

Managing Terms of Trade Shocks in Compatible Control Regimes

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Introduction

For developing countries in general, the problems posed in applying modern macroeconomics are severe because economic structures are so different. Financial markets are often virtually absent, many economies are small, open, and periodically hit by temporary trade shocks, and most of them are heavily regulated by government controls.

Furthermore, the lack of attention to institutional characteristics in the neo-classical approach and the absence of viable micro-foundations in the structuralists' theories have tended to make the exchanges between the two schools polemical. Meanwhile, many developing countries have experienced dramatic macroeconomic events, and have embarked upon large policy experiments, in an alarming vacuum of comprehension. This vacuum has arisen because both schools of thought – the neoclassical and structuralists – are right: theory must be tailored to structure to be applicable, but an atheoretic approach is inadequate. Policy research is a must.

Ghana is classifiable as a controlled open economy – a small, open economy with a weak financial market, subject to a variety of government controls and liable to 'temporary' shocks in terms of trade. In 1998, Ghana experienced a positive terms of trade (TOT) shock equivalent to a 26.5 percent improvement in the barter terms of trade. The question of interest is how did the government 'manage' the windfall? Did it tax it? Did it increase public expenditure, and if so, what? Faced with a shock of comparable magnitudes (actually somewhat bigger in 1977) on account of the Brazilian frost of 1975 which caused a large but temporary increase in the price of coffee, "*the*

governments of Kenya and Tanzania arrived at radically different answers" to this question:

In Kenya virtually the entire price increase was passed on to coffee farmers (most of whom were peasants), whereas in Tanzania almost the entire windfall was taxed.

In search of an appropriate lesson for Ghana and guide to policy as to 'best practice' for managing shocks, the temptation is to examine the experiences of these two countries with a view to assessing the efficacy of their respective policy responses. The two responses, however, are not directly comparable, owing to key differences in policies in place before the windfall. The differences constitute the less obvious but probably more important, type of policy issue, namely the way in which private behavior is constrained by government regulations which predate the windfall. For even if the private sector is permitted to receive the windfall, its responses will be shaped by the control regime.

Like the Kenyan experience, we will demonstrate that the policy response in Ghana was inconsistent and grossly sub-optimal. Not only were resources misallocated, but the regime was "*particularly ill-suited to the efficient utilization of temporary windfalls, which are a recurring feature of the economy*". The World Bank has in the context of the subsequent sharp reversal in the terms of trade noted the incapacity of the government to manage shocks, leaving the economy vulnerable to periodic shocks.

The Tanzanian policies have been described as "*an example of an incompatible control regime*". The central aspect of such policy configurations is that they are not sustainable and so must be "*eventually changed*". Indeed the particular policy combination adopted by the Tanzanian government "*gives rise to a disastrous cumulative contraction in the economy*" which may be referred to as an "*implosion*". The Ghanaian episode shares some similarities especially in the fiscal policy aspect with the Tanzanian, but differs critically in that there was a regime of universal price controls in Tanzania which is what makes that scenario an 'incompatible control regime'.

The way in which controls shape private responses to windfalls which private agents receive is central to policy analysis. Controls restrict how private agents make use of windfalls; foreign exchange controls inhibit the acquisition of foreign financial assets; import quotas may restrict the volume of imports, or alter their composition; and interest rate ceilings may alter the volume and composition of investment.

Fiscal Policy Responses – Stabilizing Taxation

A relatively passive or laissez-faire public response is inappropriate for three reasons. First, permanent national income rises with the windfall, and so does tax revenue at existing tax rates. In the absence of a mechanism assuring an automatic rise in public expenditure, an arbitrary fall in the public sector deficit will result. On the other hand, a reasonable assumption is that there is a positive elasticity of desired public expenditure with respect to permanent national income. The Ghanaian experience at the time of the windfall was that the expenditure elasticity was, if anything, higher than the elasticity of tax revenues at existing rates – also positive. Some change in the level and/or structure of tax rates may be necessary. The size and shape of the public sector would no doubt change. The critical point, however, is that there can be no guarantee that these automatic changes will correspond to what is wanted. This is why the issue of the appropriate long-run level of expenditure and taxation design arises.

Second, the marginal cost of public funds may temporarily drop during the boom. The windfall can be likened to an economic rent, so that it can be taxed away with minimal disincentive effects. Thus to the extent that the windfall was both temporary and once for all, there were powerful arguments that a high proportion of the incremental income be taxed at source (see also Economic Reforms in Ghana).

Finally, appropriate fiscal response may be influenced by the nature and composition of public expenditure, particularly by the allocation between tradables and non-tradables on the one hand, and consumption and investment on the other. The sharp appreciation of the real exchange rate will imply some shift in the optimal allocation of public expenditure between tradables and non-tradables, more markedly in the short-run than in the long run. It may also have implications for the level of government spending, as opposed to its allocation.

The CEPA position implicitly assumed that cocoa farmers were likely to be over-optimistic in their expectations were the windfall allowed to accrue to them. This would imply that cocoa farmers might attempt to consume too high a proportion of the windfall, and the government must attempt to prevent this. Ideally, the government would raise a loan, returning the money when the windfall was clearly over. This was exactly the proposal in the CEPA call for a **Cocoa Buffer Fund**. In the event, through the mismanagement of the exchange rate, the cedi depreciated nominally by only 4% -- implying high real appreciation – and with producer prices unrevised, the cocoa windfall was shared between users of foreign exchange and the Government of Ghana (GOG). Indeed, the cocoa export tax reached a high point – the highest in recent times.

Inter-temporal considerations indicate that a stable deficit is unlikely to be optimal during a windfall. Moreover, even the direction of change in the

deficit is ambiguous. What needs stressing, however, is that even if the government has more accurate perceptions than the private sector concerning the underlying instability, the obvious response is to disseminate the superior information rather than to act on the assumed ignorance of private agents as actually happened with the implicit rejection of the cocoa buffer fund.

But the main source of sub-optimality of the official policy stance is the implicit assumption that the monetary authority, the BOG was capable of exercising the required custodial function over windfall resources. This is a critical empirical question requiring substantiation. Indeed, it could be argued that it was the absence of this capacity that led to the c