LEGISLATIVE ALERT

A Publication of The Institute of Economic Affairs *Vol. 19 No.7 June/July 2012*

THE RECENT SLIDE IN THE CEDI SHOULD BE A WAKE-UP CALL

by
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Summary

The paper examines the reasons for the recent sharp depreciation in the cedi, while placing the problem in a long-term context. The paper offers both short-term and long-term solutions to safeguard the cedi's value. As a bottom line, the paper argues that the only way to stem the cedi's continual weakness is to strengthen the fundamentals of the Ghanaian economy, particularly by fortifying the export and industrial base, and the fiscal position.

IEA Ghana

Legislative Alert is a bi-monthly publication of The Institute of Economic Affairs, Ghana, an independent public policy institute. This edition is sponsored by The International Development Research Centre (IDRC)/Think Tank Initiative. Subscriptions to the Legislative Alert are made available to those who make contributions to The IEA. Address all correspondence to:
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ISSN 0855-2452

In recent months, the cedi has depreciated sharply, raising concerns about the viability of the Ghanaian currency as well as the potential impact on prices. However, while the recent depreciation may have been significant enough to attract attention, historically, this is not a new phenomenon in this country. This paper throws some light on the factors behind the cedi's incessant depreciation and suggests measures required to stem it.

It would be helpful to place the performance of the cedi in historical perspective. Immediately before 1983, the exchange rate under a fixed regime was pegged at 2.75 (old) cedis to the US dollar. However, on the "parallel/black market," the rate was of the order of 70-80 cedis to the dollar. This showed that the official rate was quite artificial as the "true value" of the cedi as indicated by the parallel market rate was nearly 97 percent below the official rate. The huge difference between the two rates demonstrates that a fixed exchange rate, in and of itself, cannot prevent exchange rate depreciation without addressing the fundamental causes. As part of the liberalization measures that accompanied the Economic Recovery Programme (ERP) adopted in 1983, some flexibility was allowed in the determination of the exchange rate, ostensibly to narrow and eventually close the gap between the official and parallel market rates. Over time, the degree of flexibility was increased, with a transition from an auction system to an inter-bank system for determining the exchange rate.

Available figures indicate that between 1984 and May 2012, the cedi lost over 99 percent of its value against the US dollar. In fact, the cedi has already lost 48 percent of its value against the US dollar since it was redenominated in 2007. Thus, the cedi has been on a continual decline, with only intermittent periods of stability. During the periods of stability, the cedi was propped up by higher export receipts, aid inflows, other foreign inflows such as remittances and foreign direct and portfolio investments, receipts from floatation of international bonds, and official interventions in the foreign exchange market.

The cedi's continual decline basically reflects the fundamental forces of supply and demand. As we know, for all these years, Ghana's economy has remained, as some people like to call it, a "Guggisberg economy," dependent on cocoa and gold, with oil being added recently. We have failed as a country to add value to these primary products so that they can fetch higher prices in international markets. As a result, our export receipts have grown slowly even as volumes have increased. On the other hand, our imports have risen sharply because we have failed to develop our domestic industries, implying that we have to import virtually every item that we consume. Thus, if you look at our external accounts, you see a widening gap between receipts and payments. As we receive less foreign exchange than we demand, our currency depreciates relative to other currencies.

Apart from these fundamental factors that have driven the cedi down continually, there appears to be some additional factors behind the recent fall in the currency's value. Available figures show that in 2010 the cedi depreciated by 4.4 percent against the US dollar and in 2011 by 5 percent. These were periods of relative stability, helped again by

high export receipts, foreign aid, inflows from other loans, and high levels of remittances. For the first five months of 2012, however, the cedi has recorded an accelerated depreciation of nearly 15 against the US dollar. The question is what could be behind such a sharp decline in the value of the cedi. We would like to answer this question by using, again, the supply and demand argument.

On the supply side, cocoa and gold exports are still doing well. Even oil should give us additional receipts, although these are not coming in at levels originally anticipated because of lower-than-projected production levels and corporate taxes. Government bonds floated on the international market added to the supply of foreign exchange. In terms of aid support to the budget, we know that donors tend to drag their feet in election years, so there could be shortfalls there. Some remittance senders, especially the astute ones, may be holding back a bit, mindful of election-year uncertainties. As a principal supplier of foreign exchange to the market, the central bank may have reduced its presence in the market, apparently in light of other demands on its resources and the need for it to consolidate its reserve position. Putting it all together, the supply of foreign exchange in the market would appear to be reduced now.

Turning to the demand side, we see several factors at play. Our understanding is that some big corporates, including the Telecos, have been making heavy demands on the foreign exchange market, for what reason we do not know. The volume of trader-traffic going to Asia, especially China and Dubai, is on a sharp increase. To the extent that these traders transact their business in physical cash, unlike formal importers who use letters of credit routed through banks, they have been exerting considerable pressure on the foreign exchange market. Further, there is high demand for foreign exchange to import oil, most of which is provided by the central bank. Also, non-resident investors have been disinvesting heavily from the money and capital markets, possibly because they may not be happy with relative returns—as interest rates have come down in recent months—or they perceive uncertainties and risks in an election year. The cedi's continued depreciation will further precipitate a “herding” behaviour by investors. It must also be said here that, people demand foreign exchange by paying cedis for it. And one of the largest sources of cedi supply is the budget. Therefore, to the extent that government's payments, including relating to the Single Spine Salary Scheme, debts to contractors, and statutory arrears, may have increased, this will add to cedi liquidity, some of which will spill over into foreign exchange demand.

The curtailed supply of foreign exchange and high demand are driving the recent depreciation. In terms of stemming the depreciation, we have to look at both short-term and long-term solutions.

In the short-term, the central bank should investigate the high corporate demand for foreign exchange to see how that can be curtailed or better managed. The central bank should also monitor closely commercial banks' transactions in foreign exchange with off-shore parties to see the authenticity of especially the outflows. In the case of Asian-bound traders, and in fact the public as a

whole, the official limits for exporting foreign exchange should be strictly enforced. This is done everywhere. The allocation of foreign exchange for oil imports can also be abated by reducing the level of subsidy, which could lower consumption. When full pass-through of petroleum prices is effected, the country may spend less foreign exchange on oil imports, and consumers, by paying higher fuel prices, would have less extra cedis to chase foreign exchange, thereby reducing the pressure on the exchange rate.

Over the long-term, the cedi's value can only be safeguarded by fundamentally transforming the economy in order to increase exports and reduce demand for imports. Concrete steps should be taken to diversify the export base and add value to existing primary products so as to increase foreign exchange earnings. At the same time, adequate support should be provided to domestic industries to produce much-needed consumer goods n to reduce our reliance on imported goods. Such support should be directed at addressing impediments like high cost of financing, deficient infrastructure, and high cost of energy and public services. Over the years, we have only paid lip service to these important interventions without concretizing them. The budget should also be restructured to become more of an instrument of growth rather than a source of macroeconomic instability through appropriate revenue and expenditure reforms.

The bottom line is that the strength of every country's currency reflects the strength of its economy. It is not by accident that the US has maintained such a strong and stable currency across two centuries; it is the strong fundamentals that have sustained confidence in the economy and currency. The only way to stem the cedi's continual weakness on an enduring basis is to strengthen the fundamentals of the Ghanaian economy.

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