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FIVE YEARS OF INFLATION-TARGETING IN GHANA: WHAT HAS CHANGED AND WHAT NEEDS TO CHANGE FURTHER TO ENHANCE THE PROCESS?

by
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Summary

After achieving political independence in 1957, Ghana set up its own central bank to conduct independent monetary policy among other functions. Since then, various frameworks have been adopted to deliver price stability as the principal goal of monetary policy.

Evidence shows that Ghana has had higher rates of inflation compared to most of its African peers during its history. This unenviable record can be attributed to both the causes and management of inflation. The causes have received considerable attention in the literature. High domestic demand fuelled by expansionary fiscal policies and accommodating monetary policies and the high proclivity of the economy to supply shocks particularly with respect to food, which commands a large weight in the consumption basket have been identified as the principal causes of the high rates of inflation.

The effectiveness of monetary management, has, however, not been sufficiently investigated. The effectiveness of monetary policy depends to a large extent on the framework chosen to conduct it. A critical analysis of the monetary policy frameworks used in Ghana has been undertaken from which important lessons for the future have been drawn.

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MONETARY POLICY FRAMEWORKS

Ghana's system for delivering price stability has evolved from essentially a monetary-targeting approach to an inflation-targeting approach.

The monetary-targeting approach was in place up to 2006 and had two variants. The first was a credit-control approach, which was implemented up to 1991. This approach targeted domestic credit directly in order to achieve money supply targets as an intermediate variable and, finally, inflation targets. The credit targets were mostly violated due to higher budget financing, leading to breaches of the money supply targets. The second variant of monetary targeting, in place between 1992 and 2006, used open market operations (OMO)—involving the sale and purchase by the central bank of financial instruments—as the operating instrument and money supply as the intermediate target. Because of the persistence of excess liquidity in the economy, OMO was invariably unidirectional, involving the sale of instruments. OMO was, however, undermined by a lack clear separation between the sale of instruments to mop up liquidity, and the sale of instruments to raise money to finance the budget. OMO was further undermined by the fact that in order to reduce cost, there was some interference with the market process to set both quantity and price (interest rate) targets. Apart from these operational difficulties, the relationship between money supply and inflation supposedly became increasingly tenuous. This phenomenon usually occurs during financial and other structural changes in an economy. In fact, in the past many years, monetary growth rates have been much higher than inflation rates, presumably because of growing money demand amid the structural changes taking place in the economy.

Against the backdrop of limited success in achieving intermediate and final targets under the monetary targeting framework, including due to the apparent weakening of the link between monetary aggregates and inflation, in 2007, the monetary authorities decided to shift from monetary targeting to inflation-targeting (IT). Under IT, the central bank uses its Policy Rate (PR) to target inflation directly without using monetary aggregates as a route. The PR is transmitted by banks through their own rates to the economy. In practice, the transmission of the PR has been tenuous and slow due to low competition in the banking industry, other structural weaknesses in the financial system, lack of safety nets in lending, and persistence of excess liquidity in the economy. This situation has somewhat undermined the IT process. Further, IT has been undermined by fiscal dominance, inadequate exchange rate flexibility, inadequate transparency, and possible shortcomings with data and forecasting.

MONETARY POLICY RECORD

Monetary policy implementation in Ghana has faced major challenges. In general, inflation rates have been generally high and targets have more-often-than-not been missed. This has cast doubts on the effectiveness and credibility of monetary policy.

The empirical literature shows that inflation has had a close relationship with monetary aggregates. Large-scale deficit financing has been a major source of monetary expansion and, consequently, inflation. As noted above, in the credit control era, ceilings on credit to government were invariably breached, which consequently affected money supply targets. During the OMO era, the capacity to control liquidity was undermined by a lack of clear separation between OMO and government debt operations (GDO). Compounding this difficulty was the growing breakdown in the link between money supply and inflation in the face of structural changes in the economy.

Notably, inflation rates have been generally lower under the IT regime. This performance, however, cannot be attributed entirely to the effectiveness of IT, which is still plagued by operational challenges. Several factors have contributed to the lower rates of inflation. Macroeconomic management in general continues to improve, including fiscal policy, although there is still room for further consolidation. Low food inflation has contributed to drive down headline inflation. In fact, the maintenance of single-digit inflation in the past two years or so has been made possible exclusively by food inflation as nonfood inflation has remained in double digits for the entire period. Major items of the CPI, including fuel and utilities, have enjoyed subsidies which have kept their prices below market prices. Close management of the exchange rate has reduced its impact on prices. Finally, Ghana has benefited from subdued global inflation following the 2007-08 financial crisis and attendant recessionary conditions in major countries.

LESSONS FROM MONETARY POLICY IMPLEMENTATION

A rundown of monetary policy practices has revealed important lessons that can be taken forward.

The first lesson is the difficulty in managing inflation in a supply-constrained economy like Ghana's, where food alone commands 45 percent of the CPI basket. Food supply is subject to natural and man-made bottlenecks and is consequently prone to shocks. Added to this is the effect on inflation of items like energy and utilities whose prices are subject to exogenous factors and government policies unrelated to normal demand and supply factors. In the circumstance, targeting headline inflation is like chasing a mirage. In other jurisdictions, the monetary authorities usually select a core measure of inflation, which they can effectively control. It is still necessary, however, to monitor the headline measure while the authorities indicate that they stand ready to take measures as needed to stem the second-round effects likely to emanate from the influence of the exogenously-influenced items in the consumption basket.

The second lesson is the difficulty in managing inflation in the face of persisting fiscal dominance in the economy as Ghana has experienced in its history. Ghana's peers that opted for currency boards and monetary unions insulated from fiscal interference have been more successful in controlling inflation. Fiscal dominance that also spills over into central bank financing of the deficit renders monetary policy incapable of effectively controlling inflation. The solution is of course restoration of fiscal discipline that complements rather than opposes monetary policy. Further, the autonomy of the central bank needs to be strengthened such that it can use its instruments freely and also be able to resist arbitrary use of its funds to finance the budget.

The third lesson is the difficulty in managing inflation, especially using a market-based approach like inflation-targeting, in an environment of low final intermediation and shallow financial depth. In such an environment, the financial sector is incapable of transmitting monetary policy signals to the real economy. There is no easy solution to this problem which requires time, but also a little bit of push, as necessary to transform the financial sector and orientate it more towards economic development.

THE APPROPRIATE FRAMEWORK AND PREREQUISITES

On the question of choosing the appropriate monetary policy framework, the country seems to have long moved away from the system of credit controls or fixed exchange rates, which were plagued by considerable operational difficulties. The pure forms of monetary- and exchange rate-targeting approaches to monetary policy do not, therefore, appear to be viable options currently. However, monetary aggregates and the exchange rate remain important determinants of inflation in Ghana and must be taken into account under any approach that is used.

Despite the teething problems of the current inflation-targeting (IT) framework, some of which have been enumerated above, it has potential and must be given the chance to work while overcoming the initial challenges. Important considerations in this regard include:

1. Complementary fiscal discipline—anchored on prudent and sustainable financial management.
2. Sufficient flexibility in the exchange rate to help absorb shocks and take some of the pressure off monetary policy. The problem is that often we set multiple targets like inflation and the exchange rate and then run out of instruments to achieve them.
3. Financial sector development and deepening to enhance intermediation and transmission of monetary policy signals to the real economy.
4. Transparency of the IT process through provision of information on the setting of inflation targets and the decisions behind changes in the Policy Rate.
5. Enhancement of the forecasting process through improvement in the timeliness and reliability of data as well as the information-content of the forecasting model.
6. Finally, an institutional commitment to and accountability for achieving inflation targets to enhance the credibility and confidence in the IT process.

Some commentators, including the IMF, have suggested that the central bank should initially focus on "inflation forecast targeting" in which it seeks to make its best "inflation forecast" equal to its "inflation target." This is in view of the initial problems with IT when inflation targets may be difficult to achieve, thereby eroding policy credibility. The authorities could give consideration to this proposal as a transition arrangement while trying to institute firm targets as IT matures.

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