NO. 46 IEA MONOGRAPH

"ACHIEVING DURABLE PRICE AND EXCHANGE RATE STABILITY IN GHANA: IS A CURRENCY BOARD THE ANSWER?"

INSTITUTE OF ECONOMIC AFFAIRS, GHANA

“ACHIEVING DURABLE PRICE AND EXCHANGE RATE STABILITY IN GHANA: IS A CURRENCY BOARD THE ANSWER?”

By

Dr. John K. Kwakye[1]

[1] Dr. Kwakye is the Director of Research at the Institute of Economic Affairs (IEA). Dr. Kwakye previously worked with the Bank of Ghana where he rose to the position of Assistant Director and Deputy Head of the Research Department. Dr. Kwakye also worked at the International Monetary Fund in Washington D.C. as Advisor to the Executive Director Responsible for Ghana. In writing this paper, Dr. Kwakye was assisted by Mr. Abel Nyarko-Asomani, Research Assistant at the IEA.

Abstract

Ghana has a long history of price and exchange rate instability reflecting the underlying structural defects of the economy, in terms of lack of diversification and overdependence on imports, compounded by absence of durable fiscal and monetary discipline. Addressing the structural defects will take time and, therefore, strengthening monetary and fiscal management is seen to be important in stemming the perennial price and exchange rate instability, as many of Ghana's peers have been able to do. A currency board imposes discipline on monetary and fiscal management and, thereby, ensures price and exchange rate stability. As such, there have been growing calls for Ghana to adopt such a system. This paper assessed the suitability of a currency board for Ghana. It notes that while the currency board can deliver the needed macroeconomic stability, it has notable limitations, including loss of monetary policy independence and flexibility to influence the economy; loss of exchange rate flexibility to respond to shocks and as a competitiveness tool; lack of lender of last resort function, which may be needed in financial crises situations; and lack of fiscal agency function as a backup for potential fiscal shocks. For the foregoing reasons, the paper did not consider a full-blown currency board to be currently suitable for Ghana. Rather, it proposed a "currency board-lite" system, comprising stringent monetary and fiscal rules backed by a strong enforcement and oversight regime.

Executive Summary

Ghana has a long history of price and exchange rate instability. The underlying structural defects of the economy, in terms of the lack diversification and over-reliance on imports, are a contributory factor. Addressing these defects will, however, take time, given the slow pace of measures to that end. Nevertheless, it is a fact that many of Ghana's peers in Africa and elsewhere, with similar economic structures, have been able to maintain lower rates of inflation and currency depreciation. The difference is that these successful peer economies have maintained more stringent monetary and fiscal management systems of various forms. On the contrary, Ghana has maintained a more liberal monetary and fiscal management system, with poorer outcomes. This evidence suggests that Ghana need not wait to address its structural defects in order to achieve price and exchange rate stability.

A currency board is a very stringent monetary and fiscal management system that is known to deliver price and exchange rate stability. In view of this, several experts have called for Ghana to adopt a currency board. It is this call that motivated this paper. The paper examined the merits and demerits of the currency board and its suitability for Ghana for addressing the country's twin problems of price and exchange rate instability.

By design, and contrary to a central bank, a currency board maintains a fixed exchange rate, pegged to a reserve currency. It maintains 100 percent foreign reserves cover for its domestic currency, which ensures its full convertibility. The currency board does not hold domestic assets on its balance sheet, as it does not finance the government budget and does not play lender of last resort role for banks. The currency board does not operate independent monetary policy but rather passive, automatic or rule-bound policy. By its nature, a currency board does not create inflation, depreciation or balance-of-payments crises. These are problems that have bedevilled Ghana for decades and for which no solution seems to be in sight. With policy discretion continuing to deliver poor outcomes, it is natural that there is a crave for a currency board to impose rules to force the economic managers' hands and ensure more positive outcomes.

However, a currency board has several limitations that need not be glossed over. These include: loss of monetary policy independence and flexibility to influence the economy; loss of exchange rate flexibility to respond to shocks and as a competitiveness tool; lack of lender of last resort function, which may be needed in financial crises situations; and lack of fiscal agency function as a backup for potential fiscal shocks. Further, key conditions are required for a currency board to be successful, which could be difficult to achieve and, therefore, limit its applicability. These include: a) Adequate foreign exchange reserves to provide the required one-hundred percent backing for the domestic currency; b) Fiscal discipline so as not to undermine the currency board system but also such that the budget can cope with the absence of possible financing that is available under a central bank system but absent from a currency board system; c) Strong and well-managed financial system for it to be able to stand on its own without the lender of last resort opportunity that is available under a central bank but absent under a currency board; and d) Strong legal system to support the currency board, particularly regarding enforcement of the applicable rules.

Because of these significant limitations, the paper did not consider a full-blown currency board to be currently appropriate for Ghana. The paper rather proposed a "currency board-lite" system for Ghana, comprising a system of monetary and fiscal rules backed by a strong enforcement and oversight regime. The key monetary and fiscal management proposals are as follows:

Monetary Management:

- Enforcement of the 5% ceiling on Bank of Ghana lending to Government. Further, a requirement that any such lending should be liquidated by the end of the fiscal year to which it applies without the possibility of securitising it into a permanent debt; and
- Progressive increase of the minimum foreign exchange cover for the cedi issue from the current 40% to 70% during 2023-25.

Fiscal Management:

- Scaling down of the ceiling on the fiscal deficit from the current 5% to 3% in consonance with the ECOWAS and WAMZ convergence criteria and setting of time limits and conditions for a return to the ceiling after agreed suspension in times of unanticipated economic shocks or crises; and
- Imposition of a ceiling of 60% of GDP on the public debt to be observed at any time. The ceiling may be varied only with the approval of Parliament for reasons of unanticipated economic shocks and crises based on timelines and conditions for a return to the limit.

Enforcement and Oversight:

- Strict enforcement of spending ceilings approved in the Parliamentary Appropriations Acts, with appropriate sanctions for breaches.
- Establishment of a Parliamentary Budget Office (PBO) manned by independent professionals appointed by the Public Services Commission. The PBO will assist Parliament with independent budget analysis and forecasts, and estimates of the costs of Government projects and programmes, among other functions.

Entrenching these monetary and fiscal rules and backing them with strong enforcement and oversight regime, will ensure durable price and exchange stability in Ghana, while otherwise avoiding the pitfalls associated with the rigid currency board alternative. The support of Parliament and CSOs will be important for the adoption of the rules and in instituting the necessary enforcement and oversight regime.

CONTENTS

1. Introduction

Ghana has a long history of price and exchange rate instability. The underlying defective structure of the economy, in terms of the lack diversification and over-reliance on imports, is a contributory factor to the perennial price and exchange rate instability. However, many of Ghana’s peers in Africa and elsewhere, with similar economic structures, have been able to maintain lower rates of inflation and currency depreciation. A key feature of the successful peer economies has been their ability to maintain stricter monetary and fiscal management systems. On the contrary, Ghana has practised more liberal fiscal and monetary policy regimes, with poorer outcomes. Addressing the underlying structural defects of the economy through transformation will certainly take time, given the wide gap between promises and concrete measures to that effect. However, the evidence from our more successful peers suggests that we do not have to wait for a complete transformation of the economy before we can achieve an acceptable degree of price and exchange rate stability. Obviously, we cannot continue to operate the same lax fiscal and monetary policy systems and expect to have different outcomes. We need to think outside the box and seek alternative solutions.

A Currency Board is a stringent monetary and fiscal management system known to deliver price and exchange rate stability. It is for this reason that some experts have advocated for a Currency Board for Ghana as the solution to the country’s perennial price and exchange rate instability. The question, however, is whether a Currency Board is the right model for Ghana. This paper examines the merits and merits of the Currency Board and its suitability for Ghana for addressing the country’s twin problems of price and exchange rate instability.

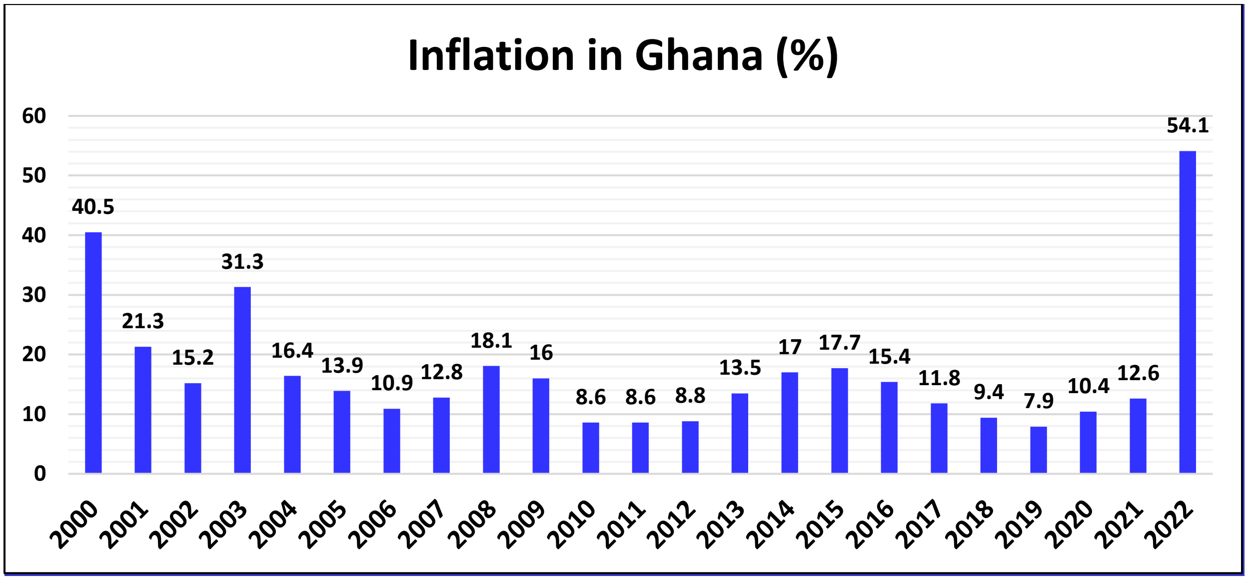
The paper is structured as follows: Section 2, which follows, discusses Ghana’s monetary and fiscal management record for 2000-22 and the comparative record against SSA peers for 2011-2024. Section 3 discusses the features, merits and demerits of a Currency Board as a solution to Ghana’s price and currency instability. Section 4 discusses an alternative monetary and fiscal management system for Ghana for addressing the perennial problem of inflation and currency depreciation. Section 5 is the conclusion to the paper, with the summary and recommendations.

2. Ghana's Monetary and Fiscal Management Record

2.1 Ghana's Own Record

2.1.1 Inflation

Figure 1: Inflation trend in Ghana (2000-2022)



Source: Ghana Statistical Service

During 2000-22, Ghana had varying rates of inflation, ranging from the lowest of 7.9% in 2019 to the highest of 54.1% in 2022. These rates are even generally lower than those that were experienced in the eighties and nineties. Thus, on the whole, Ghana has not been able to achieve an enduring price stability in its economic history. The reasons for the perennial price instability include: a) structural defects in the economy that inhibit supply and/or fuel production costs, b) the pass-through of exchange rate-driven import prices, and c) demand pressures from expansionary fiscal policies and accommodating monetary policies.

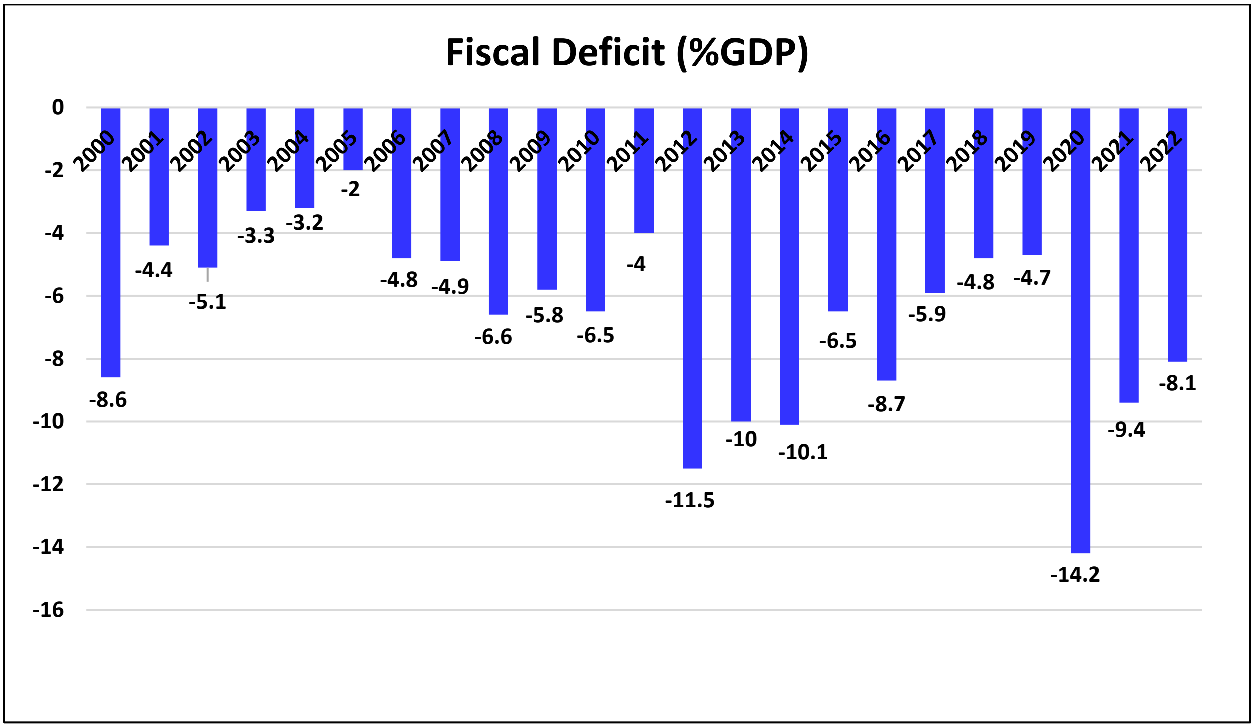
2.1.2 Exchange Rate

Ghana adopted a flexible exchange rate regime in 1983. Before the start of the flexible regime, the rate was fixed at c2.75=US$1.00. Since then, the cedi has experienced decline, with only short intermittent periods of stability. Today, the rate is GHc12.00=US$1.00 or c120,000=US$1.00. By our calculation, the cedi has depreciated by some 99.99998% over the period. Even if we take it from 2007 when the cedi was redenominated and defined as GHc0.93=US$1.00, the Ghana cedi has depreciated by 99.9225% from 2007 to today when the exchange rate is GH¢12=US$1.00.

One of the highest rates of depreciation occurred in 2022. According to Bank of Ghana's data, the cedi depreciated by 54.2% to the dollar between January and November, 2022 before recovering a bit in December, bringing the depreciation in 2022 to 30.0%. In 2023, the cedi has depreciated by 22.1% through March. The London-based Economic Intelligence Unit (EIU) has projected that the cedi would depreciate by 30% in 2023. There appears to be no end in sight as far as cedi depreciation is concerned. Indeed, the local currency is under "existential threat," to put it bluntly! Recently, the Bank of Ghana has had to phase out the 1 cedi and 2 cedi notes from circulation because of their high replacement costs due to their high turnover arising from their loss of value from high inflation and depreciation. The pressure has already shifted to the 5 cedi notes. Given the continuing high inflation and depreciation, it would not be long before we consider redenominating the currency yet again, as we did in 2007.

2.1.3 Fiscal Deficit

Figure 2: Fiscal Deficit, 2000-2022



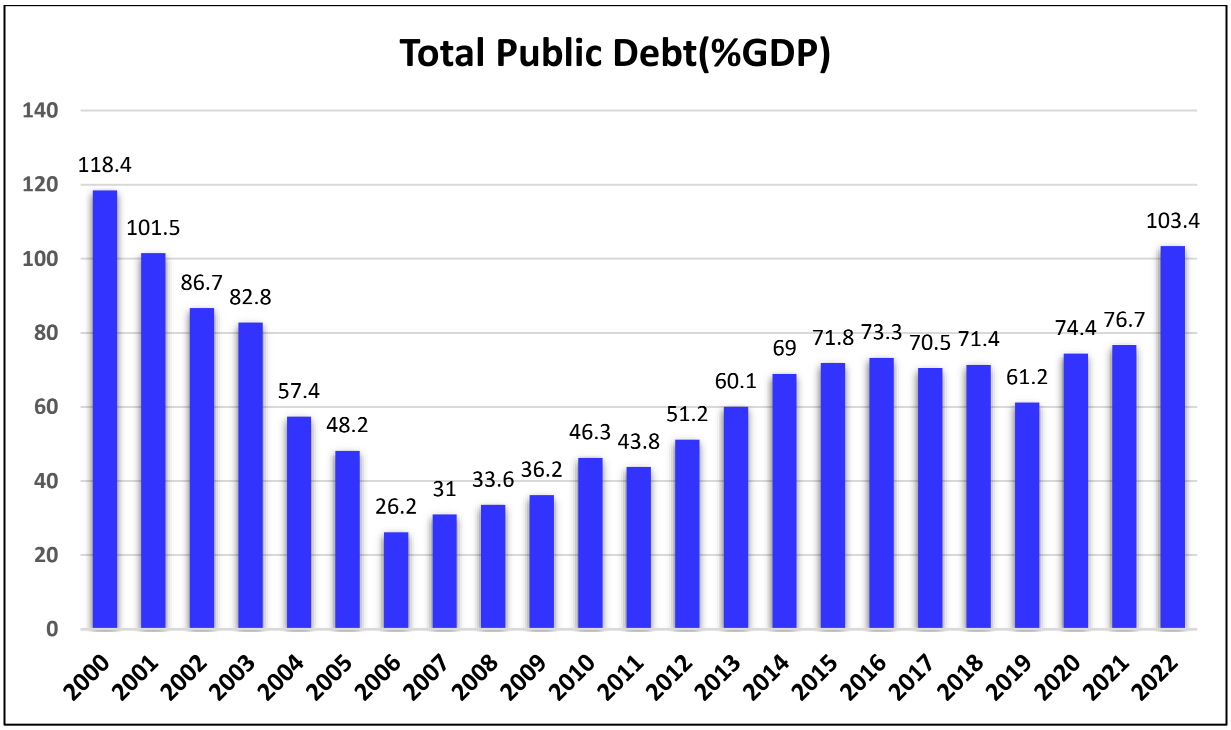
Source: Ministry of Finance, Ghana

During 2000-20, Ghana experienced a fiscal deficit every year that ranged from the lowest of 2.0% in 2005 (aided by HIPC assistance) to the highest of 14.2% in 2020. The deficits were simply the result of enduring gaps between revenue collection and expenditure. The deficit tends to escalate in elections years (2000, 2004 being exception because of HIPC assistance, 2008, 2012, 2016, 2020) due to election-fueled expenditures. The problem with the enduring fiscal deficits is that they fuel macroeconomic instability in the form of high inflation, currency depreciation, balance-of-payments crises and high interest rates, which do not only crowd out the private sector but also stifle economic growth.

In 2018, government passed a Fiscal Responsibility Act that set a deficit ceiling of 5% of GDP. The Act included an escape clause that allowed the Minister of Finance, with the approval of Parliament, to suspend it in times of fiscal or economic shocks. In early 2020, the Minister got the Act suspended based on the Covid pandemic and it remains suspended to today.

2.1.4 Public Debt

<u>Figure 3: Public Debt, 1990-2013</u>



Source: Bank of Ghana

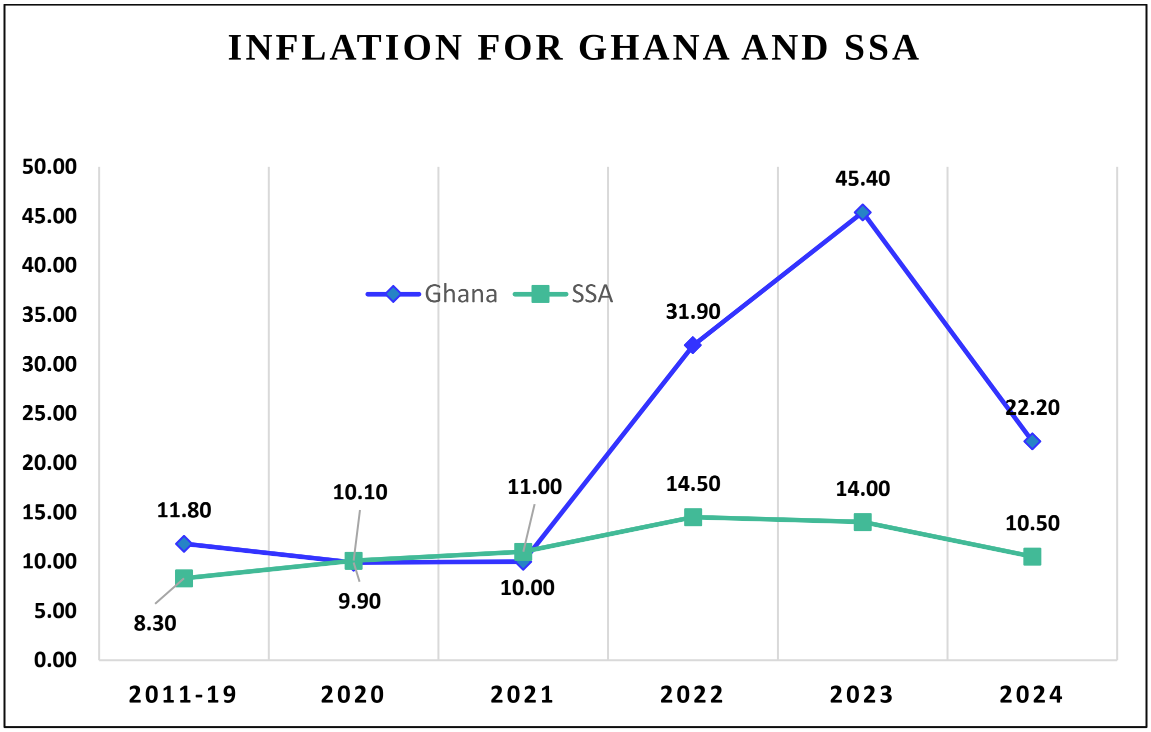
During 2000-22, Ghana's debt/GDP ranged from the lowest of 26.2% in 2006 (aided by HIPC debt relief) to the highest of 118.4% in 2000. A significant feature of the debt profile is the drop from 118.4% in 2000 to 26.2% in 2006 and the steady rise to 103.4% in 2022. We seem to have returned the debt to HIPC standard. The biggest problem for the country is the debt service burden that has risen to unbearable levels and forced us to return to the IMF the seventeenth time for financial bailout

2.2 Comparison of Ghana's Record with the Average Record of Sub-Saharan African Countries

Selected Macroeconomic Data for Ghana and Sub-Saharan African (SSA) Countries, 2011-2024			
Year	**Inflation**	**Fiscal Balance**	**Public Debt**
	GHA	***GHA***	***GHA***
2011-19	11.80	-6.60	49.60
2020	9.90	-17.40	72.30
2021	10.00	-12.10	79.60
2022	31.90	-9.90	88.80
2023	45.40	-7.30	98.70
2024	22.20	-8.40	92.80
	SSA	***SSA***	***SSA***
2011-19	8.30	-3.30	37.60
2020	10.10	-6.40	57.10
2021	11.00	-5.00	56.60
2022	14.50	-4.40	56.50
2023	14.00	-4.30	55.50
2024	10.50	-4.20	53.90
Source: IMF Regional Economic Outlook (REO) for Sub-Saharan Africa (SSA), April 2023			

2.2.1 Inflation

Figure 4: Annual Average Inflation for Ghana and Sub-Saharan Africa (SSA)

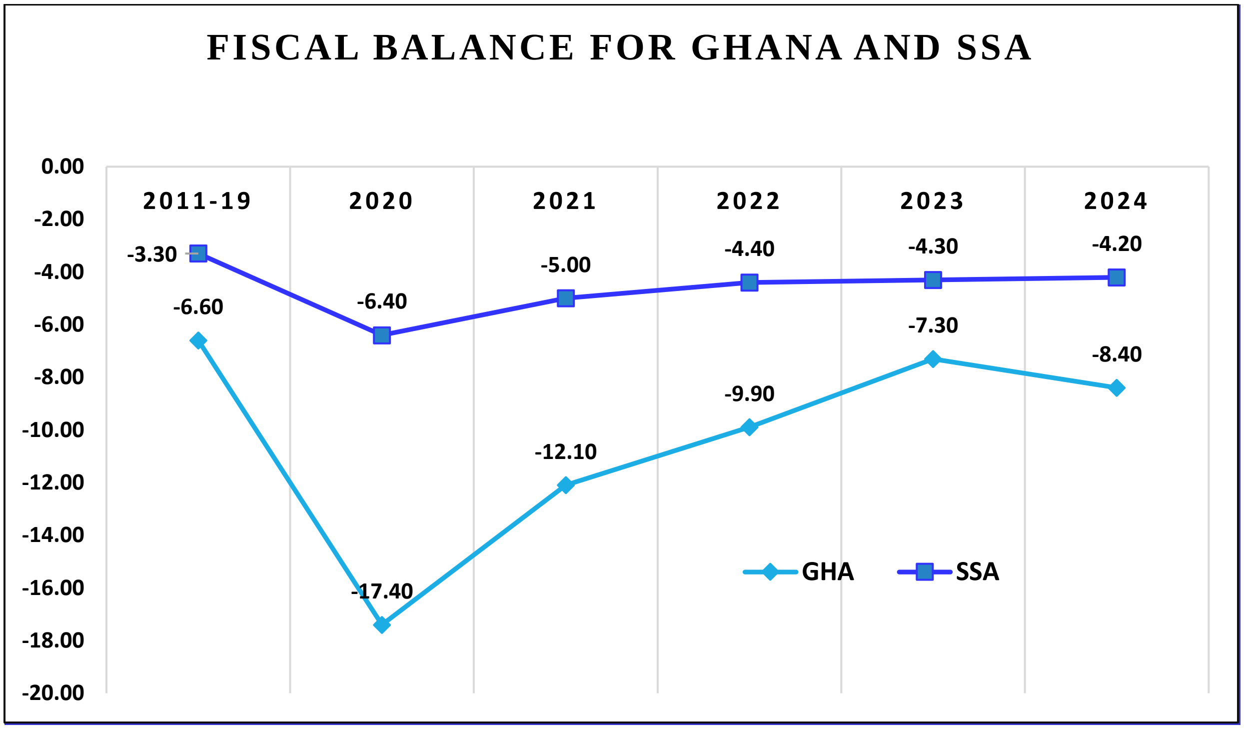


Source: IMF Regional Economic Outlook (REO) for Sub-Saharan Africa (SSA), April 2023

During the ten-year period, 2011-19, Ghana had higher average inflation than the SSA average. During 2020-21, Ghana's average inflation declined to equal the SSA average. However, in 2022, Ghana's average inflation virtually exploded well above the SSA average. The IMF projects that Ghana's average inflation would rise further in 2023 before falling in 2024 to a level that would still be more than twice the SSA average.

2.2.2 Fiscal Balance

Figure 5: Fiscal Balance for Ghana and SSA

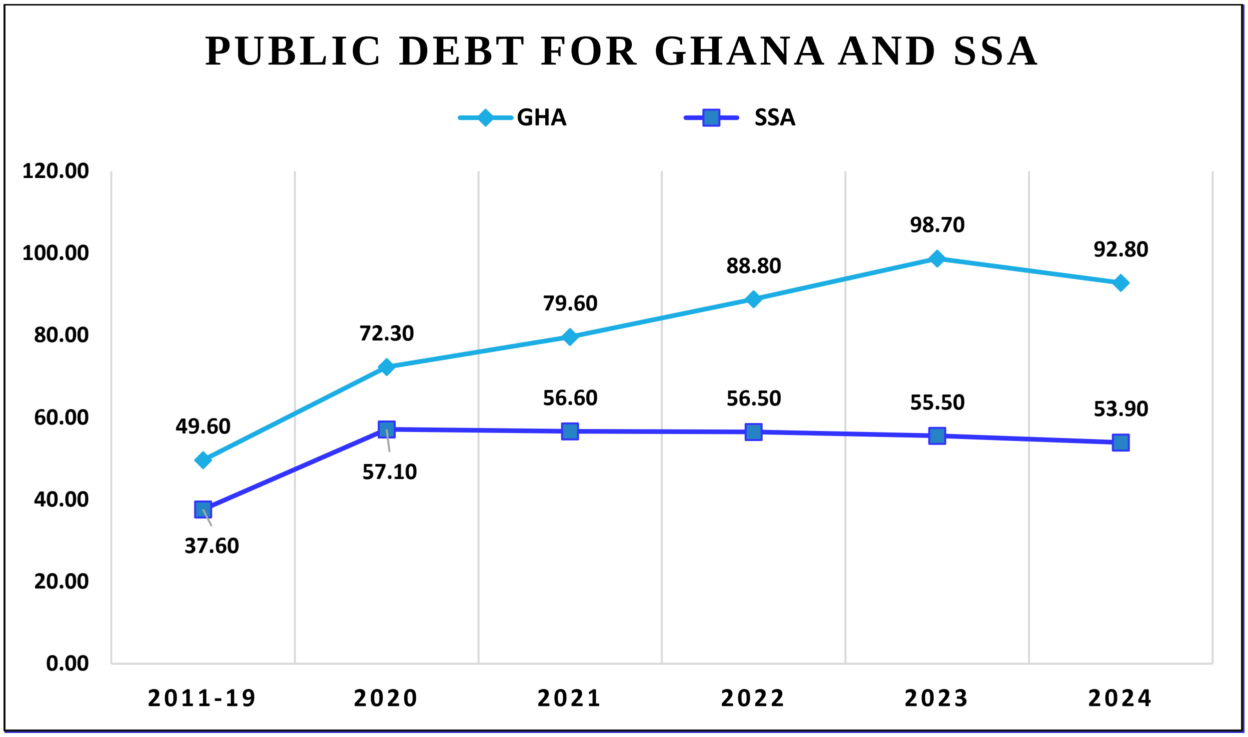


Source: IMF Regional Economic Outlook (REO) for Sub-Saharan Africa (SSA), April 2023

Throughout the period 2011-2022, Ghana had consistently higher fiscal deficits than the SSA average. This trend is projected by the IMF to persist through 2024.

2.2.3 Public Debt

Figure 6: Public Debt for Ghana and SSA



Source: IMF Regional Economic Outlook (REO) for Sub-Saharan Africa (SSA), April 2023

Ghana consistently had higher public debt/GDP than the SSA average during the entire period 2011-2022, a trend that is projected by the IMF to persist through 2024. Further, the gap has widened almost throughout the period. Ghana's higher public debts are a mirror image of its equally higher deficits, which must be financed by borrowing.

3. Currency Board

3.1 Key Features of a Currency Board

Principally, a central bank issues domestic currency and exercises wide discretion over the conduct of monetary policy. It can buy and sell domestic assets (bonds and bills). On the other hand, by design, a currency board does not operate discretionary monetary policy, but rather rules-based policy. An orthodox currency board issues notes and coins convertible on demand into a foreign anchor currency at a fixed rate of exchange. It holds reserves in foreign currency and gold set by law and equal to 100 percent of the currency issue. A currency board cannot engage in fiduciary issue of money, i.e. money not backed by foreign exchange. Its operations are, therefore, passive and automatic. The sole function of a currency board is to exchange the domestic currency it issues for an anchor currency at a fixed rate. Foreign reserves are the only asset on a currency board’s balance sheet, because it cannot buy and sell domestic assets. Because the currency board backs its currency fully by foreign assets, it can fully meet demand for foreign exchange in exchange for domestic currency. In that respect, in principle, there cannot be a balance-of-payments crises and the domestic currency does not depreciate.

A key feature that distinguishes a central bank from a currency board relates to the exchange rate regime. A central bank in developing countries usually simultaneously manages exchange rate policy and monetary policy. It operates exchange rate systems that are variously referred to as “pegged, pegged-but-adjustable, bands, or managed-floating.” With a currency board, however, a monetary authority sets the exchange rate—it is fixed—but it has no monetary policy. Another distinguishing feature that merits attention concerns the issuance of credit by a monetary authority. A central bank can act as a lender of last resort and extend credit to the banking system. It can also make loans to the fiscal authorities and state-owned enterprises. Consequently, a central bank can go bankrupt. A problem in many developing countries is that the legislative system is weak and so are the institutions of governance. Consequently, a “principal-agent problem exists” because the “voters (principals)” have very little effective control over their “agents (politicians).” A currency board remedies the principal-agent problem, in part, because it cannot extend credit to the fiscal authorities or state-owned enterprises. In addition, a currency board cannot engage in lender of last resort activities. The fiscal regime, therefore, is subordinated to the monetary regime, and a hard budget constraint is imposed on the politicians. In the same way as the gold standard was adopted to control fiscal authorities, a currency board imposes a hard budget constraint. By putting the monetary authorities in a straitjacket, a currency board is viewed as a means to impose fiscal discipline.

The differences between a central bank and a currency board are summarised in Table 2.

Table 2: Currency Board versus Central Bank

Central Bank	Currency Board
1. Issues notes, coins and deposits (lender-of-last resort role)	1. Issues only notes and coins
2. Exchange rate regime may range from a peg to floating	2. Exchange rate is fixed and pegged to a reserve currency
3. Foreign reserves usually less than 100% of domestic currency	3. Foreign reserves cover 100 percent of domestic currency
4. Limited currency convertibility	4. Full currency convertibility
5. Holds domestic assets in the form of loans to government, banks and public corporations	5. Does not hold domestic assets on its balance sheet
6. Discretionary monetary policy	6. Passive, automatic or rule-bound monetary policy
7. Can create inflation	7. Cannot create inflation
8. Can cause balance-of-payments crises	8. No balance of payments crises
9. Lender of last resort (to banks)	9. Not lender of last resort
10. Can finance spending by government	10. Cannot finance spending by government
11. Could be politicized	11. Protected from political pressure

The key distinguishing features between a central bank and a currency board relate to monetary policy, the exchange rate regime and issuance of credit.

The difference between a central bank and a currency board in terms of their nature and consequences may be captured by a quote from Professor Peter Kenen, formerly of Princeton University.[2]

Professor Kenen wrote:

"In the beginning, God created sterling and the franc. On the second day, He created the currency board and, lo, money was well managed. On the third day, God decided that man should have free will and so He created the budget deficit. On the fourth day, however, God looked upon His work

[2] This quote is cited by Professor Steve Hanke (1999) of the Johns Hopkins University. Professor Hanke has been an ardent follower of Ghana's economy, commenting copiously on emergent issues. He has made several calls for Ghana to "set up a currency board to save the cedi."

and was dissatisfied. It was not enough. So, on the fifth day, God created the central bank to validate the sins of man. On the sixth day, God completed His work by creating man and giving him dominion over all God's creatures. Then, while God rested on the seventh day, man created inflation and the balance-of payments problem."

The import of this statement is to suggest the potential risks posed by unrestrained fiscal and monetary policies under a central bank system in terms of the disposition to cause inflation, balance-of payments problems and currency crises. A currency board essentially acts as a macroeconomic anchor to the extent that it helps to stabilize inflation, the balance-of payments and the exchange rate. However, a currency board has far-reaching implications for monetary policy. The country necessarily gives up its right to influence its own monetary policy through adjustment of the money supply. The currency board cannot create money and thereby loses some policy flexibility.

The closest model to a currency board that comes to mind is a monetary union (with a pegged exchange rate), which is practiced by our neighbours in the CFA zone. More importantly, these countries provide near-100% foreign reserve cover for their currency, they limit central bank (BCEAO) lending to governments and peg their currency to the euro. It is no wonder that they have been able to maintain low inflation, low budget deficits, and a stable currency all these years. It does not, however, mean that these countries would necessarily show superior economic performance in all areas, including growth. This is because while macroeconomic stability engenders economic growth, it is not sufficient, and it should be buttressed by other growth-boosting policies, including public sector reforms, labour market reforms, trade reforms, financial market reforms, and concomitant development of human and physical capital and technology.

3.2 Merits of a Currency Board

There are many cases in the literature where currency boards adopted by countries at one time or another delivered overall superior economic performance than central banks. An empirical study for 98 developing countries (1950-93) and for IMF member countries (1970-96) showed that for both studies, currency board countries had superior performance compared with central-bank countries with respect to real GDP growth, inflation and the fiscal deficit. The argument made sometimes that currency boards may be inherently associated with poor economic performance is, therefore, not fully substantiated.

Currency boards were previously seen as desirable and, indeed, workable only in special circumstances, such as small, open economies or city-states and small islands. As such, between the 1960s and 1980s, the number of currency boards declined sharply. Subsequently, however, interest in currency boards seems to have resurfaced (See Table 1).

Table 1: Currency Boards in Operation, 1998

Currency boards in operation			
Country/region	**Years in operation**	**Peg currency**	**Special features**
Antigua and Barbuda	32	U.S. dollar	Member of East Caribbean Central Bank (ECCB)
Argentina	6	U.S. dollar	One-third of coverage can be in U.S. dollar-denominated government bonds
Bosnia and Herzegovina	1	deutsche mark	
Brunei Darussalam	30	Singapore dollar	
Bulgaria	1	deutsche mark	Excess coverage in banking department to deal with banking sector weaknesses
Djibouti	48	U.S. dollar	Switched peg currency from French franc to U.S. dollar
Dominica	32	U.S. dollar	Member of Eastern Caribbean Currency Board (ECCB)
Estonia	6	deutsche mark	Excess coverage for domestic monetary interventions
Grenada	32	U.S. dollar	Member of ECCB
Hong Kong SAR	14	U.S. dollar	
Lithuania	4	U.S. dollar	Central bank has the right to appreciate the exchange rate
St. Kitts and Nevis	32	U.S. dollar	Member of ECCB
St. Lucia	32	U.S. dollar	Member of ECCB
St. Vincent and the Grenadines	32	U.S. dollar	Member of ECCB

Sources: Baliïo and others (1997); and Ghosh, Gulde, and Wolf (1998).

Following the successful use of a currency board to stabilize the economy in the aftermath of Argentina's hyperinflation in 1991, additional attributes of currency boards became evident as a result of the successful efforts made by two transition economies—Estonia and Lithuania—to achieve credibility quickly for their newly established currencies. In 1997, a currency board was introduced to end the economic chaos in Bulgaria. In view of the favourable outcome, and given that to date no currency board has had to be abandoned as a result of a crisis, the discussion about potential candidates has recently been broadened further. In early 1998, there was serious discussion of whether a currency board would be an appropriate anchor to use in efforts to halt the Indonesian currency crisis. Most recently, there have been calls to study the possibility of stabilizing the Russian rubble under a currency board.

3.3 Demerits of a Currency Board

Currency boards are not without disadvantages, nevertheless, and one should not gloss over them. Key disadvantages of currency boards mentioned in the literature include:

1. Loss of monetary independence or sovereignty, to the extent that a currency is not able to use monetary policy to influence macroeconomic conditions, especially growth, through changes in interest rates. With a currency board, the national authorities cannot use financial policies, such as adjustments of domestic interest or exchange rates, to stimulate the economy. Economic adjustment can only take the form of wage and price adjustments, which can be both slower—and even more painful.

2. Possibility of loss of competitiveness: There is the possibility of the pegged currency becoming overvalued and, thereby, causing loss of competitiveness. This may, however, be countered somewhat by improving efficiency in other areas of the economy through appropriate reforms.

3.Vulnerability to shocks: Due to loss of monetary independence and exchange rate flexibility, there is equal loss of the chance for these instruments to contribute to the response to economic and financial shocks.

4.Lack of lender of last resort status. Notably, unlike a central bank, a currency board cannot be an unlimited lender of last resort to banks in financial trouble. However, an arrangement can be made for the currency board to provide loans from an emergency fund that is either set aside at the time the currency board is created or, over time, funded from central bank profits.

Further, key conditions are required for a currency board to be successful, which could be difficult to achieve and, therefore, limit its applicability. These include:

1. Adequate foreign exchange reserves This is needed to provide the required one-hundred percent backing for the domestic currency. A currency board can be credible only if it holds sufficient official foreign exchange reserves to cover its entire money supply, as appropriately defined. In this way, financial markets and the public at large can be assured that every domestic currency bill is backed by an equivalent amount of foreign currency.

2. Fiscal discipline. This is necessary so as not to undermine the currency board system but also such that the budget can cope with the absence of possible financing that is available under a central bank system but absent from a currency board system.

3. Strong and well-managed financial system. This is required to for the system to be able to stand on its own without the lender of last resort opportunity that is available under a central bank but absent under a currency board.

4. Strong legal system: This is required to support the currency board, particularly, regarding enforcement of the applicable rules. A sound legal basis is essential because a currency board arrangement derives much of its credibility from the changes required in the central bank law concerning exchange rate adjustments.

Ultimately, every country will have to take its own particular circumstances into consideration in deciding to adopt a currency board or not, weighing the merits against the demerits. The fact that a currency board has worked or not worked for one country cannot be the basis for another country's decision, although it can learn lessons from others' experiences. Furthermore, as we saw above, a country may decide to adopt a currency board for a limited period only to deal with prevailing economic or financial crises and phase it out when the crisis has been resolved.

3.4 Suitability of a Currency Board for Ghana

A currency board has obvious advantages in terms of its ability to minimise inflation, currency instability and balance-of-payments crises. These are problems that have bedevilled Ghana for decades and for which no solution seems to be in sight. For these reasons, the call for Ghana to adopt a currency board has continued to gain momentum and currency. With policy discretion continuing to deliver poor outcomes, it is natural that there is a crave to impose rules to force the economic managers' hands and ensure more positive outcomes.

However, we are also mindful of the several limitations of a currency board, as enumerated above, including especially possible loss of monetary policy independence and flexibility to influence the economy, loss of exchange rate flexibility to respond to shocks and as a competitiveness tool, lack of lender of last resort function, which may be needed in financial crises situations; and lack of fiscal agency function as a backup for potential fiscal shocks.

For the foregoing reasons, we do not consider a full-blown currency board to be currently appropriate for Ghana. As we provide details in the next Section, we would want to see rather a “currency board-lite” system for Ghana, essentially to mitigate some of the disadvantages of a full-blown currency board.

4. Alternative Monetary and Fiscal Management System for Ghana: "A Currency Board-Lite"

What we envisage for Ghana is an alternative to a full-blown currency board that entails tightening monetary and fiscal rules as well as enforcement and oversight regimes.

4.1 Monetary Rules

We propose strengthening two key monetary rules. These are: a) the limit on Bank of Ghana lending to Government, and b) the minimum foreign exchange cover for the cedi issue.

4.1.1 Limit on Bank of Ghana Lending to Government

The Bank of Ghana (Amendment) Act, 2016 (Act 918) imposes a ceiling of 5% of the previous year's revenue on the Bank's lending to Government at any time. However, the Bank of Ghana Act, 2002 (Act 612) authorises the Governor, the Minister and the Controller and Accountant General to vary the limit in an emergency and requires the Minister to report to Parliament within six sitting days after the decision. These provisions are, however, not always followed. Indeed, in February this year, the Bank issued a statement to confirm that its "net claims on Government" had increased by GHc44.5 billion in 2022. This figure was almost 64% of the 2021 revenue of GHc70 billion, far in excess of the 5% (or GHc3.5 billion) ceiling. The Bank explained that the excess financing of Government was part of "a crisis management tool in dealing with the difficulties of 2022" and that it expected the Minister to report to Parliament accordingly. While, as the Bank asserted, it acted to save the economy from possible collapse, the price that was to be paid for that action was inflation and currency depreciation. The worrying part is that, as we speak, we are not aware that the Minister has made a report to Parliament, and, unsurprisingly, Parliament has also kept mute about it! We call for strict enforcement of the Bank of Ghana lending ceiling. Also we propose an additional provision in the Bank's Act that any lending to Government should be repaid by the end of the fiscal year to which it applies and that it should not securitised into a permanent debt as has been the practice.

4.1.2 Minimum Foreign Exchange Cover for the Domestic Currency Issue

The Bank of Ghana Act, 2002 (Act 612) requires the Bank to cover its currency issue by at least 40% of foreign exchange. This requires that the "fiduciary currency issue," i.e. the portion of the currency issue that is backed by government debt to the bank, should not exceed 60%. To assess compliance with these provisions requires information on the currency issue and the Bank's relative holdings of foreign exchange reserves and Government debt. It will be recalled that the currency board covers its currency with 100% foreign exchange and this is what strengthens the currency and protects it from depreciation. To help strengthen the cedi in a similar fashion, we recommend that the foreign exchange cover be increased gradually to 50% in 2023, 60% in 2024 and 70% in 2025. This will be short of the full 100% cover under a currency board but it will be enough to give the cedi the necessary support and stem its perennial depreciation, sometimes due to speculative attacks riding on the limited foreign exchange cover.

4.2 Fiscal Rules

We propose the strengthening of two fiscal rules. These are: a) the ceiling on the fiscal deficit, and b) limits on government borrowing and debt.

4.2.1 Ceiling on Fiscal Deficit

The Fiscal Responsibility Act 2018 (Act 982) imposes a ceiling of 5% of GDP on the fiscal deficit. The Act provides an escape clause that allows the Minister of Finance, with the approval of Parliament, to suspend the ceiling in the case of unanticipated economic or fiscal shocks. However, the suspension is not time bound. Indeed, the Minister exercised this authority and got the ceiling suspended at the onset of Covid-19 in early 2020. As we speak, the Act remains suspended. As a result of the suspension, the deficit reported by the authorities shot up from 4.7% in 2019 to 14.2% in 2020, before dropping to 9.4% in 2021 and an estimated 8.1% for 2022. Even this year (2023), the deficit is projected to be 7.7%, at a time that IMF programme is expected to be in place. The indefinite suspension of the Fiscal Responsibility Act has clearly eroded fiscal discipline and is unacceptable.

We propose strengthening of the deficit rule in two respects.

- First, the deficit ceiling should be reduced from the current 5% to 3% of GDP in consonance with the ECOWAS and WAMZ convergence criteria. This will stem the rate of borrowing and debt accumulation.
- Second, there is a need for a time limit and conditions set by Parliament for a return to the ceiling after its approved suspension.

4.2.2 Limits on Government Borrowing and Debt

The evidence is that constant borrowing to finance budget deficits has historically driven up our debt to unsustainable levels. The debt reached over 100% of GDP prior to 2004 and dropped to 26% in 2006 after we received HIPC relief. However, the debt has ballooned yet again to over 100% presently due renewed borrowing to finance the fiscal deficits. This is what has taken us back to the IMF and prompted restructuring of the debt. Sometimes, one wonders how the excessive borrowing happens in the plain sight of Parliament that is supposed to approve all of Government loans as per Article 181 of the Constitution.

We propose the following rules to rein in the debt on a durable basis as part of the envisaged rules-based fiscal management system.

- First, borrowing beyond the budget estimate should be prohibited except with express approval of two-thirds of Parliament for stated reasons such as unanticipated economic shocks and crises based on timelines and conditions for a return to the estimate.
- Second, Parliament should impose a debt limit of 60% of GDP on the public debt to be observed at any time. The ceiling may be varied only with the express approval of Parliament for stated reasons with attached timelines and conditions to return to the limit.

4.3 Enforcement and Oversight of Monetary and Fiscal Rules

It has to be said that it is not that we have no monetary and fiscal management rules. In fact, we can mention a couple of them, such the Public Financial Management Act, the Bank of Ghana Act, the Fiscal Responsibility Act and the relevant provisions in the 1992 Constitution, which represent attempts to introduce rules in our fiscal and monetary management system. However, there are serious questions regarding not only their enforcement but their effectiveness as well. And that is the reason we feel strongly about the need to strengthen the rules as well as their enforcement and oversight. Unfortunately, Parliamentary oversight of the budget is extremely weak. Spending and deficit overruns occur regularly, quite in breach of the Appropriations Acts, which approve government spending. Ironically, nobody is sanctioned for these breaches. The two major political parties are both culprits. It is like you scratch my back and I scratch yours, with none prepared to sanction the other. We propose two elements of Parliamentary oversight.

The first is strict enforcement of the Parliamentary Appropriations Acts, including institution of sanctions for breaches. The second is the establishment of an independent Parliamentary Budget Office (PBO), akin to a Fiscal Council (FC), to assist Parliament carry out its fiscal oversight mandate. The PBO would be similar to the Congressional Budget Office (CBO) in the US, Office of Budget Responsibility (OBR) in the UK, or the Fiscal Council in many other jurisdictions. The PBO should be part of the Parliamentary Service. The PBO should be manned by professionals appointed by the Public Services Commission. The PBO’s functions should include, but not limited to: a) undertaking independent evaluation of Government budget and fiscal policy, including the forecasts and underlying assumptions; b) monitoring the implementation of Government budget and fiscal policy, comparing performance against targets; c) carrying out independent estimates of the costs of Government projects and programmes; d) providing regular information to Parliament to assist it in its oversight mandate; and e) responding to requests for fiscal and related information from the public.

5. Conclusion

Ghana’s has a long history of price and exchange rate instability fuelled by expansionary fiscal policy and accommodating monetary policy, for which no antidote seems to be in sight. As a result, the call for adoption by Ghana of a currency board, which imposes a “straightjacket” system on monetary and fiscal management and guarantees macroeconomic stability, has gained increasing momentum and currency. However, because of the rigid nature of the currency board, which constrains policy flexibility to influence economic conditions and respond to shocks when needed, we do not consider a full-blown currency board to be currently suitable for adoption by Ghana. On the other hand, we propose a “currency board-lite system” for Ghana comprising a system of monetary and fiscal rules backed by a strong enforcement and oversight regime.

<u>On the monetary management side, we propose</u>:

- Enforcement of the 5% ceiling on Bank of Ghana lending to Government and requiring that any such lending should be liquidated by the end of the fiscal year to which it applies without the possibility of securitising it into a permanent debt; and
- Progressive increase of the minimum foreign exchange cover for the cedi issue from the current 40% to 70% during 2023-25.

<u>On the fiscal management side, we propose</u>:

- Scaling down of the ceiling on the fiscal deficit from the current 5% to 3% in consonance with the ECOWAS and WAMZ convergence criteria and to set time limits and conditions for a return to the ceiling after agreed suspension in times of unanticipated economic shocks and crises; and
- Imposition of a ceiling of 60% of GDP on the public debt to be observed at any time. The ceiling may be varied only with the approval of Parliament for reasons of unanticipated economic shocks and crises based on timelines and conditions for a return to the limit.

<u>On enforcement and oversight, we propose:</u>

- Strict enforcement of spending ceilings approved in the Parliamentary Appropriations Acts, with appropriate sanctions for breaches; and
- Establishment of a Parliamentary Budget Office (PBO) manned by independent professionals appointed by the Public Services Commission. The PBO will assist Parliament with independent budget analysis and forecasts, and estimates of the costs of Government projects and programmes, among other functions.

Entrenching these monetary and fiscal rules and backing them with strong enforcement and oversight regime, will ensure durable price and exchange stability in Ghana, while otherwise avoiding the pitfalls associated with the rigid currency board alternative. The support of Parliament and CSOs will be important for the adoption of the rules and in instituting the necessary enforcement and oversight regime.

References

Charles Enoch, Alain Ize, Veerathi Santiprabhob, and Peter Stella, 1997, Currency Board Arrangements: Issues and Experiences, *IMF Occasional Paper 151 (Washington: International Monetary Fund).*

Charles Enoch and Anne-Marie Gulde, 1997, "Making a Currency Board Operational," IMF Paper on Policy Analysis and Assessment 97/10 (Washington: International Monetary Fund).

Atish R. Ghosh, Anne-Marie Gulde, and Holger C. Wolf, 1998, "Currency Boards: The Ultimate Fix?" IMF Working Paper 98/8 (Washington: International Monetary Fund).

The Institute of Economic Affairs, A Public Policy Institute

P.O.Box OS 1936, Osu, Accra, Ghana.
Tel: +233 – 302244716 / 307010714
Fax: +233 – 302-222313. Email: iea@ieagh.org
Website: www.ieagh.org

IEA
Ghana