

Inflation and Interest Rate Fixation in Ghana

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James Akpo's diatribe on inflation and fixation of interest rates in Ghana makes interesting reading (see Ghanaian Times of May 21, 2003 and June 2, 2003). Equally interesting was the Bank of Ghana's response in the Ghanaian Times of June 2, 2003. At the risk of being branded a "textbook economist and a smart conformist", I wish to submit that James Akpo is simply wrong in his "innovative" ideas on monetary policy making.

Inflation is, by definition, a historical concept. Inflation is a persistent and appreciable increase in the general price-level **over a period of time**. Whether the 'period of time' is a year, month, week or a day depends on what we are using the rate of inflation for.

Interest rate fixation is one of the tools in the arsenal of the Bank of Ghana in its attempt, together with the fiscal authorities, to shape the economic landscape in Ghana. Whether it is an effective tool is another academic exercise altogether. Nevertheless, to the extent that it reflects the cost of capital, the interest rate conveys important information to investors and dealers on the financial market.

Any link between inflation and interest rates? Inflation is the cost of holding cash while the rate of interest is, crudely, the cost of holding wealth in any other asset. Thus as the rate of inflation rises those holding their wealth in the form of cash lose. On the other hand capital becomes more costly as the interest rate rises. An investor will normally like to balance out his options for gaining or losing by holding cash and or alternative assets. Such an investment decision involves planning, which depend on expectations. Fixation of interest rates by the central bank is to influence such expectations.

People form expectations in different ways. If you have perfect knowledge, then of course, you do not need any "historical" inflation data to modify your expectations. You will theoretically be so "current" and up-to-date in your expectations formation that perfectly weigh your options at any moment in time. Alternatively, your expectation may be formed taking into consideration all available information on the market; that is, to be "rational" about your expectations. While this alternative is academically appealing, it is practically difficult to implement. A last option is for the individual to form his expectations of the future based on historical trends. This option generally referred to as "adaptive expectations" is commonly used.

Generally businessmen have a planning horizon of a year or more. Thus while inflation can 'historically' be computed over the past month it makes more sense to adopt the year-on-year as the working tool. In my opinion, the policy-makers are right in using the year-on-year inflation rate as **ONE** of the pointers in fixing the policy rate of interest.

In his reply to the Bank of Ghana's rejoinder in the June 2, 2003 issue of the Ghanaian Times, James Akpo shifts the import of his article from the earlier attack on the

theoretical underpinning of monetary policy-making to the levels of interest rates. Like James Akpo, I am also of the opinion that the rates of interest in the country are too high. And I also agree that the high interest rates worsen the fiscal problem. However, in policy terms, the problem of the interest rate is like the proverbial “chicken and egg” problem. High interest rates hurt the business sector and hurts growth of real output, which then comes back to haunt inflation. But unlike James Akpo, I do not think the Government is simply being treated as a “scapegoat”.

Continually faced with a fiscal deficit, which is structural in nature, the Government is the chief borrower on the financial market. Interest rates as the price of financial capital will be rising the higher the demand for the latter. So long as Government continues to borrow more from the market, interest rates will be on the upward path. If Government is not made to pay the right price of capital it is not likely to be responsible. As United States former President Ronald Reagan said, “Government is like a baby. An alimentary canal with a big appetite at one end, and no sense of responsibility on the other”.

But the interest rate problem does not rest with Government and the Bank of Ghana only. The rising rates of interest are acts perpetuated by the banks for more profit. Rates charged by the banks are just too high and that is what hurts the investors. In addition, the banks impose charges and commissions which are completely inexplicable (More on this in different article soon!)

A lot of effort must be made by Government and all other players to bring interest rates down. Changing definitions to suit our whims and caprices under the guise of “innovative ideas” will certainly not do the trick.