of fixed exchange rates adopted under the Bretton Wood agreement was replaced by the floating exchange rate system. Since the initiation of the ERP macroeconomic indicators have improved relatively and the exchange rate continues to play an important role in the adjustment and stabilization of the economy.

1.0 Introduction

Exchange rates policy plays an important role in the macroeconomic performance of an economy. Changes in the level of the exchange rate can affect household consumption, firm production, government fiscal position and hence the entire economy. In Ghana, the real exchange rate is an important economic adjustment tool and relative price indicator and thus, its movement is keenly monitored by economic participants operating in different facets of the economy. First of all, the economy is heavily reliant on imports. The industrial sector as well as households depend greatly on imported goods such as machinery, crude oil, all-purpose vehicles, electrical appliances, building materials and certain food items to name but a few. Thus, changes in the level of the exchange rate has the tendency of affecting prices of general goods and finished products from the manufacturing sector. Persistent changes in the level of the exchange rate could, therefore increase uncertainty in doing business and affect private investment. From another angle, it can be observed that governments have mostly relied on external capital inflows[1] for developmental projects. This has often been the case because the economy has consistently recorded fiscal deficits due to low revenue mobilization efforts and high recurrent expenditure. High inflow of foreign currency tends to increase its supply, resulting in an appreciation the Ghanaian cedi and hence reduce competitiveness of Ghana's exports. Again, participants in the export sector pay export taxes and receive revenues from trading partners across the world. Unfortunately, Ghana's exports are dominated by few commodities which are susceptible to world price movements. Nonetheless, movements in the exchange rate tends to affect the value of the export earnings. Evidently, issues related to the exchange rate is crucial for such an economy that politicians even tend to measure their success by their ability to keep the exchange rate stable.

There have been substantial changes in the structure and performance of the macroeconomy of Ghana since independence in 1957. The gross domestic product (GDP) grew at an average rate of 3.04 percent from 1960 to 1970. After 1970, the economic fortunes of Ghana took a turn for the worse. There was a decrease in the GDP growth rate between 1973 and 1983 to 1.78 percent. The statistics show that the rate of inflation increased steadily from 3.03 percent in 1970 to 122 percent

[1] Official development assistance, loans, grants etc. Domestic sources of capital has often led to the crowding out of the private sector and resulted in high interest rates.

in 1983. This was attributed to the bad performance of the agricultural sector, high unemployment, low output of the industrial sector, high indebtedness along with increases in population growth rate. The problems were also blamed on the persistent control of prices by the government which fuelled the activities of parallel market and in foreign exchange market particularly. The poor performance of the economy pushed the government to adopt the Economic Recovery Program (ERP) in 1983. The objective was to introduce pragmatic macroeconomic policies to address the distortions and grow the economy. One of the key policy measures taken was the liberalization of the exchange rates. The liberalization followed a very slow trajectory until 1992 (the beginning of constitutional governance in Ghana) 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. Since the launch of the ERP macroeconomic indicators have improved relatively and the exchange rate continues to play an important role in the adjustment and stabilization of the economy. The objective of this paper is to qualitatively examine the interaction between the various exchange rate policies and key macroeconomic indicators in Ghana since the launch of the economic recovery reforms.

The next section sheds light on how exchange rate policy has evolved since the country became a republic in 1960. Section 3.0 discusses changes in macroeconomic performance overtime and its interactions the exchange rate in Ghana. Trends in monetary policy, external capital, fiscal policy, trade policy and exchange rate movements are discussed in the following sections.

2.0 Exchange Rate Policy Development

The exchange rate regime in Ghana has undergone significant transformation since 1960 when Ghana became a republic state. Exchange rate policy in Ghana has been predisposed to the direction of the various political administrations since the time of independence. For the purpose of analysis, exchange rate policy in Ghana will be discussed under the period before the ERP, the period after the ERP, the inter-bank exchange rate regime and the period after the redenomination of the cedi.

The Pre-ERP period

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. A cycle of controls and fiscal adjustments were put in place to take care of potential excesses in foreign currency demand. A typical example of these controls was the import license issues. The choice of a fixed exchange policy by the government was motivated more by political ambitions (Harrigan and Oduro, 2000). The fixed exchange rate adopted during the period, however, resulted in drastic declines in exports as well as declines in foreign exchange earnings leading to an unfavourable balance of payment and deflation (Dordunoo, 1994). Coupled with other macroeconomic challenges facing Ghana, and other developing countries around the early 80's, the government resorted to the Economic Recovery Program (ERP) which coincided with the Structural Adjustment Program (SAP) in 1983.

The Post-ERP period

After the launch of the ERP in 1983, an exchange rate liberalization process was initiated. The process begun with the use of different exchange rates for specific payments and receipts. However, these rates were ultimately integrated at ₵30.00/US$1.00 by the last month in 1983. Subsequently, the real foreign exchange cost in purchasing power parity (PPP) was introduced. This necessitated adjustments of exchange rates on quarterly basis in conformance with comparative inflation rates of the country's main trade partners. By December, 1984 the government 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 (Bank of Ghana, 2010). 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.

By 1986, the government had adopted the auction market approach to enhance the adjustment of exchange rates as well as the liberalization of trade. This way, exchange rates were partially determined through the interactions between the forces of demand and supply. The auction market approach introduced the dual exchange rate system whereby the first window maintained the fixed but amendable exchange rate fixed at ₵90.00/US$1.00 and the second employed the weekly auction system organized by the Bank of Ghana, which allowed the determination of exchange rates by market forces. The rates in both windows were applied to specific activities. While the first window rate applied to transactions involving the government, importation of petroleum and cocoa and traditional export deals, the rate in the second window was used in every other transaction. These two arrangements were also unified by February, 1987. The Dutch auction approach was also launched which allowed successful bidders to pay the bid price. This system was abrogated in 1988.

Inter-bank exchange rate regime

The exchange rate was completely liberalized in 1988 with the legislation that allowed forex bureaux to operate legally (Bhasin, 2004). This coincided with the Financial Sector Structural Adjustment programme (FINSAP). By 1990, the weekly retail auction was substituted by the interbank wholesale system under which the interbank exchange rate (the composite exchange rate) was introduced. The wholesale auction systems were strictly reserved for Banks as the only financial institutions allowed to take part with the exclusion of the forex bureaux. The Bank of Ghana engaged in the sale of forex to the bureaux as a way of intervening in the market. The activities of the banks in the auction process as well as the forex bureaux implied that there were two spot rates in the foreign exchange market. In 1992, the system of wholesale auctioning was brought to an end and substituted with the inter-bank market. From that time, banks and forex bureaux have been operating in a competitive environment (Bank of Ghana, 2010).

Table 2.1: Exchange Rate Policy Regimes in Ghana from 1957 - 2004

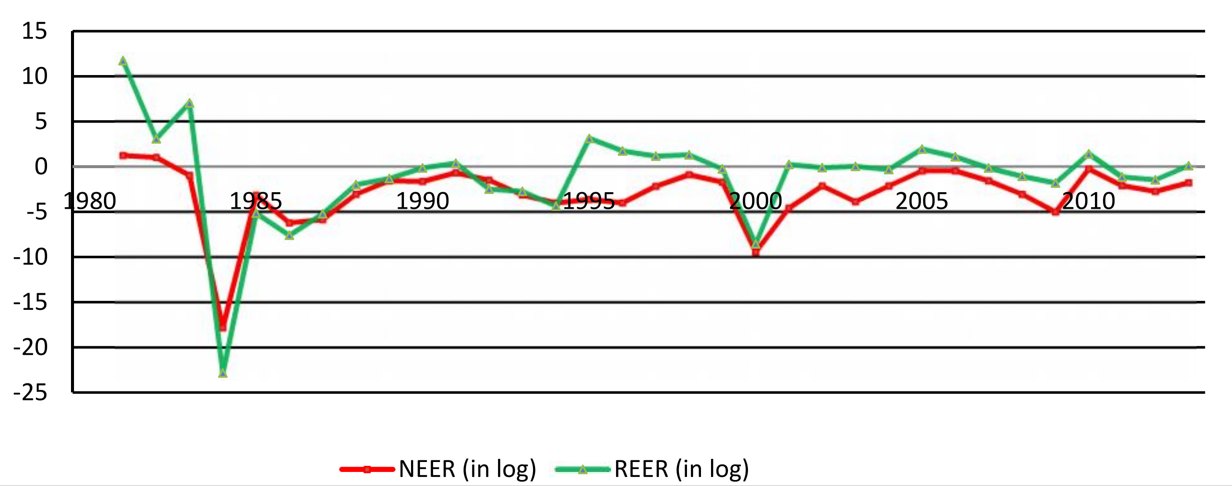
Regime	Period	Policy
1	1957 – 1966	Fixed to British pound
2	1966 – 1982	Fixed to American dollar
3	1983 – 1986	Multiple exchange rate system auction
4	1986 – 1987	Dual exchange rate system-auction determined dual retail auction system
5	1987 – 1988	Dutch auction system
6	1988 – 1989	Foreign exchange 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

Post – Redenomination period

Since the liberalization of exchange rates in 1983, the cedi has mostly depreciated against the dollar. By January 2007, the value of the cedi relative to a dollar was around 9,200. Thus, in order to deal with the high numerical values of prices in addition to foreign money exchange in the cedi terms as well as curtail the problem of carrying huge loads of money to transact business and enhance book and statistical record keeping, the Ghanaian cedi was re-denominated by the Bank of Ghana in July 2007 leading to the initiation of the new Ghana cedi. Thus, ₵10,000 of the old cedis became equivalent to ₵1.00 of the new cedi. Subsequent to that, the value of the cedi relative to the dollar was set at one to one towards the latter part of 2007. Few years after the redenomination, the Ghanaian currency continues to depreciate against the dollar and other major trading currencies like the pound and the euro. Figure 1 below shows the real effective exchange rate from 1980 – 2013. It can be observed that for most part, the NEER and the REER have moved in a similar pattern except in 1995 where they moved in opposite direction. There was a sharp depreciation of the REER and NEER in 1984 after the economic reforms were initiated. Since then, the REER and the NEER has depreciated and appreciated within a marginal threshold.

Figure 2.1 Trends in nominal and real effective exchange rate depreciation, 1980 - 2013



Author's construct with IFS data

3.0 Macroeconomic Performance of Ghana

It is important to analyse the performance of the economy over the changing regimes of the exchange rate. This section, therefore, reviews interactions between the exchange rate policy and other key macroeconomic policies, specifically monetary policy, fiscal policy, and trade policy. Trends between the exchange rate and the appropriate monetary, fiscal and trade proxies over the period 1980 - 2013 are assessed. Possible relationship between political business cycles and the exchange rate is also explored.

Figure 3.1

Figure 3.2 Real and Nominal Effective Exchange Rate and growth performance

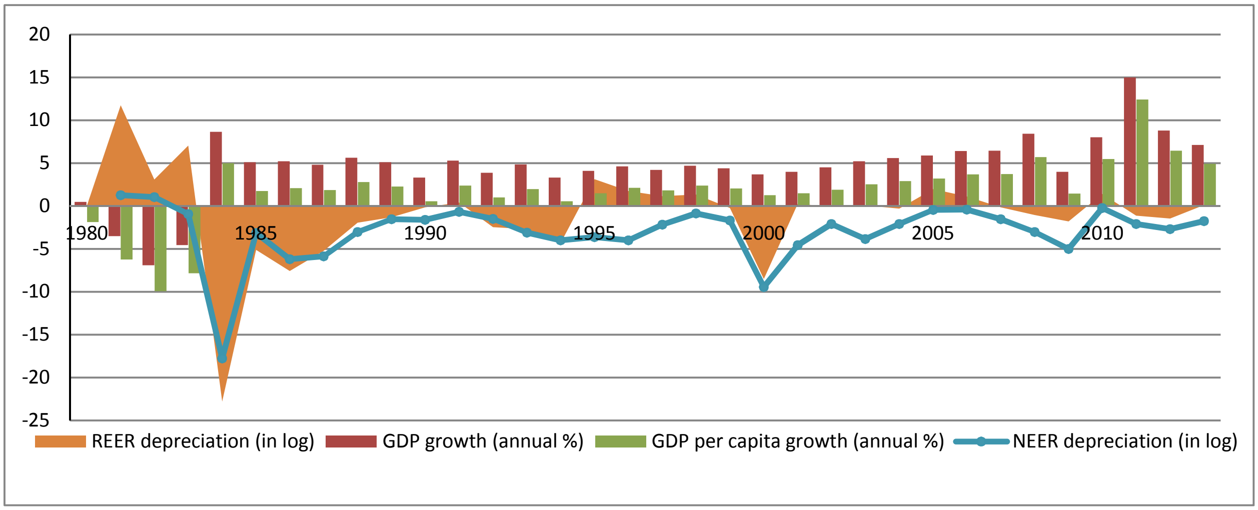


Figure 3.2 attempts to capture the logarithmic pattern of the nominal and real effective exchange rate depreciations and growth performance. There seems to be a relationship between the real effective exchange rate depreciation and the proxies of growth. From 1980 to 1983, the real effective exchange rate shows an appreciation and for the same period, GDP growth and GDP per capita growth were negative. However, from 1984, while the real and nominal effective exchange rates show a depreciation, both GDP growth rate and the GDP per capita growth rate start to record positive values. It can be observed, however, for the period between 1995 and 2000 and that between 2005 and 2006 that episodes of mild appreciation were concurrent with positive values of growth.

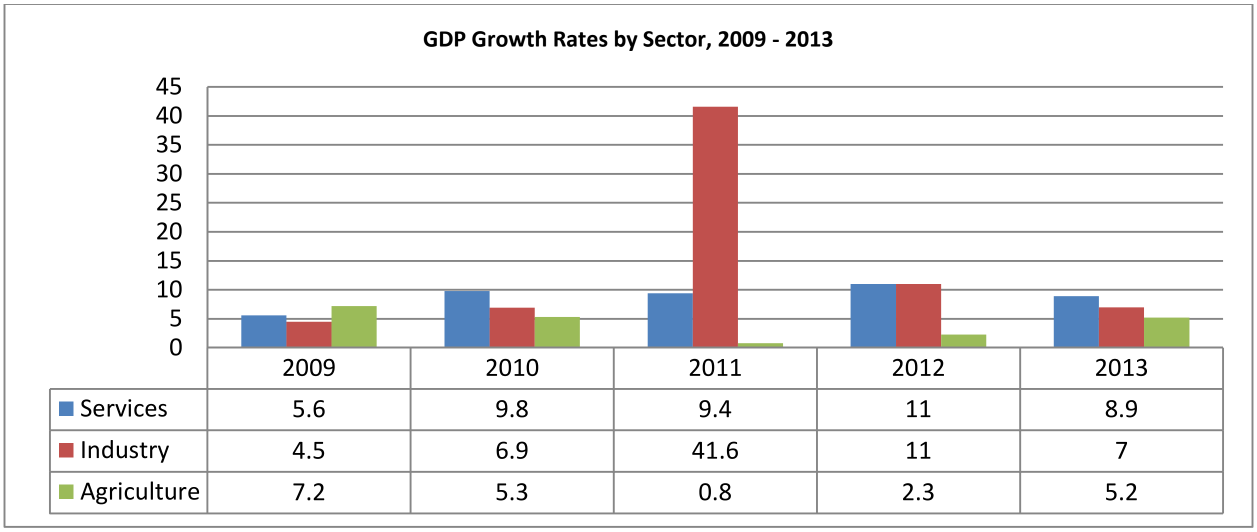
3.1 Trends in output growth

The agricultural sector has historically played a very significant role in Ghana with respect to employment, exports and contribution to GDP. However, since 1990, statistics indicate that the services sector has been the biggest driver of growth in Ghana with an average growth rate of 9% over the last six years contributing about 49% to GDP. Since 2011, (after Ghana became one of the oil producing economies) the industrial sector has been the second largest sector relegating the agricultural sector to the bottom. Even though the agricultural sector seems to be improving, its contribution to the economy, averaging about 23 percent of GDP has been declining persistently since 2012. This may have dire implications for employment generation and export earnings. One may ask if the change in the pattern of contribution to GDP (with services being the highest contributor) points to a change in the structure of the economy of Ghana towards increased modernization driven by technology.

Table 3.1 GDP at current market prices by economic activity (in GH million)

	2009	2010	2011	2012	2013
Agriculture	11,343 (31.8)	12,910 (29.8)	14,155 (25.3)	16,668 (23.0)	19,969 (22.0)
Industry	6,776 (19.0)	8,294 (19.1)	14,274 (25.6)	20,787 (28.6)	25,978 (28.6)
Services	17,543 (49.2)	22,184 (51.1)	27,423 (49.1)	35,131 (48.4)	44,988 (49.5)

Ghana Statistical Service
Notes: figures in brackets represent distribution of GDP at basis prices



Generally, economic growth indicators in Ghana over the last 54 years shows periods of high growth and low growth and relative stability. GDP growth rates during the period between the 1970's and the early 80's recorded an average of 1.7 percent. After the introduction of the floating exchange rate system in 1983, the output growth took a turn towards a relatively more stable pattern. Annual growth recorded an average of about 3.5% between 1983 and 2008. There was a sharp decline in GDP performance after 2008, which was an election year. GDP growth recorded an increase in 2011 after Ghana joined the league of oil-producing economies. This can also be seen the increase in the contribution of the industrial sector to GDP in 2011. There are expectations that the oil production will continue to be among the major drivers of growth in Ghana over the medium term period bringing in the much desired foreign exchange.

Table 3.2 Selected Macroeconomic indicators

	2009	2010	2011	2012	2013
GDP constant 2006 prices (million GH)	22,454	24,252	27,891	30,343	32,507
GDP current (million GH)	36,598	46,042	59,816	74,959	93,461
GDP current (million US$)	25,773	32,186	39,517	41,459	48,678
Non-oil GDP current (million GH)	36,698	44,353	56,070	71,627	89,545
Non-oil GDP constant (million GH)	22,454	24,187	26,519	28,674	30,538
Per capita GDP (GH)	1,563	1,900	2,431	2,898	3,530
Per capita GDP (US $)	1,100	1,328	1,606	1,603	1,838
Growth rates					
GDP at current market prices	21.3	25.8	29.9	25.3	24.7

GDP at constant 2006 prices	4.0	8.0	15.0	8.8	7.1
Non-oil GDP at constant 2006 prices	4.0	7.7	9.6	8.1	6.5

The GDP growth has, however, been decelerating since 2012 probably as a result of the relative poor performance in both the productive sectors of the economy. The fall in gold prices on the international market and oil production not meeting stipulated targets may also a factor. Specifically, GDP growth declined from 15% in 2011 to 8.8% in 2012 and to 4.4% in 2013. The continuous decline in growth has been attributed to the intermittent power rationing exercise[2] which has generally impeded the performance of several sectors of the economy. In addition, electricity and water tariffs were increased to a tune of more than 50% each while corporate taxes and VAT were increased marginally.

3.2 Trends in Monetary Policy and Exchange Rate Management

The financial sector in Ghana as in most developing countries in Africa is predominantly bank-based. It is made of the banking industry consisting of the deposit money banks, rural and community banks and the non-bank financial institutions. Since independence, there has been a number of monetary policy regimes. After the direct controls regime were abolished in 1983, the central bank instituted the monetary targeting regime from 1983 to 2001. The inflation targeting regime currently in practice. The highest rates of inflation were recorded around the period when the economy maintained the direct control regime, that is period of the fixed exchange rate system. By 1983, inflation had growth to around 125%. It diminished significantly after the policy of direct controls were obliterated. During the monetary targeting regime, money supply was the main anchor for inflation until 2002 when the country adopted the inflation targeting (IT) approach to monetary policy. The formal announcement of the adoption of the policy was made in 2007. The objective of the inflation targeting policy was to make price stability the primary long term goal of monetary policy while enhancing fiscal consolidation. Since the adoption of the IT, inflation has been relatively low. Single-digit inflation was attained in 2011.

[2] This was due to the shutdown of the West African Gas Pipeline

3.3 Trends in External Capital flows and the Exchange rate

Both official and private forms of external capital over time have constituted a key source of financing infrastructural gaps and provided the much needed capital to grow most developing economies. Aid, grants, official development assistance (ODAs), foreign direct investments and other forms of capital flow have played a significant role in financing developmental projects in Ghana. Indeed, statistics show that external capital inflows increased compared to the level in the early 90's. Also, ODAs increased significantly after the 90's but started to dwindle in the latter part of 2000, probably as a result of the global financial crisis. Another new feature in Ghana's private capital inflow is the receipts from the issue of Eurobonds. Ghana made history in 2007 when it issues its first $750million sovereign bond on the international capital market. This coincided with the re-denomination of the cedi. While the inflow of such funds is important for the economy, it has its own connotation on the movement of exchange rates. In 2010, the World Bank categorized Ghana as one of the low middle-income countries. ODA as percentage of GDP decreased from an 8.8% in 2000 to 5.2% in 2010 while as a percentage of revenue and grants, it decreased from 44.6% in 2010 to 11.4% in 2012 (African Economic Outlook, 2013).

3.4 Fiscal Performance

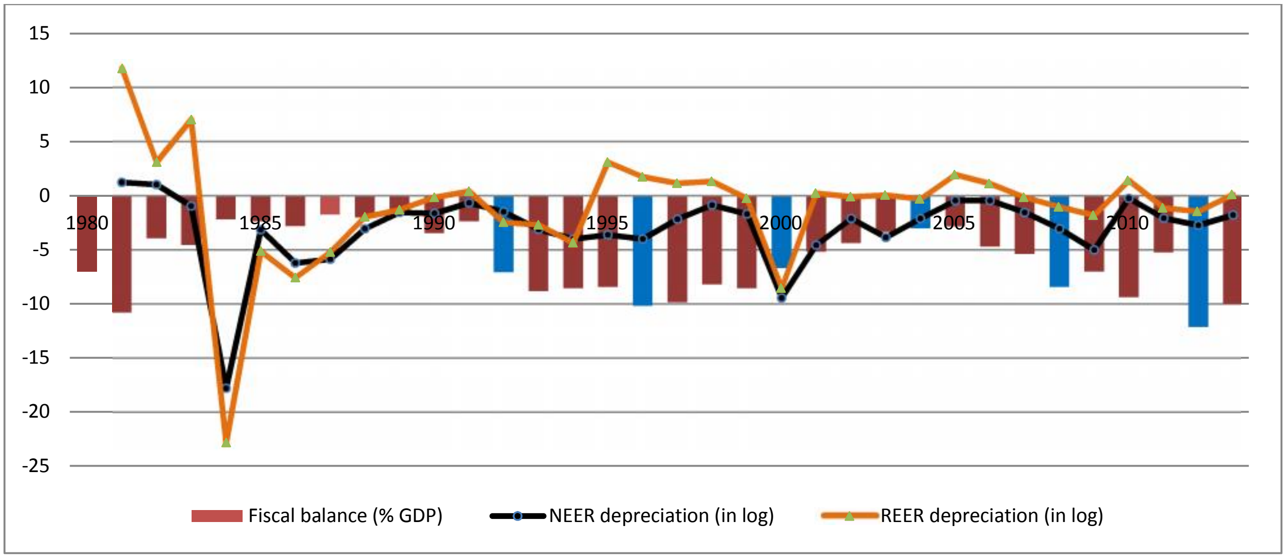
It is very important to highlight the interaction between the real exchange rate and the fiscal position of the government. This is because the level of the real exchange rate can affect the ability of the export sector to make significant contribution to the government purse and thereby exacerbate the fiscal deficit. Again, high levels of government expenditure in an economy that is heavily reliant on imports accompanied by low revenue mobilization can pose challenges for the macroeconomy.

Total revenue as a share of GDP has been increasing since the 90's even though at a slow pace. Between 2005 and 2011 total revenue as a share of GDP has, however, decreased from 21 percent to 14 percent of GDP. In Ghana, taxes form about 80% of total domestic revenue. Other sources of revenue like social contributions, and grants are relatively small. Grants from development agencies have generally been declining. For example grants have decreased from 27 percent of revenue in 2001 to about 4 percent of revenue in 2013. Taxes accruing from international trade through import duties, export duties, profits of export or import monopolies and exchange profits and taxes recorded an average of 30 percentage of total revenue between 1990 and 1993. Available statistics show that taxes from international trade has trended downwards with an average of 20 percent of revenue between 2001 and 2011. Notably, since 2003, the composition of tax revenue has tilted more towards taxes on goods and services than from international trade. Generally, revenue mobilization efforts have been weak in a system that has a narrow tax base and characterised by low tax compliance.

On the contrary, government consumption expenditure has been quite erratic even after the launch of the ERP in 1983. Thus, the fiscal balance of Ghana has consistently been in deficit. Fiscal deficit has moved from an average of 2.8 percent of GDP between 1984 and 1992 to 7.8 percent of GDP between 2006 and 2013. Total expenditure has mostly been dominated by capital spending. However, since 2006 the wage bill has been dominant averaging about 8 percent of GDP. Even though the objective of fiscal policy in Ghana has been to consolidate fiscal position with the aim of reducing the budget deficit, several governments have persistently engaged in activities that have resulted in the widening of the budget deficit. For example, the deficit has been observed to be high in election years, particularly in 1992, 1996, 2008 and 2012. In line with that several governments, in efforts to gain public confidence, increase spending on capital projects and succumb to the pressures of the labour unions for agitations of wage increases in election years. In the general elections in 2012, there was significant expenditure overrun which propelled a budget deficit of about 12% of GDP.

Several governments have consistently been unable to meet fiscal targets and in most cases have resorted to debt leading to high public debt levels in the country. Public debt as at 2013 was around US$22,737 million of which domestic debt was US$12,569.83 million (55.3 percent) and the external debt component was US$10,167 million (that is 44.7 percent). Relative to GDP, the public debt has increased from 25% in 2006 to 65% in 2014. It is important to note that rising government debt levels could have consequences for the real exchange rate and other macroeconomic indicators. Increasing domestic debt leads to high interest rates, increase the cost of capital and crowding out the private sector. The increase in interest rates could also result in inflow of capital for short term portfolio investments which could increase the volatility of the exchange rate. Servicing of external debt also implies higher demand for foreign currencies which could also influence the movement of the exchange rate. Figure plots the fiscal balance along with the REER and NEER. It can be observed that fiscal balance has been in deficit since 1980. It can also been seen except for 1984 and 1995, periods with relatively lower fiscal balance have been accompanied by relatively lower depreciation of the REER.

Figure 3.3



3.4 Trade Policy and Exchange rate movements

Ghana has maintained an open and liberal-market policy especially after the initiation of the ERP. The principal policy advisor, the Ministry of Trade and Industry (MOTI), bears the responsibility of formulating and implementing policies aimed at promoting and developing trade and industry at both domestic and international levels. The country is engaged in trade at the multilateral and regional and sub-regional levels through its membership with the World Trade Organization (WTO). African Union (AU), Economic Community of West African States (ECOWAS) and other bilateral trade arrangements like the Economic Partnership Agreement (EPA) between Ghana and the European Union (EU). Trade is more reliant on European markets, the ECOWAS sub-region as well as markets in other African countries.

The setting up of Ghana Free Zones Board (GFZB) through an Act of Parliament in August, 1995 was a step towards further trade liberalization. One of the objectives was to establish free zones in Ghana to promote economic development through trade. This initiative, cladded with generous incentives, was particularly aimed at attracting foreign direct investment which will improve the performance of the manufacturing sector to produce goods and services which can be traded on the international market to increase the country's foreign exchange earnings while boosting employment. In line with this initiative, Ghana has attracted significant amounts of foreign direct investment (FDI) as compared to countries in the sub-region. The institution of Ghana Export Promotion Authority (GEPA) in 1969 and the Export Development and Agricultural Investment Fund (EDAIF) in 2000 have delivered support in various forms including credit facilities to exporters, particularly those in the agricultural sector.

Another step towards trade liberalization is the Economic partnership Agreements (EPA). The EU initiated formal negotiations for economic agreements with different sub-regions of the African, Caribbean and Pacific (ACP) group of States to create a free trade area (FTA) in order to promote trade and development in September, 2002. Ghana and Ivory Coast[2] were the first countries to initial the interim EPA between the EU and West Africa at the end of 2007. Ratification of the agreement by the Ghanaian government is still pending as negotiations are still on-going conjointly under ECOWAS.

Ghana is relatively active on the international trade scene. Trade as a percentage of GDP increased from 11.5% to 110% between 1983 and 2001. Thereafter, it started dwindling till 2011 when Ghana started exporting oil. Ghana currently exports significant amounts of gold, unprocessed cocoa as well a few non-traditional[3] exports products and oil. The three main export commodities (cocoa, gold and oil) constituted 78.3% of total export earnings in 2013 (Bank of Ghana, 2014). It accumulates most of its foreign exchange earnings through these exports. Oil production in 2012 increased from about 75,000barrels a day to about 110,000barrels a day earning close to USD3.0billion which accounts for close to 22% of total export value (about 5% of total revenue of government) for the country. Ghana, being the second largest producer of gold in Africa[5] accumulates most of its foreign exchange earnings through the exportation of this mineral. By the end of September 2012, export of gold and cocoa made 46% and 18.8% of exports receipts while crude oil accounted for 20.7% (The African Economic Outlook 2013). Performance of trade in 2013, however, probably as a result of the fall in prices of the major export commodities (gold and cocoa) resulting in a decrease in export earnings. There was also a decline in services. This did not affect the trade deficit significantly because of the offsetting increase in revenues from oil and non-traditional exports as well as a reduction in the demand for imported goods, influenced to an extent by the steady depreciation of the Ghanaian cedi relative to major trading currencies.