CEPA

CENTER FOR POLICY ANALYSIS

ELECTION YEAR EXCESSES, CEDI DEPRECIATION, AND INFLATION – THE CURRENT EXPERIENCE

JUNE 14, 2012

www.cepa.org.gh

Election Year Excesses, Cedi Depreciation, and Inflation – The Current Experience

Every election year in the Fourth Republic, especially the hotly contested ones, has been associated with excesses (in spending and behavior), rapid depreciation of the cedi, and accelerating inflation. The most recent to such years is election year 2000 when the excesses led to an exchange rate depreciation (number of cedis per US dollar) 0f 100 percent from 3,500 old cedis at the beginning of the year to 7,000 at the end of the year.

The next after that was election year 2008 when election year excesses led to a fall in the value of the cedi from 1.0152 cedis / dollar in June 2008 to 1.4524 cedis / dollar in June 2009 – a year-on-year depreciation of about 43 percent which was halted only by the stabilization program agreed with the IMF.

The current situation has seen the cedi depreciate by about 17.3 percent in the first half of the year and by about 20.5 percent, year-on-year, from June 2011 to June 2012. The pass through from depreciation to inflation is obvious.

A stable cedi (in the sense of predictability of value in domestic foreign exchange and goods markets) must be anchored on the fiscal policy stance. This has proved elusive in post-Independence Ghana.

In the market-oriented Fourth Republic, the cedi has been particularly vulnerable to speculative attacks in every election year resulting in sharp depreciation in foreign exchange markets, large losses in gross international reserves and upsurge in inflation.

Accelerated growth with productive jobs for poverty reduction, and macroeconomic stability requires fiscal and debt sustainability. Operationally, fiscal policy should target medium to long term economic growth leaving monetary policy to deal with the short-run trade-off between economic growth and job creation, on the one hand, and macroeconomic stability – low inflation and stable exchange rate – on the other hand.

The mild depreciation pressure of the fourth quarter of last year was initially mistakenly attributed to seasonal factors rather than financial markets concerns about the excesses of election year spending – the so-called political business cycle (PBC) observable in nascent democracies in developing countries.

Thus in response to the sharp depreciation of the cedi in January, the BOG intervened with a large injection of foreign exchange estimated at about US$800 million. As the record shows, this was neither sufficient nor sustainable.

By the end of the month, it became obvious to the monetary authority that something credible and sustainable needed to be done to improve the attractiveness of the cedi – and cedi based financial assets – relative to holding foreign exchange. Investor fears about the value of the cedi resulting from excessive election year domestic spending had shifted the balance against holding the cedi. The MPC Press Release of February 2012, observed and reported the flight from the cedi as investors exercised their right and liquidated their holdings of domestic bonds in exchange for foreign exchange in expectation of a rise in yields in subsequent new bond issues.

The decisive shift in preferences against the cedi has been the cause of the fast-depreciation of the cedi and the surge in inflation.

Thus far, the BOG has done the right thing. Beyond the direct interventions in the foreign exchange market, the BOG also instituted a number of off-market measures which seek to enforce existing regulations and in the process support the monetary policy tightening objective. Among these was the measure to ensure that foreign investors stay firmly off the short-term end of the money and domestic bond market.

Another important measure was the directive to banks to keep the mandatory cash reserve requirement of 9 percent of <u>total deposits</u> – i.e. <u>both</u> cedi-based and foreign currency based – in <u>cedis only</u>. At a time like the present when banks are awash with excess reserves – i.e. reserves beyond the mandatory requirement – and face a fast depreciating cedi this single act holds out important potential positive outcomes:

- It locks up the (cedi) equivalent of 9 percent of foreign currency deposits – thus reducing the excess reserves by as much
- It frees the foreign exchange held as reserves – thus increasing the supply of foreign exchange onto the market
- It discourages domestic residents who purchase foreign exchange from the forex bureaux to deposit in their foreign exchange accounts – thus reducing the demand for foreign currency and hence the pressure on the cedi.

For the same foreign exchange deposit, the cedi value rises with depreciation. Therefore, the bank would have to hold 9% of this larger value in cedis. This raises the cost of the foreign exchange account to the bank. And, moreover, as market interest rates rise, the cost of holding the foreign currency deposits would rise even further.

The information that banks would pass on the increased cost of holding foreign currency deposits to their clients created a lot of anxiety on the part of would be investors as this was interpreted by the public to mean that the BOG intended to close foreign exchange accounts. In response, the BOG issued a statement of denial and emphasized its objective has been that of shifting the balance of preference in favour of the cedi and cedi based assets. In its statement, the BOG stated that:

> *The Bank of Ghana's attention has been drawn to media reports being attributed to the Bank that it is planning on closing all foreign deposit accounts and has instructed that a 2% per annum charge be levied on all foreign deposit accounts in the banks.*
>
> *The general public and all stakeholders are assured that the Bank of Ghana has not taken any such decision.*
>
> *The recent policy measures taken by the Bank are intended to make the cedi assets more attractive to hold.*

A government spokesman also pointed out that the BOG is only taking steps to stop certain uses of foreign exchange accounts that are in breach of the foreign exchange laws and the dollarization of the economy. He explained that opening a foreign exchange account in the domestic banking system is legal with the backing of a law passed by Parliament. The BOG cannot close foreign exchange accounts without a repeal of the relevant law.

The spokesman indicated that there is, however, a difference between using the foreign exchange accounts for one's business and offloading it to another business or a foreign exchange bureau. This latter activity implies trading in the currency – which is outside the law. The BOG is drawing attention to the fact that such uses of foreign exchange accounts may be in breach of the law.

The idea behind the increased cost of holding large speculative foreign currency balance is therefore to cause people to see some advantage in selling some of their foreign exchange holdings to increase the supply of foreign exchange in the market and thus help bring about the needed exchange rate stabilization. With the robust tightening of monetary policy these interventions by the BOG can be expected to be increasingly effective over the course of the year.

There is considerable concern over how much further monetary tightening can go. The MPR has reached 14.5 percent. Money market rates have also risen quite sharply. The recent 5-year bond issue by the GOG to pay maturing issues – the third government bond issue thus far this year – was described as oversubscribed, although the fixed yield rose to 26% per annum – an increase of 1000 basis points.

The most powerful indication – and proximate cause – of the present macroeconomic instability in is the private sector financial balance – the difference between spending and income of households and private business. Normally, but particularly, in election years this turns into a significant deficit – i.e. debt financed. This puts strong responsibility on the government to contain domestic spending pressure by running a surplus primary balance if at all possible – i.e. ensuring that some portion of the debt service requirement is from own resources and not from borrowing.

As the saying goes, the sovereign is the actor upon whom investors depend for rescue during systemic crises. When this appears unlikely doubt and fright turn to flight to safe havens. The current rapid depreciation of the cedi is one such instance of a flight from the cedi into foreign assets.

In a panic, fear has its own power – speculative attacks become self-fulfilling. To assuage fear and panic, one needs a lender of last resort willing and able to act on an “unlimited scale.” Perceptions matter and, as such, it is in our national interest to have the IMF and the Development Partners by our side; providing support to deal with the speculative attack on the cedi.

The economy is in a fragile state, facing a trade-off between macroeconomic stability and jobs. Public interest in the policy decisions being taken has also led to anxiety and intense debate over what needs to be done to address the recent challenges facing the country. An effective management of the situation, therefore, requires first, that the central bank improve its communication of policy measures being taken – to reduce the anxiety and misunderstanding on the part of the public. It also requires that there is better complementarity between fiscal and monetary policy, as well as an improvement in the forecasting of cash flows that would enable the central bank to stay ahead of events.

Accelerated growth with jobs requires fiscal and debt sustainability with monetary policy playing a complementary role to smoothen any short-term deviations from the trend growth path. There must, therefore, be a strong national – all political parties and relevant stakeholders – commitment to fiscal responsibility and expenditure accountability. The agreement between the MoFEP and the IMF to extend the program with the IMF is a move in the right direction towards showing Government's commitment to fiscal responsibility during this election year. In CEPA's view, however, there is a need for an agreed IMF staff-monitored program that would run into the first quarter of 2013. This would assure

- The commitment of the IMF to provide support in the face of speculative attacks; and
- A national commitment to fiscal responsibility which would be independent of the outcome of the 2012 elections