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THE ANSWER TO THE CEDI'S WEAKNESS IS TO ADDRESS THE ECONOMY'S FUNDAMENTALS

by
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Summary

The Ghanaian Cedi has been on the decline for the better part of its history, apparently with no end in sight. An IEA study has determined that the long-run decline of the Cedi is influenced by economic fundamentals that drive the real rate towards its equilibrium level. Further, despite the recent sharp depreciation of the currency, there is no clear evidence of misalignment. In particular, contrary to expectation, the study did not find any significant "overshooting" of the equilibrium value or "real undervaluation." The results of the study suggest that to stem the tide of depreciation, policy strategy must focus on strengthening the economy's fundamentals, with sustained macroeconomic stability and growth being at the center.

IEA Ghana

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Ghana adopted an independent currency and monetary policy from the time of independence in 1957. After operating with a fixed-type exchange rate regime through 1982, a more flexible regime was introduced in 1983 as part of the Economic Recovery Program (ERP). This regime has more or less been kept in place till today. Over the years, the currency has been redenominated several times. Meanwhile, the exchange rate has depreciated continuously, fueling inflation, eroding national income, and undermining confidence in the economy.

The exchange rate is affected occasionally by short-term demand and supply shocks, some seasonal in nature. The long-term depreciation, however, reflects more fundamental factors. Past studies, including some undertaken by the IEA, focused largely on identifying the causes of the depreciation. Not much work has however been done on determining the equilibrium path for the exchange rate. Such determination is important in unraveling any misalignment, i.e. overvaluation or undervaluation. Like other prices, exchange rate misalignment can cause distortions in the economy, including poor performance of exports, undesirable levels of imports, adverse movements in the capital account and sub-optimal domestic output. Misalignment can also precipitate inflation and debt crisis. It may also breed rent-seeking and protectionism. In general, exchange rate misalignment can jeopardize competitiveness and the overall performance of the economy.

In a recent study, the IEA determined the fundamental drivers of the real exchange rate and assessed the degree of misalignment for the period 1980-2010. In line with both the theoretical and empirical literature, the fundamental determinants were represented by productivity, trade openness, real relative interest rate, government expenditure, terms-of-trade and foreign reserves. The results showed a significant causal relationship between the real exchange rate and these fundamental factors.

Providing some detail on the effects of the individual factors, while trying not to be too technical, productivity is found to have a positive (appreciating) impact on the real exchange rate, supporting the theory that an increase in productivity raises the wage level, which increases spending on, and the prices of, nontradables vis-à-vis tradables, a situation that manifests in real appreciation. Trade openness has a negative (depreciating) impact on the real exchange rate, consistent with the theory that more trade openness increases demand for imports and reduces relative demand for, and prices of, nontradables as well as resulting in the worsening of the current account. Real interest rate relative to trading partner rates has a negative (depreciating) impact on the real exchange rate, in line with the literature that higher demand resulting from capital inflow that emanates from an increase in the real relative interest rate is directed mostly at tradables. Total government expenditure has a positive (appreciating) impact on the real exchange rate, supporting the theory that such expenditure is mostly directed toward nontradables. The terms-of-trade has a positive (appreciating) impact on the real exchange rate, consistent with the literature that improvement in the terms of trade increases national "wealth" that leads to higher domestic demand directed at nontradables. Finally, foreign reserves have a negative (depreciating) impact on the real exchange rate, in line with the theory that an increase boosts demand that is directed mostly at tradables. While this result seems counter to the preponderance of the literature that assigns a positive (appreciating) influence of reserves on the real exchange rate through the "Dutch disease," it is consistent with other findings for Ghana and Nigeria.

The equilibrium real exchange rate follows a declining path during the study period. This implies that the combined effect of the factors pulling it down (i.e. causing it to depreciate) outweigh the effect of those pulling it up (i.e. causing it to appreciate). This also suggests that there has been constant downward pressure on the actual real exchange rate, since

any deviation of the actual real exchange rate from the equilibrium level must be corrected over time. The study, indeed, found that as much as 97% of any misalignment is corrected within a year. This is a relatively fast pace of adjustment that is consistent with other findings for Ghana.

The results of the study show clear evidence of misalignment of the real exchange rate one way or the other—i.e. overvaluation or undervaluation—throughout the study period. Starting from a position of undervaluation in 1980, the real exchange rate became strongly overvalued during1981-83 vis-à-vis its equilibrium level. This was a period when the fixed nominal exchange rate became grossly overvalued in the face of high inflation, general macroeconomic instability, and severe economic distortions. Starting from 1983, extensive steps were taken to liberalize the economy and to improve its overall performance. These corrective measures eliminated the previous overvaluation and led to undervaluation during 1984-90. For the rest of the period, 1991-2010, various policy measures led to bouts of macroeconomic stability and instability, which affected the direction and degree of misalignment. On the whole, the real exchange rate was found to be overvalued during 1981-83, 1991-92, 1996-99, 2005-08, and 2010; and undervalued during 1980, 1984-90, 1993-95, 200-2004, and 2009. (See Table).

Table 1

Period	Direction of Misalignment	Degree of Misalignment
1980	Undervaluation	Pronounced
1981-83	Overvaluation	Elevated
1984-90	Undervaluation	Pronounced
1991-92	Overvaluation	Moderate
1993-95	Undervaluation	Moderate
1996-99	Overvaluation	Pronounced
2000-04	Undervaluation	Moderate
2005-08	Overvaluation	Moderate
2009	Undervaluation	Moderate
2010	Overvaluation	Moderate
Jan. 2011-June 2012*	No clear indication*	Negligible*

*Tentative inferences

The determination of exchange rate misalignment extends to 2010 based on available data. Beyond that date, some tentative inferences can be made using data available from Bank of Ghana. The data indicates that from January 2011 to June 2012, the bilateral dollar-cedi rate depreciated by about 20%. However, the (trade-weighted) real effective exchange rate depreciated by only 2%. This suggests that nearly 18% of the nominal depreciation accounted for inflation differential with Ghana's trading partners. The IEA study found "real overvaluation" of about 1.6% as of end 2010. Therefore, the 2% real depreciation that occurred during January 2011-June 2012 just about erased the real overvaluation existing as of end 2010. Further, assuming all things equal, in particular that the equilibrium real exchange rate does not change between end-2010 and June 2012, it can be deduced that the sharp nominal depreciation that occurred during the period restored the real exchange rate to its equilibrium level and that by June 2012 there was no significant misalignment one way or the other.

The study importantly determines that the long-run decline of the cedi is influenced by economic fundamentals that consistently drive the real rate towards its equilibrium level. Further, despite the recent sharp depreciation of the currency, the study does not find any clear evidence of real misalignment. In particular, contrary to expectation, the study does not find any significant "overshooting" of the equilibrium value or "real undervaluation." The results of the study suggest that to stem the tide of cedi depreciation, policy strategy must focus on strengthening the

economy's fundamentals, with sustained macroeconomic stability and growth being at the core. The IEA has articulated some of these policy measures in other publications.[1]

[1] **1.** IEA Legislative Alert, vol. 10, No. 7, June/July 2012: *The recent slide in the cedi should be a wake-up call.* (by Dr. J. K. Kwakye).

2. IEA Legislative Alert, vol 19, No. 8, 1 June, 2012, *The perils of a "Guggisberg economy.*" (by Dr. J. K. Kwakye).

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