

THE ROLE OF THE EXCHANGE RATE IN ECONOMIC POLICY DESIGN AND ANALYSIS

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Introduction

The exchange rate is one of the most important economic adjustment instruments and yet it is also one of the most difficult and controversial economic policy tools.

Changes in the exchange rate have led to the fall of governments. In fact, in the early 1960s up to the early 1980s, it was generally predicted that any government that devalued the currency would fall within six months of the devaluation.

Changes in the exchange rate were associated with all sorts of economic hardships, including inflation, the collapse of domestic industry, and unemployment. As a result, the exchange rate was politicized and some politicians would measure their success by the stability of the exchange rate.

Introduction (2)

Evolution of the Exchange Rate Regime

- o In the period between 1983 and 1990, government implemented a wide range of trade and payments policies with the objective of switching away from direct government intervention and controls towards increased reliance on market outcomes.
- o The official exchange rate was adjusted in several discrete steps during the period April 1983- January 1986
- o Starting in 1986 with a two-window system, Ghana moved to a dual exchange rate market. Window One maintained a fixed but adjustable exchange rate; Window Two used a weekly auction system.
- o The rate in Window One was applicable to government transactions, petroleum imports, cocoa and other traditional export receipts. The rate in Window Two applied to all other transactions.

Introduction (3)

Evolution of the Exchange Rate Regime

- o In 1992, the two-window auction systems were unified and replaced by an Interbank wholesale system in which a weekly wholesale auction is used to determine the Interbank rate.
- o Only banks were permitted to participate in the wholesale system. The Forex Bureaux are explicitly prohibited from participating in the interbank market; conversely, banks cannot retail to the Forex Bureaux.
- o In theory, there is therefore no arbitrage between the interbank market and the Forex bureau market. Even though the Bank of Ghana intervenes in the Forex bureaus market by selling foreign exchange to them, the two markets are effectively segmented. Thus, the Forex bureaus operate an essentially self-financing system.

The Exchange Rate and Inflation

- o One of the most debated aspects of the exchange rate is that it is associated with inflation. And this is for good reason. When the exchange rate depreciates, prices of imported goods would rise. This will affect consumer prices through the prices of finished goods or the increase in the costs of domestic producers using imported inputs.
- o The most persistent concern is that the rate of depreciation of the exchange rate causes inflation. This concern has led to calls on the Bank of Ghana to stabilize the exchange rate

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The Exchange Rate and Inflation (2)

In the short-term, the Bank of Ghana has five, but not mutually exclusive options:

1. Intervene in the foreign exchange markets by selling more foreign exchange currency to domestic money banks (DMBs) and the Forex Bureaux
2. Raise interest rates to levels that may induce a shift from foreign currency holdings in cedi-denominated assets as a way of savings: As the demand for foreign currency is reduced in favor of cedis (or cedi-denominated assets) because of attractive interest rates, the cedi is expected to appreciate in value.
3. Reduce the money supply drastically in order to stabilize: the money supply may not be under the complete control of the Central Bank
4. Regulatory Intervention: this is an option advocated by some employers

The Exchange Rate and Inflation (3)

- o A fast depreciating currency is the most visible daily information available to the general public compared with more fundamental data such as the money supply, budgetary performance, and output supply conditions. Because of its ready availability and because it conveys information about the fundamentals in the economy, a fast depreciating cedi may fuel inflationary expectations.
- o It is also possible that a depreciating cedi may divert demand away from foreign goods to domestically produced goods. This is what may be referred to as expenditure switching-induced inflation. However, this argument would seem to run in the face of manufacturers' complaints about flooding the domestic market with cheap imports.
- o Finally, one might argue that the direct impact on costs of production and prices of final consumption goods could be inflationary. This impact will, however, depend on the size of imports in consumption as well as the proportion of imported inputs in the total costs of production.

The Exchange Rate and Inflation (4)

- If the arguments above provide the basis for explaining inflation, then one should expect to see lower levels of inflation during periods of fixed exchange rates and higher rates during periods of flexible and generally depreciating exchange rates. The evidence in the Ghanaian context is provided in Table below
- It is noticeable that the highest rates of inflation in Ghana were experienced during periods of fixed exchange rates and very high levels of both tariff and non-tariff barriers to international trade. The period 1975-1982 was one with fixed exchange rates and yet it recorded the highest rates of inflation in the country's history. On the other hand, the period of the sharpest depreciation of the cedi, April 1983-1989, was associated with much lower rates of inflation. It is clear that the depreciation of the exchange rate is not the cause of the high rates of inflation in recent times. On the other hand, it is unreasonable to expect a stable nominal exchange rate when the rate of inflation is rising. This will be bad economics and the consequence for export and domestic production in the long run could be disastrous. This is because such a policy will lead to an appreciation of the exchange rate, which will be disastrous for both exports and import-competing industries.

Exchange Rate and International Competitiveness

- The combination of exchange rate and tariff reform affect not only the real exchange rate but also the relative profitability of producing for the domestic market vis-à-vis the external market.
- A real depreciation increases the profitability of producing tradables relative to non-tradables. However, within the tradable goods sector, importables face a different exchange rate compared with exportables. The difference arises from the differential impact of trade and exchange rate policies on the two groups of commodities

Exchange Rate and International Competitiveness

- Two measures of the real effective exchange rate — i.e., the nominal exchange rate adjusted for relative inflation between Ghana and her major trading partners, and weighted by the volume of trade between Ghana and these trading partners (the United States, the United Kingdom, and the European Union) — are presented in Figure 1 to capture the incentives system to the production of tradable goods, importables and exportables implied by the policy changes.
- The first, the currency weighted, summarizes information contained in the country's bilateral exchange rates with trading partners and employs as weights the value of the payments by currency of transactions for imports and receipts from exports.

Exchange Rate and International Competitiveness

(2)

- The second measure, the direction-of-trade weighted, simply uses the proportions in the volumes of total trade (imports plus exports) of the respective trading partners as the appropriate weighting scheme — i.e., irrespective of the currency in which imports and exports transactions are made.
- Both indices measure the country's competitiveness in international markets: continuous real appreciation makes domestic producers of exports and import substitutes less competitive, while increasing the demand for imports.

Exchange Rate and International Competitiveness (3)

- As shown, the two measures tracked each other quite closely for the period up to May 2002; thereafter, a sharp divergence with an upward trend ensued up to January 2003 after which the divergence widened as the trend was reversed downwards.
- Both measures signaled increasing appreciation of the real effective exchange rate in 2005 — 11.1 percent in the case of the currency of transactions-weighted index and 16.6 percent in the case of the direction-of-trade index.

The Exchange Rate and Domestic Industry

- A depreciation of the exchange rate offers protection to domestic industry. This is because depreciation increases the domestic costs of production by much less than the rate of depreciation, while prices of imported equivalents increase by the full amount of the depreciation.
- Supposing the share of imported inputs in the domestic costs of production were 70 percent and the exchange rate depreciated by 30 percent. The cedi costs of production will increase by 21 percent while the prices of the imported equivalent will increase by 30 percent, given that the rate of taxation remains the same. The contrary will occur with an appreciation of the cedi.

Exchange Rate and External Shocks

- Every country will once a while be confronted with an external shock. For African countries these shocks may occur from the commodity markets abroad, capital markets abroad and domestic weather conditions.
- The way an economy responds to these shocks depends on the:
 - nature of the shock;
 - expected duration of the shock; and
 - exchange rate regime.

Exchange Rate and External Shocks (2)

- The most common external shocks for Africa are those that affect the prices of a country's exports and imports — i.e., the terms of trade. But there are also external shocks in terms of interest rate changes affecting the costs of borrowing. For this lecture let us concentrate on price changes.
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- These changes can be favorable or unfavorable — for instance, an increase in world market prices of crude oil and petroleum products. For Nigeria, this is a favorable external shock, but for Ghana this will be an unfavorable external shock. In both countries the external shock may affect the balance of payments either favorably or unfavorably.

Exchange Rate and External Shocks (3)

- Governments must respond to external shocks because they produce undesirable consequences in terms of balance of payments deficits, lost income and unemployment.
- In responding to external shocks governments face three levels of choice:
 - 1. They must decide the extent to which the external shock must be met by financing or by adjustment. The decision here may depend on the government's assessment of the duration of the external shock. If the shock is perceived to be temporary or transitory, then we can finance its consequences or the balance of payments consequences. If, however, we expect the shock to last longer, then we need policies that will help the country to adjust to the shock. These measures may include changes in the exchange rate, fiscal and monetary policies.

Exchange Rate and External Shocks (4)

- 1. To the extent that adjustment is required, governments must decide on the extent of reliance on expenditure-reducing or expenditure-switching measures — i.e., on cutting public and private demand or on trying to shift that demand and the demand of foreigners as well from foreign-produced goods to domestically produced goods. In general, a combination of both sets of policies may be required.
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- 2. To the extent that expenditure switching is required, governments must use exchange rate changes or trade policy changes. If, however, we have a fixed exchange rate regime or belong to a currency union then the use of the exchange rate may be excluded and we are left with fiscal adjustment only.

Exchange Rate, Balance of Payments and Monetary Policy

- Changes in the exchange rate are one of the long-term policy measures that economists recommend for dealing with balance of payments difficulties. And devaluation of the exchange rate, together with fiscal and monetary retrenchment is a typical Fund policy combination for dealing with macroeconomic imbalances characterized by deficits in the balance of payments.
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- Both Ghana and Nigeria have tried this policy combination at some stage. While Ghana persisted with the policy combination, Nigeria has had occasions to reverse some aspects of the combination.

Currency Union

- Since the second half of the 1990s, monetary integration initiatives have received attention in Africa. In West Africa, the creation of a single currency has been part of the grand design of the Economic Community of West African States (ECOWAS) since its inception. The establishment of the ECOWAS unit of account, the West African Clearing House, the West African Monetary Agency (WAMA), and West African traveler cheques can all be interpreted in terms of efforts at monetary union.
- The attempts more recently to establish a second monetary zone among the English speaking West African countries represent more direct and more serious efforts at monetary integration. In the monetary union, national sovereignty over both monetary and exchange rate policies is given up to a third party. And in this scheme, monetary policy is employed to maintain the exchange rate.

Currency Union (2)

- The basic arguments for African monetary unions are that African governments lack the political institutions necessary for government to commit credibly on an individual basis to fiscal and monetary discipline. It is argued that monetary unions can provide an alternative means of credible commitment to sound macroeconomic policies. Such a monetary arrangement, it is expected, will lead to macroeconomic stability and long run economic growth
- One of the fundamental problems with African monetary unions is the low level of trade integration among African countries. This has led some to argue that the stability enjoyed by the CFA zone may well come from the monetary stability generated by the peg with the French franc than the common currency across member states. In other words the CFA arrangement reflects the desire for a monetary anchor.
- Will African monetary unions require an external anchor, or can African countries form independent monetary unions?

END OF SESSION

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