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Monday September 7, 2009

CEPA Disagrees with Central Bank

The Centre for Policy Analysis (CEPA) has said that the inflation targetting regime of the Bank of Ghana (BoG) is neither fully functional nor well established.

It said the regime lacks operational transparency with respect to policy objectives and the way in which current policy actions are intended to achieve them.

“Even though the Bank of Ghana has adopted a “de-facto” inflation-targetting regime, the International Monetary Fund (IMF) argues that the BoG has been operating a monetary regime that is akin to following an *inflation targetting lite*,” CEPA said last week.

It explained that the IMF believes that the BoG is operating a secondary exchange rate objective as part of the inflation targetting framework that aims at establishing the stability of exchange rates.

According to the CEPA, evidence cited by the IMF includes the high compulsory surrender requirement by the BoG for main export items of cocoa and gold. Also, the BoG supplies foreign exchange to Tema Oil Refinery (TOR), the main oil importer, through deposit money banks - particularly the Ghana Commercial Bank.

“The essence of this critique is that the interbank foreign exchange market is shallow and overwhelmingly dominated by the BoG. The deposit money banks often rely on the BoG for foreign exchange,” CEPA said in an assessment of government’s monetary policy for the year.

“The IMF contends that the BoG uses its predominance in the foreign exchange market to heavily manage the exchange rate,” it added.

The BoG’s position, however, is that the high surrender requirement on cocoa export proceeds is to ensure foreign exchange repatriation by the manager of the cocoa industry, Ghana Cocoa Board. This prevents exchange rate volatility that could result from the lumpiness of those proceeds if sold directly to the market.

Based on the IMF’s observation that the standard inflation targetting framework works reasonably well for countries that have achieved low inflation rates, CEPA concluded that the inflation targetting framework is not appropriate for Ghana’s economy.

This is because Ghana has very high potential to grow and the tendency is for inflation to remain high during periods of high growth.

“The standard model is less appropriate for Ghana, because during disinflation periods credibility is likely to change over time, which is not captured in the standard model,” CEPA said.

It has been argued that inflation-targetting takes care of all variables – including exchange rates, stock prices, housing prices and long-term bond prices.

CEPA however contended that in the present time of financial-system explosion, that view is no longer plausible.

CEPA also contended that the current monetary policy of the BoG has been tighter than should have been the case, because of the perceived loss of credibility by the BoG as an inflation fighter.

It said in the IMF staff-model, loss of credibility results in upward-biased inflation expectations, which in consequence calls for a tighter monetary policy than would have been the case.

A tight monetary policy results when the Monetary Policy Committee pegs the prime interest rate high or further increases the rate. It is flexible when the reverse occurs.

The prime rate was maintained at 18.5 percent in July this year by the Monetary Policy Committee, against a year-on-year inflation rate of 20.5 percent for the month.

The worry, according to CEPA, is that tight monetary policies cost society in terms of diminished economic growth and increased poverty that may have to be incurred to achieve the inflation target.

It cited that if the inflation target for 2008 was achieved by the Monetary Policy Committee, economic growth would have had to slow down to as low as four percent compared to the 7.3 percent that was achieved.

“The implications from this magnitude of slowdown for jobs and poverty reduction need to be carefully analysed... international evidence has shown it is the poor and politically voiceless - in the US experience, the youth, the unskilled, women, Blacks and Hispanics - who bear the brunt,” CEPA added.