Rethinking Inflation Management in Ghana in the Wake of Covid-19 and Russia-Ukraine War

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1. Introduction

The entire globe is experiencing unprecedented rates of inflation brought on by Covid-19 and the Russia-Ukraine war. Disruption of production and supply chains have driven up food and fuel prices, which have spilled over to other consumer goods. In the US, inflation was 8.6% in May, the highest in 40 years; in the UK, it was 9.1% in May, the highest in 40 years; in the EU, it was 8.1% in April, the highest in 25 years; in India, it was 7.8% in April, the highest in 8 years; in Nigeria, it was 16.8% in April, and in Turkey, it was over 70% in April. To come home, in May, Ghana's inflation reached 27.6%, the highest in 18 years. In the past year, inflation has risen consistently every month and has nearly quadrupled over the period. Almost every consumer item has been affected and, with wages and most incomes being almost stagnant, Ghanaians are experiencing untold economic hardship.

So far, the Bank of Ghana (BoG) has responded quite aggressively to the inflation crisis by raising its Policy Rate (PR) cumulatively by 550 basis points in the past year to 19.0%, the last increase being 200 basis points in May. The strong policy tightening, however, has not been able to bring inflation under control. Central banks in the US, UK, EU and elsewhere have all tightened their policies significantly in recent months, albeit with limited success. The struggle by central banks in reining in inflation may be partly explained by the scale and persistence of the supply-side drivers of the current inflation, especially food and energy. These drivers are less amenable to the traditional demand tools used by central banks to manage inflation. Many countries risk being plunged into recession if the causes of the inflation persist and central banks also continue to tighten their policies. For us in Ghana, the pandemic and the Russia-Ukraine war have exposed our underlying economic vulnerabilities, while offering an opportunity for us to rethink our inflation management.

2. Inflation Management

The BoG adopted Inflation Targeting (IT) in 2007 as its new monetary policy framework, replacing the previous Monetary Targeting (MT) framework. Unlike MT that targeted money supply directly, IT targets inflation directly without going through the money supply route. The introduction of IT was partly based on the judgement by the BoG that the link between money supply and inflation had become increasingly tenuous, with growing changes in the financial and economic structure. Based on a broad range of information on the economy, IT uses the Policy Rate (PR), the base rate for lending to banks, to influence interest rates banks charge on various consumer loans. To reduce inflation, the PR is raised to increase the cost of credit throughout the economy. Faced with the high cost of credit, consumers, in principle, reduce their purchase of goods and services generally, which brings down prices in the economy. The central bank's signal to control inflation should also help to dampen inflation expectations, which could slow down wage demands and price increases by producers and traders, thereby, further helping to ease inflation pressures. The snag, however, is that unlike in mature economies with developed financial systems where the PR is easily transmittable to interest rates on credit cards, mortgage loans and other consumer loans and, thereby, easily influences consumer behaviour, these conditions do not entirely prevail in a developing country context such as Ghana's. Because the Ghanaian financial system is less developed, financial products are limited and financial inclusion is low, the PR is less transmittable through the economy and its potential to influence consumer behaviour and inflation is constrained.

In principle, IT enhances transparency and accountability in inflation management compared to MT. To be effective, however, IT requires certain structural and policy conditions to be in place. First, a fully-developed financial system that comprises highly-competing institutions and offering a variety of financial products is required for effective transmission of monetary policy impulses. In Ghana, as in many developing countries, the financial system is not fully-developed and this makes the transmission of monetary policy slow or incomplete. Second, the central bank should have sufficient autonomy to be able to make independent monetary policy decisions without much interference from the "Treasury." To a large extent, the BoG meets this requirement as autonomy is conferred on it by its Act *(*Act *918),* and is able to make independent policy decisions. Further, the Bank's financing of the budget has been severely restricted in recent years to prevent the kind of inordinate financing that prevailed under, and undermined, MT. Third, fiscal discipline is key to reduce fiscally-induced demand pressures that tend to undermine monetary policy. This condition does not fully prevail in Ghana, where high fiscal deficits persist and fuel demand pressures and, consequently, inflation. Fourth, a flexible exchange rate regime is necessary to help in absorbing economic shocks and, thereby, ease pressure on the PR. While Ghana operates a flexible exchange rate regime, flexibility is limited by active interventions by BoG to stem inordinate depreciations. The inclination by the BoG to stem exchange rate depreciation renders the exchange rate a *de facto* secondary target of monetary policy, which is, thereby, somewhat undermined. Fifth, initial low inflation at the time of adoption of IT is desirable so as to be able to set reasonably-low inflation targets. This condition was not in place as Ghana adopted IT in 2007. As of end-2016, Ghana's inflation was 10.9%, which was much higher than that of other inflation targets at the time they adopted IT. This led the central bank to set an initial inflation target of (8.5+/-2)%, which was also much higher than initial rates set by other inflation targets. In fact, because high inflation has persisted subsequent to adoption of IT, the initial target has been changed only marginally to (8+/-2)%, which stands currently. Sixth, adequate and reliable data and a robust and comprehensive forecasting model are ideal requirements for a successful IT. Data adequacy and reliability cannot be said to be the best, placing limitations on IT. The forecasting model may be of IMF standard, but the question that always arises is whether it is fully applicable to a developing-country context like Ghana's. The jury may be said to be out as far as this requirement is concerned. It is clear that not all the key conditions of IT were met at the time BoG adopted IT in 2007—and even up till now. In view of this deficiency, the IMF initially expressed reservation about the adoption of IT by BoG. Indeed, the IMF chose to classify Ghana's IT initially as *IT-lite* rather than a fully-fledged IT. However, with the passage of time, the IMF came around to endorse, albeit reluctantly, BoG's IT.

It is important to point out that even though IT does not control money supply directly, like MT, it is also a demand-management framework. In other words, it is based on the theory that inflation is predominantly a demand phenomenon. Thus, IT seeks to control demand as a pathway to controlling inflation. The theory that inflation is a demand phenomenon, however, may be more applicable to advanced economies that do not face significant supply constraints. In those economies, controlling demand may be enough to control inflation. In developing economies, however, supply constraints may be the principal originators of inflation, while demand may play largely a propagatory role. Thus, apart from the inherent shortcomings of IT mentioned above, the framework is further inhibited in supply-constrained developing economies. This is not to say that it is not necessary to control demand factors in developing economies, for even if they do not originate from inflation, they may generate second-round effects that may still have to be contained.

We reported above that even the mature economies are struggling to bring their current inflation under control due to the severity and persistence of the causes and also in view of the strong supply, rather than demand, undercurrents. For Ghana, in particular, the current and past inflations have strong supply and cost undercurrents. Food and the exchange rate, in particular, are major drivers of inflation. Fuel shocks also impart occasional upward pressure to the inflation profile. In view of these reasons, a strict and sole adherence to IT would be counterproductive as it may inflict more harm to the real sector than intended. It has to be pointed out also that in a country like Ghana where wages, incomes generally and aggregate demand are low, as most people live virtually from hand to mouth, to attempt to squeeze demand further through the IT framework in controlling inflation would seriously dampen economic activity and growth.

3. Inflation Trends and Causes

Ghana has a history of relatively high inflation compared to most of our peers in Africa and elsewhere. In the eighties and nineties inflation was in the high double digits. Over the last twenty years, however, inflation has declined significantly along with improvement in general macroeconomic performance. Empirical evidence identifies fiscal policy, food and the exchange rate as key drivers of Ghana’s inflation.

Fiscal policy has been mostly expansionary and has been a source of demand pressures. Government spending supported by borrowing increases money supply, aggregate demand and inflation. Government borrowing to finance its deficit also increases interest rates and the cost of production that can be passed on in higher prices of goods. The magnitude of inflation that fiscal policy can cause is related to the scale of the deficit. It has to be said that fiscal policy would be more inflationary if government expenditure is more wasteful and unproductive. If however, government expenditure is more productive such as in the form of investments, then while it may boost demand today, it would also lead to more future production that would contribute to lower prices. Government expenditure has been increasingly dominated by recurrent expenditure at the expense of capital expenditure. This is a clear recipe for fiscally-fuelled inflation. We have evidence that shows that fiscal policy in Ghana has been largely macreconomically destabilising, while having limited impact on growth. In recent years, the deficit has escalated, fuelled by Covid, energy and financial sector costs. It is clear that fiscal policy has been fuelling inflation. Ghana's peers in Africa and elsewhere are currently facing the same exogenous shocks, but many of them have experienced less inflation and, in general, less macroeconomic instability precisely because they have reined in their fiscal policy.

Food constitutes an important source of inflation in Ghana. Food production deficits, storage, preservation and processing inadequacies, bottlenecks in carting to markets and inability to ensure adequate supplies all year-round, make food an important determinant of the cost of living and inflation. The fact that food accounts for **43%** of the CPI basket is a testimony to its importance in terms of the cost of living and inflation. Comparative figures for India (16.8%), US (15.2%), and UK (9.2%) indicate that Ghana has a long way to go in resolving its food problem. If food supply is improved and made available all-year round, the cost of living and inflation in Ghana would be reduced significantly.

The perennial depreciation of the exchange rate, the result of the persistent gap between foreign exchange supply and demand, affects domestic prices through imports. The Bank of Ghana, with its limited reserves supplemented by occasional borrowing, is able to intervene occasionally to stem rapid depreciations. The banks' interventions, however, will remain palliatives but cannot stabilise the exchange rate on a durable basis. Only transformative policies that substantially increase our foreign exchange earnings and reduce our demand for foreign exchange would ensure lasting stability of the exchange rate and stem its impact on inflation.

Apart from fiscal policy, food and the exchange rate, occasional shocks to world oil prices, coupled with multiple taxes and levies in the domestic price build-up represent a perennial source of inflation pressure.

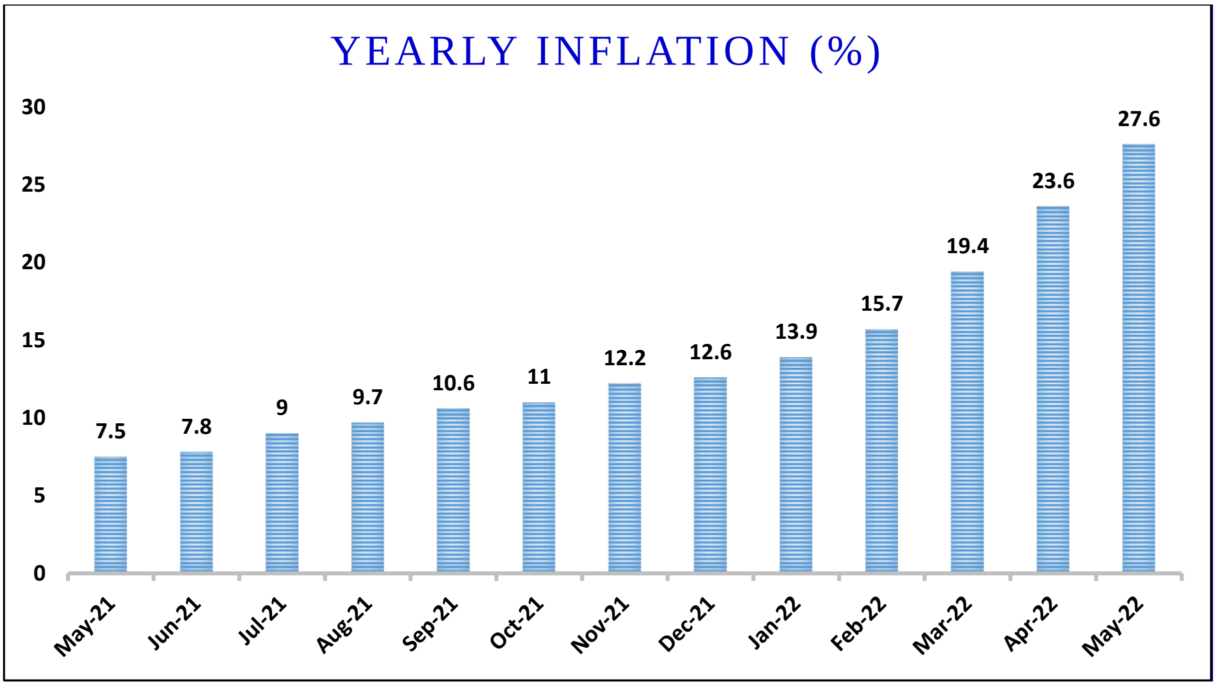
Fiscal policy, which imparts demand pressures to the economy, may be more amenable to IT as a demand-management tool. However, food, the exchange rate and fuel represent supply or cost factors, which may not be directly amenable to the IT, although the IT could help mitigate the second-round inflation that they tend to cause.

Table 1: Inflation (Year-on-Year), 2000-2020

Year	Inflation Rate (Year-on-Year)
2000	40.5
2001	21.3
2002	15.2
2003	31.3
2004	16.4
2005	13.9
2006	10.9
2007	12.8
2008	18.1
2009	16.0
2010	8.6
2011	8.6
2012	8.8
2013	13.5
2014	17.0
2015	17.7
2016	15.4
2017	11.8
2018	9.4
2019	7.9
2020	10.4
Average	15.5

Source: Ghana Statistical Service

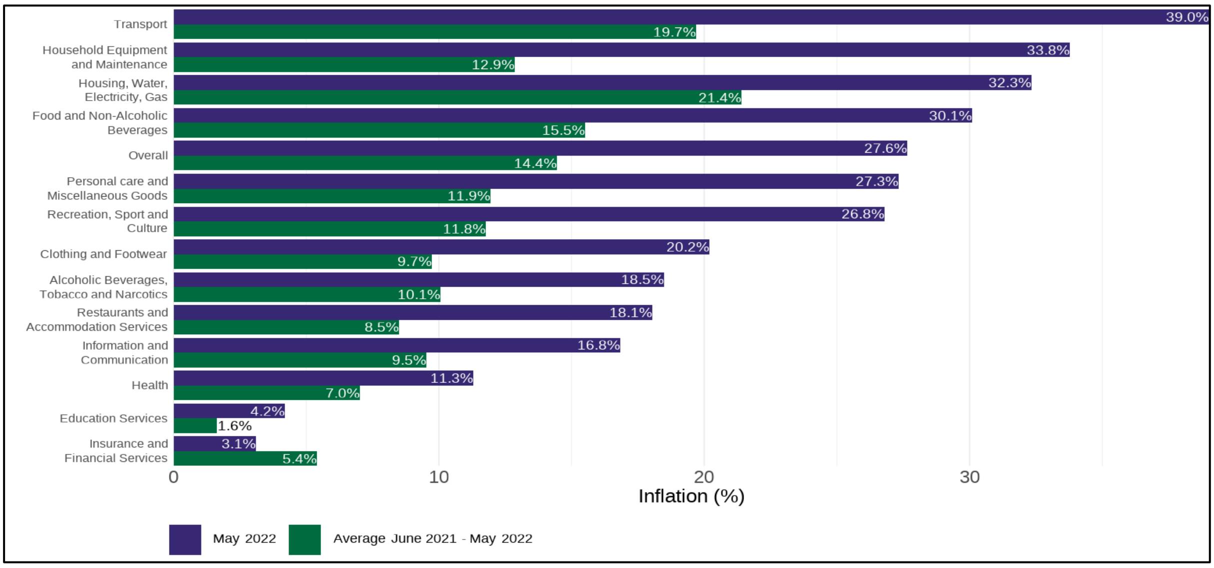
Fig 1: Yearly Inflation, May 2021-May 2022



Source: Ghana Statistical Service

In fact, as recent as May 2021, inflation had declined to just 7.5%, although the decline had been helped by low food inflation and the rebasing of the CPI in May 2019. Since then, however, inflation has risen consistently to 27.6% in May 2022.

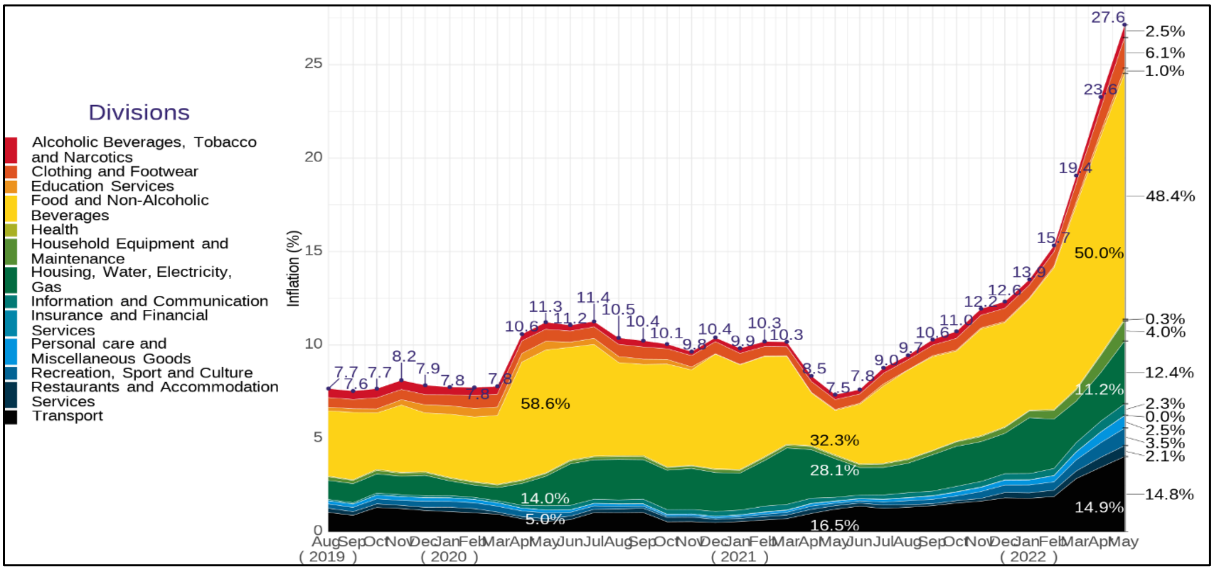
Fig 2: Relative Inflation in the 13 Major Divisions of the CPI in May 2022



Source: Ghana Statistical Service

Notably, some items in the 13 major divisions of the CPI recorded much higher rates of inflation in May than the headline rate of 27.6%. These were: Transport (39.0%), Household Equipment and Maintenance (33.8%), Housing, Water, Electricity, Gas (32.3%), and Food and Non-Alcoholic Beverages (30.8%).

Fig 3: Contributions of the 13 Major Divisions of the CPI to May 2022 Inflation



Source: Ghana Statistical Service

In terms of contributions to headline inflation in May, three of these very four items were dominant. These were: Food and Alcoholic Beverages (48.4%), Transport (14.8%), and Housing, Water, Electricity, Gas (12.4%), bringing their total contribution to 75.6%. Indeed, over the 3-year period, May 2020-May 2022, these very items dominated inflation, contributing an average of 76.7% per year. These figures clearly point to the key factors driving Ghana's inflation and which should receive the most attention in addressing the problem.

The Ghana Statistical Service (GSS) provided data on the 15 most inflationary items in May (Table 1). The figures showed that inflation for these items was much higher than the headline inflation of 27.6%.

Table 2: Top 15 Most Inflationary Items in May 2022

Item Name	Item Type	Year-on-year inflation (May 2022)
Grapes	Food, imported	100.8%
Diesel	Non-food, imported	81.1%
Solid Fuels (firewood)	Non-food, local	73.7%
Watermelon	Food, local	73.2%
Petrol	Non-food, imported	62.0%
Maize	Food, local	61.2%
Corn Dough/Corn Flour	Food, local	60.8%
Gas	Non-food, imported	60.2%
Washing Soap	Non-food, local	59.9%
Charcoal	Non-food, local	57.6%
Wheat Flour	Food, local	57.0%
Avocado Pear	Food, local	54.4%
Vegetable Oil	Food, imported	53.4%
Groundnut Oil	Food, local	53.3%
Margarine	Food, imported	49.3%

Source: Ghana Statistical Service

Topping the list were: Grapes (100.8%), Diesel (81.1%), Solid Fuels (Firewood) (73.7%), Watermelon (73.2%), Petrol (62.0%), Maize (61.2%), Corn Dough/Corn Flour (60.8%) and Gas (60.2%. The figures also show that Ghanaians experience different rates of inflation and different degrees of economic hardship depending on what goods and services they predominantly consume.

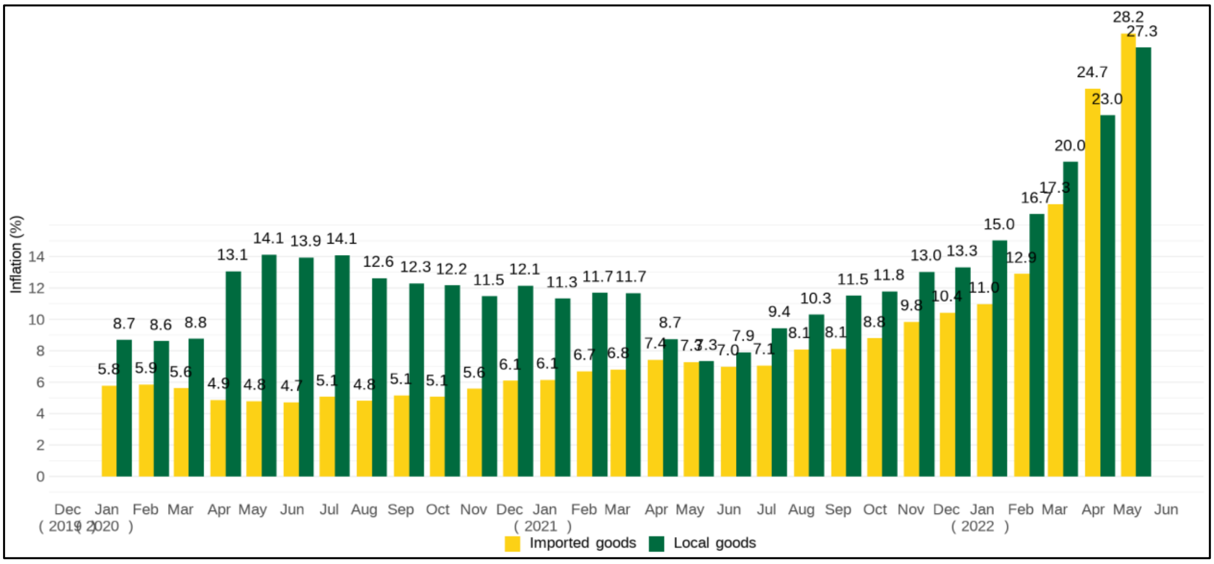
4.0 A New Approach to Managing Inflation

The nature of inflation in Ghana actually requires concerted efforts by both the Bank of Ghana and Government to address it. This can be done while the BoG retains primary responsibility and its autonomy in controlling inflation. Even in major countries such as the US and UK, the governments have made inflation control a top policy priority and are taking measures to complement their central banks' actions. The same approach is needed in Ghana.

With respect to the current inflation, the Government must act to mitigate the effects of the major drivers, which, according to the figures quoted above, include food, fuel and transport. Indeed, the GSS has been at pains to point out the main sources of Ghana's inflation, with the view to guiding policymakers in taking appropriate remedial measures. For food, the Government should access the ECOWAS strategic stock to supplement domestic supply. This is the time also to import some food items and ban exportation of essential items such as maize. Further, the Government should provide a temporary subsidy for staples like maize, rice and bread to ease the burden on low-income consumers. Even the IMF, which is known not to be a fan of subsidies, has called on Governments to provide food subsidies to cushion effects of high prices on their citizens. For fuel, the Government should use some of its windfall earnings from higher oil prices of over US$100 as against the budget estimates of about US$60 to cushion domestic pump prices. This is the time to activate the Energy Sector Stabilisation Levy Act (ESLA), meant to accumulate tax funds to cushion future shocks. Government should also reduce some of the numerous fuel taxes and levies. For transport, the Government should increase the availability of intra- and inter-city buses. Government should also subsidise public transport to reduce the hardship on commuters.

The role of food, fuel and transport in fuelling inflation is directly discernible from the GSS data. What may not be so discernible, however, is the role of the exchange rate.

Fig 4: Imported Goods vs Local Goods Inflation, Jan 2020-May 2022



Source: Ghana Statistical Service

In May, inflation for imported goods was 28.2% as against 27.3% for local goods. Indeed, imported goods inflation has increased almost consistently since May 2020 and the exchange rate is clearly behind this. The BoG should act to stem the current instability in the exchange rate. To this end, the BoG should, as it, rightly, initiated recently, enforce the foreign exchange laws, including relating to external transfers generally, money laundering, domestic trading in foreign currency and domestic pricing in foreign currency to ease pressure on the *cedi*. The BoG should go further to engage with foreign mining companies, oil and gas companies, telcos and banks that are making windfall profits to slow down the repatriation of their profits and dividends to ease pressure on the *cedi*. The BoG may offer to keep custody of, and remunerate, the funds until they are ready to be repatriated. The BoG should continue to conduct measured market interventions to counter extreme exchange rate volatilities. Meanwhile, the BoG should continue to keep monetary policy on a tight leash to stem demand pressures in the economy, while watching how inflation evolves in the coming months. If global supply chains improve, that will have a soothing effect on global inflation generally, although a lot depends on how the Russia-Ukraine war evolves. The risk of a more aggressive monetary policy tightening, however, is to arrest the fledgling economic recovery, a risk that faces even advanced economies.

While the current inflation being experienced has new exogenous drivers like the pandemic and Russia-Ukraine war, it has clearly exposed Ghana's underlying proclivity to inflation as well as the limitations of the monetary policy management framework. To deal with inflation on a lasting basis, a multi-pronged approach is needed. This should be a combination of the IT approach with an approach that directly targets the persistent supply and cost undercurrents. This may be likened to a "micro-management" approach to the extent that it targets individual items in the CPI as against the IT framework that essentially targets the entire CPI, and may therefore be classified as a "macro-management" approach. The following specific policies are recommended in support of the IT framework:

Food policy: There is a need to ensure adequate food supply all year-round. The Planting for Food and Jobs, One-Village One-Dam and One-District One-Warehouse policies are potentially important food supply-chain initiatives, but their effect is yet to be fully felt. It will be important to intensify efforts to increase food production and ensure that excess produce is properly stored and preserved especially during the peak seasons so that there will be enough buffer stocks to cushion prices during shocks and the lean seasons. This will require promoting modern mechanised farming while also supporting traditional farmers with needed inputs like seeds and fertilizer as well as affordable credit, extension services and ready markets. Achieving sustainable food-sufficiency and food-security must be a top policy priority.

Fuel policy: It is important for the country to be able to respond to oil shocks when they occur. To that end, BOST should be resourced to be able to maintain strategic reserves that could be released to cushion pump prices in the midst of shocks. It is equally urgent to resuscitate the Tema Oil Refinery (TOR) so that Ghana's share of crude oil can be refined locally to provide ready supplies of refined products to TOR. This is an important national asset that must not be allowed to die. In case of price shocks, the Government should use some of its windfall earnings to cushion domestic prices. Government should also consider eliminating or reducing some of the numerous fuel taxes and levies, some, such as those related to legacy debts, of which have outlived their usefulness or relevance. It has to be said that Government reliance on petroleum taxes is overbearing and counterproductive since they unduly increase domestic production costs and stifle economic activity and growth. Government must explore other, non-petroleum revenues to fund the budget. This is also the time to use some of the funds accumulated from the ESLA to cushion fuel prices.

Transport policy: Transport is the first to be affected by fuel price hikes, which is then transmitted to other consumer goods and services.

Table 3: Inflation in Ten Items with the Highest Weights in the CPI in May 2022

	Item Name	Weights	Item Type	Year-on-year inflation (May 2022)
1	Bus and Trotro Fares	5.8	Non-food, local	39.9%
2	Cooked Rice	3.8	Food, local	32.0%
3	Payment For Rents	3.7	Non-food, local	27.6%
4	Rice (Imported)	3.2	Food, imported	27.0%
5	Public/Private Secondary School Fees (SSS)	3.0	Non-food, local	5.0%
6	Herrings - Smoked	2.5	Food, local	31.2%
7	Accommodation (Hotel)	2.3	Non-food, local	22.1%
8	Bread	2.1	Food, local	41.3%
9	Pre-Primary And Primary Education	2.0	Non-food, local	0.0%
10	Fish (River)	1.8	Food, local	18.9%

Source: Ghana Statistical Service

Indeed, in May, as shown in Figs 2 and 3 above, transport prices increased by 39.0% on a yearly basis and contributed 14.8% to the overall inflation. Meanwhile, out of the ten top items in the CPI with the highest weights, Bus and Trotro Fares recorded the second highest yearly increase of 39.9% after bread (41.3%) (Table 2). These demonstrate the importance of transport in inflation and the cost of living. Moderating transport fares would cut inflation significantly. To cushion the effect of fuel price increases on transport fares, the public transport system should be improved and expanded, particularly regarding intra- and inter-city transport. A viable railway system is also a necessity for improving public transport and taking some of the pressure off road transport. The ongoing railway rehabilitation project should, therefore, be pursued to its logical conclusion. The railway system is a national asset that cannot be sacrificed on the altar of political expediency. The project should be incorporated into our national development planning and should not be tied to party manifestoes.

Exchange rate policy: The way to stabilise the exchange rate on a durable basis is to close the supply-demand gap. This requires fully leveraging our capacities and opportunities for earning foreign exchange, including by increasing and diversifying exports and increasing earnings from natural resources by taking greater control of the resources. We should also increase inflows from the Ghanaian diaspora by streamlining the institutional and legal framework regarding remittances. At the same time, we should aggressively promote production of import substitutes domestically through industrialisation so as to curtail demand for imports and foreign exchange. Building confidence in the economy also represents an important vehicle for increasing the attractiveness of government debt and other domestic financial assets so as to support the exchange rate. This requires domestic policy credibility, particularly in terms of fiscal and debt sustainability.

Fiscal policy: The fiscal deficit needs to be restrained and brought down within the 5% ceiling imposed by the Fiscal Responsibility Act within a reasonable time period by linking expenditure closely to revenue. The Governor of the Bank of Ghana is reported recently to have called on the Government, "to adopt other policy measures," to help stem inflation, citing expenditure control among them. While this is the right call, it is equally important for the Government to explore all avenues to increase the revenue envelope, including by widening the tax net and plugging the numerous loopholes, and allocate more revenue to development spending so as to support higher growth and employment generation without undermining long-term economic stability and debt sustainability.

It has to be pointed out that the Ghana Statistical Service has been deliberately providing more disaggregation of the CPI components to show the major sources of inflation as a guide to both consumers and policymakers. Unfortunately—and frustratingly—these signals are not being picked up, and responded to, by policymakers. What we are calling for is an approach to inflation control that, in addition to pursuing the IT approach aimed at controlling demand pressures and the second-round effects of supply shocks, also targets directly the perennial drivers of inflation, in particular food, fuel, transport and the exchange rate. Most importantly, the supporting "micro-management" approach being proposed seeks to increase supply of some specific goods and services. From that standpoint, the approach has the potential to stimulate economic growth rather than dampen growth as IT, working alone, might do.

Finally, we wish to emphasise that we are proposing a pragmatic rather than an ideological approach to resolving what has become a perennial national problem. What we all want is what works for Ghana. Further, it is important that our policymaking bodies refrain from operating in silos or pigeon holes, as that would not work for us. The BoG and Governments should work together to achieve the common national goal of finding a durable solution to Ghana's inflation persistence. Indeed, with many other central banks equally struggling to contain the current type of inflation—and many considering targeted interventions, including subsidies—Covid-19 and the Russia-Ukraine war may well have already triggered a rethinking of monetary policy and inflation management not only in Ghana but globally.

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