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Subject: **Reacting to a depreciating cedi: some comments and preliminary ideas**
To:

Comments, random thoughts, preliminary ideas: intended to be thought-provoking ... Forgive typos ...

Most Ghanaians live in rural areas or poor neighborhoods. They eat at chop bars and buy food and other items in stores and markets where prices are not quoted in dollars. They rarely buy or sell dollars because their lives are not dollarized. In terms of the number of transactions or the proportion of the population involved, dollarization is very low. Although data is not available, I suspect that this it is the value of dollarized transactions that is high. The proportion of the population in the dollarized economy is small. The dollarized economy in Ghana is the economy of the elites.

If the welfare of the consumers (the citizens) is ultimately what matters, why do we seem to directly use the exchange rate as an anchor or target but not the internal inflation rate? **If we want to reduce imports, shouldn't we allow the cedi to depreciate to some level**? Or it because we have no locally-produced goods and services for the reduced imports? This point was poignantly made in an article by a self-described "kenkey economist":

"As the Cedi depreciates, imported goods become more expensive and our affordability declines. Goods produced in Ghana may also become more expensive as a result of the currency depreciation because they often use some imported raw materials, equipment and spare parts. By making imported goods more expensive, the Cedi's fall by itself is a corrective mechanism which curbs our affordability and forces us to reduce our appetite for imports.

However, this blanket increase in the cost of every imported item may be a less optimal way for Ghanaians to address our excess import consumption situation. **A better result could be achieved through effective government policy aimed at reducing excessive import demand by favouring imported items that are likely to be of most benefit to the average Ghanaian like medicines, agricultural and industrial equipment that encourage local production, and at the same time imposing more punitive measures (e.g. special taxes) on those imported items that may be nice to have but least necessary for the average Ghanaian (e.g. imported drinks, furniture, luxury cars etc)**.": http://www.modernghana.com/news/521747/1/the-kenkey-economist-how-we-ar.html

What informed the Bank of Ghana's recent directives? The Bank of Ghana partly relies on an index it developed in 2003 to monitor month-to-month movements in economic activities. This index called the Composite Index of Economic Activity (CIEA) was developed in a BOG working paper (WP/BOG-2003/04) titled "Estimating a Composite Indicator of Economic Activity for

Ghana": http://www.bog.gov.gh/privatecontent/Publications/Staff_Working_Papers/composite%20indicator%20of%20economic%20actvity%20for%20ghana.pdf

The **authors** of this paper and the Bank must be commended for developing this index for Ghana, a commonly-used index in other countries. However, a curious aspect of the CIEA is the inclusion of imports as a positive sign of economic activity. In the original 2003 paper at the link above, this component of the index was described as "Commodity Imports, which captures a proportion of domestic consumption patterns". While the analysis in the paper followed standard methodology in other countries, this aspect of the index may lead to misleading policy responses in a country that is too dependent on imports.

Addressing the media after a meeting of a Monetary Policy Committee meeting in September 2013, the governor of the Bank, Dr Wampah's views about the state of the economy were reported as follows:

"Dr Wampah said **on the balance of risks to inflation and economic growth**, the Monetary Policy Committee decided to keep the policy rate unchanged at 16 per cent. According to Dr. Wampah, an update of the Bank's Composite Index of Economic Activity (CIEA) in July 2013 suggested increased momentum in economic activity, with the real CIEA improving to 350.1, from 326.9 in July 2012, representing a year-on-year growth of 7.1 per cent.

Driving this pace of activity, he said, were industrial electricity consumption, exports, manufacturing sales, DMBs credit to the private sector, sales of cement and domestic VAT, adding that **the positive growth recorded in these variables was partially offset by contractions in** port activity, SSNIT contributions and **imports**.": http://www.ghana.gov.gh/index.php/2012-02-08-08-32-47/general-news/3113-monetary-policy-committee-reviews-economy

Does the Bank really believe that a reduction in imports is necessarily bad for the Ghanaian economy? The import of what? Don't hold the authors of the index responsible. No need to play politics. That's not my goal.

What signal did the CIEA give the Bank in say January 2014? According to Bank's Monetary Policy Committee's press release on February 5, 2014:

"The uncertainties in the outlook and **weakened domestic fundamentals** underscore the need for continued tight fiscal and monetary policies and measures that would reduce the country's vulnerability to shocks, **re-anchor inflation expectations** and sustain macroeconomic stability. **These informed the decision to increase the policy rate by 200 basis points**"

The BOG kept the policy at 16% from September 2013 (or earlier) to January 2014. It only increased it by 200 basis points to 18% about 5 days ago. Like some Central Banks (e.g., the Bank of Canada), the Bank of Ghana follows a policy of **Inflation Targetting**; it targets inflation at 9% with a band between 7% and 11% (it's 1% for the Bank of Canada with a band between 1% and 3%). Since September 2013, inflation has been higher than 11% (outside the Bank's inflation band) with the months of October, November, and December recording figures in excess of 13%. Why did the Bank maintain the policy rate for five months till its emergency meeting a few days ago? Did we not see this coming? Just asking. Besides, should we use contractionary monetary policy to solve a problem of cost-push or low-supply-induced inflation?

Why do we think that $1 = 2.60 cedis is too high or the rate of depreciation is too fast? What is happening to the rate of inflation? Does a 13.5% rate of inflation in December 2013 with a 7.2% **food/non-alcoholic** inflation rate justify the Bank of Ghana's reaction? According to the Ghana Statistical Service, in December 2013, "Housing, water, electricity, gas and other fuels recorded the highest rate of 35.0 percent followed by Transport which recorded 25.6 percent." Instead of foreign exchange controls, we could have responded by reducing the numerous taxes on petroleum products plus much less draconian forex controls (a mix of policies). The reduction in these taxes will worsen the deficit but that it is better than these draconian forex restrictions (which pill shall ye swallow?). Furthermore, the adverse effect on the deficit can be mitigated by cutting frivolous expenditure. We don't have to look hard to find them. In this respect, the Monetary Policy Committee of the Bank in its press release on February 5, 2014 was right in noting that:

"**All these must be re-enforced by ensuring that all the budgetary targets are strictly adhered to, for fiscal consolidation**. The Committee acknowledges the on-going reforms to improve revenue mobilization whilst containing expenditures. However, **a lot more is required in rationalizing the high wage bill**."

The Monetary Policy Committee also recommended that:

"In the medium to long term, government must seek to broaden the tax base further, diversify and broaden the export base, reduce imports especially of consumption goods that have local substitutes, and intensify efforts to block foreign exchange leakages, such as transfer pricing. We are aware of efforts by Government in this direction.

There is also the need to consider renegotiating existing stability agreements with exporters to ensure that all retention accounts are maintained with domestic banks as pertains in other countries such as Angola, Guinea, and Nigeria among others."

The Ghana Statistical Service's (GSS) Consumer Price Index (CPI) is based on a basket of 408 goods and services. The rate of inflation over a given month is equal to the percentage change in the CPI over that month. I suggest that the CPI should be disaggregated in terms of the goods in the basket that are imported (call it import CPI) and locally-produced or non-tradable goods (call it local CPI) in the basket (e.g., transport fares, rent, food like yams, kontomire, etc). The overall CPI can then be algebraically expressed as a weighted sum of the local CPI and the import CPI, with the weights depending on the proportion of expenditure on local and imported goods in the base year. We can then provide an exact answer to the question: "what proportion of the overall percentage change in the CPI per month (the inflation rate) is due to the changes in the import CPI?" We should then compare the weighted percentage changes in the import CPI to (a) the weighted percentage changes in the local CPI and (ii) percentage changes in the nominal cedi-dollar exchange rate. These comparisons recognize the effect of changes in the exchange rate on the prices of non-tradable goods/services like accommodation (rents) and transport (fares). This exercise will help us to devise more informed and measured policy responses to a depreciating currency instead of fear-induced responses.

An objection to my proposal is that some locally-produced goods use imported inputs, so the distinction between local CPI and imported CPI may be blurred. Fortunately, this is not a problem because the CPI measures the changes in the cost of a basket of **final consumer** goods and services. The effect of the prices of inputs will be captured in the prices of locally-produced consumer goods and services in the basket. A list of products imported by Ghana can be found here: http://countries.bridgat.com/Top_Products_Imported_by_Ghana.html

By the way, the GSS has a group of miscellaneous goods and services in its CPI basket (7 items in this group). Guess what, one of the services in this group is **prostitution**. Go figure! See the third page of this document:
http://www.statsghana.gov.gh/docfiles/CPI%20Release_pdf/cpi_national_time_series_jan1970-sept2012.pdf