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THE RELEVANCE OF MONETARY POLICY IN STABILISING PRICES AND OUTPUT LEVELS IN GHANA

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The Relevance of Monetary Policy in Stabilising Prices and Output Levels in Ghana

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***Abstract** – This study has reviewed recent monetary and financial policies pursued in Ghana. The paper concludes that generally, while there have been remarkable improvements in the key monetary indicators which suggest relatively effective monetary policies during the period under review, the fiscal imbalance in the country has limited these outcomes. There is clearly the need for greater fiscal discipline given that monetary policies cannot achieve their intended purposes in the presence of fiscal imbalances. Moreover, although the policy rates have signaled a downward trend in lending rates, this has not reflected in the lending rates charged by deposit money banks (DMBs). This suggests that there are other factors driving interest rates in the country and therefore the need for policy intervention to make the cost of doing business favorable to the private sector.*

Generally, both fiscal and monetary policies seek at achieving relative macroeconomic stability. Based on countries' experience on the role of monetary policy in controlling economics instability, this study examines the efficacy of monetary policy in controlling inflation rate and exchange rate instability. The analysis performed is based on a rational expectation framework that incorporates the fiscal role of exchange rate. Using quarterly data spanning over 1980: 1 to 2000: 4, and applying time series test on the data used, the paper shows that the effort of monetary policy at influencing the finance of government fiscal deficit through the determination of the inflation tax rate affects both the rate of inflation and the real exchange rate, thereby causing volatility in their rates.

The study employed correlational research design. The study used time series empirical data on the variables to describe and examine the effectiveness of monetary policy tools in countering inflation in Ghana by establishing correlation coefficients between the inflation and the monetary policy tools. The study used secondary data on the Consumer Price Index for inflation, 91-day Treasury bill rate, exchange rate, money supply (M3) and repo rate. The analyses entailed the computation of the various coefficients of correlation denoted as 'β' in the model to determine the effectiveness of monetary policy tools in countering inflation in Ghana.

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INTRODUCTION

Monetary policies all over the world have been pursued together with fiscal policies to ensure that economic progress is achieved while fiscal and other macroeconomic challenges are addressed. These policies and strategies have been dynamic and in line with global trends in order to be relevant. Monetary policy involves the use of different measures with the aim of regulating the value, supply and cost of money in consonance with the expected level of economic activity. The common objectives of any monetary policy may include price stability, maintenance of balance of payments equilibrium, creation of employment, output growth, and sustainable development. In order to be effective and globally acceptable, monetary policies have to be dynamic. Thus, monetary policies have undergone dynamic changes globally but in African countries this begun in the 1980s and 1990s where there was a conscious* move away from the direct control measures to indirect monetary policy. However, due to the absence and illiquidity of financial markets such as secondary bill markets, many countries were hardly employing indirect monetary control instruments such as open market operations (Ncube, 2007). In the specific case of Ghana, monetary policies have evolved from the use of directinstruments1to the market-based approach where the main tar-get of policy is the money supply. For instance, before the start of financial sector reforms in 1992, the Bank of Ghana (BoG) operated a system of managing the amount of money in the economy by using direct controls and a fixed exchange rate system. While this approach was relatively easy to implement and also appealed to the government (which was mainly interested in channeling resources to certain "priority sectors" of the economy), there were several

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inefficiencies associated with its ability to give the right signals for allocating resources efficiently. As the reforms began, this system was abolished in favour of a relatively more market-based form of distributing and managing resources. Under the market-based system, the aim was to use indirect instruments to regulate money supply in order to achieve price stability and other economic objectives. This approach was based on the strong conviction that inflation in Ghana was solely or predominantly a monetary phenomenon, following the monetarist school of thought. Within this monetary policy framework, reserve money served as an operating target, money supply (M2+) as the intermediate target, with the final target being inflation.

The Bank of Ghana has since 2002 mimicked the policy of price stability,2 particularly; low inflation and a fairly stable exchange rate. Quartey (2010) notes that although the central bank has been pursuing low inflation policies as of 2002 albeit it does not follow an explicit inflation targeting framework. However, the low inflation pol-icy framework mimics an inflation targeting regime in which a specific level of inflation is set and targeted jointly by the central bank and the Ministry of Finance, but the target does not involve the usual modeling and minimizing of the loss functions as is typically done under inflation targeting regimes (Sowa and Abradu-Otoo, 2007). However, one thing that is very evident is that although this "inflation targeting" framework has been operational since 2002; its outcome has not received much interrogation. This paper therefore reviews recent trends in financial and monetary policies before and after the inflation targeting framework was instituted. Specifically, the paper analyzes the current trends in monetary policies and movements in some of the key indicators. The rest of the sections are as follows: The section discusses the monetary policy options pursued under the various medium-term development strategies. The subsequent section reviews the monetary policy outcomes after the financial sector reforms. The final section provides the concluding remarks.

Monetary policy has the major responsibility for curbing inflation and currency instability and also can ensure long-term economic growth. There is little agreement on what constitutes an optimal rate of inflation apart from stating that it should be low. However, there is growing acceptance among both policymakers and economists that the pursuit of price stability (defined as maintaining a low and stable rate of inflation) is the main medium- to long-run goal of monetary policy.

It is now almost universally acknowledged that inflation control is necessary for strong and sustained economic growth. A number of factors are responsible for this realization. Prominent is the simultaneous experience of high inflation and decline in output growth by many countries from the 1970s to the early 1980s that brought to the fore the idea that even moderate levels of inflation damage real growth. While the literature points to varied sources of inflation, the agency responsible for its control is the central bank. To make central banks successful at discharging this responsibility, their hitherto diffused objectives have been focused, and price stability assigned primacy. This commitment of central banks to price stability has from the 1990s been shared by industrialized and developing countries alike.

Similarly, the methods of monetary policy conduct have converged, with most countries adopting an explicit or implicit inflation targeting framework, implemented with market-oriented instruments. For countries in sub-Saharan Africa, this shift has occurred with varied intensity over the past two decades, usually as part of comprehensive reforms driven by the Bretton Woods institutions to liberalize the hitherto control-led approach to economic management.

One of the defining characteristics of the Ghanaian macro economy over the past 40 years has been its high, and often variable, rates of inflation 1 . Inflation was particularly high and variable in the politically turbulent 1970s and early 1980s, but has persisted throughout the gradual economic recovery since 1983. Though inflation has been lower and less variable in the latter period, it still remains high in absolute terms and by comparison with Ghana's trading partners. High and variable inflation is typically seen as a symptom or indicator of macroeconomic instability. Monetary policy in Ghana is aimed at reducing inflation and improving international competitiveness.

The attainment of the price stability objective is to a large extent related to the efficiency with which monetary policy is implemented and policy impulses are transmitted to target and goal variables such as output and inflation. There has therefore been much interest in the last two decades, following the adoption of inflation targeting and price stability objectives by many countries, in investigating the effectiveness of monetary policy along the lines, one, from empirical estimations of interest rate setting by central banks and subsequent assessment of the stability properties of policy setting; and two, analysis of the ability of monetary policy to affect market interest rates and broader macroeconomic variables.

Inflation has been one of Ghana's major macroeconomic problems since the late 1960s, though the magnitude of this problem continues to vary over time. Immediately after independence, the rates of inflation were low and in the single digit range, averaging below 10% in the period 1957 – 1972. Although the rates were low, they were increasing gradually over time and in most cases beyond the rates achieved during the late 1950s. The period 1957–1972 marks the first inflationary episode in Ghana, typified by active involvement of the state in economic activity.

Inflation became a serious issue during the period 1973- 1982, the second inflation episode. This period

was marked by several military interventions. Within this period, the various military leaders who came to power pursued expansionary economic management, which led to huge balance of payments deficits. The deficits that resulted were financed through expansionary monetary policy, which resulted in increases in money supply and, subsequently, effects on the economy through high general price levels. By 1983, inflation had reached a record high of 123 %.

When inflation was out of control and the entire economy was near collapse in 1983, the government adopted the economic recovery programme (ERP) proposed by the International Monetary Fund (IMF), with the aim of stabilizing the economy. This marked the beginning of the third episode of inflation in Ghana. Though the ERP achieved some success in terms of reducing inflation rates and creating a degree of stability in the economy, the rates of inflation were still high compared with those achieved in the immediate period after independence.

Ghana still has not been able to achieve the single digit target level of inflation that it had achieved in the 1950s and early 1960s. Though various policies were adopted by successive governments to reduce the high and variable rates of inflation to a single and a relatively stable digit, there has not been any notable success.

The monetary policy setting in Ghana is typical of a small open developing economy. The primary goal of monetary policy is to maintain stable prices or low and stable inflation. Fluctuations in the exchange rate, in particular, may have a significant impact on the macroeconomic fundamentals such as interest rates, prices, wages, unemployment, and the level of output. This may ultimately result in a macroeconomic disequilibrium that would lead to real exchange rate devaluation to correct for external imbalances. Price stability and financial stability are viewed by Bernanke and Gertler (1999) as complementary and mutually consistent objectives of monetary policy.

This argument stems from the notion that price stability tends to produce stable macroeconomic conditions and that higher inflation and surging asset prices are both counteracted by higher interest rates. Price stability and financial stability may also be conflicting goals of monetary policy as economic theory suggests that both price shocks and interest rate shocks are two fundamental forces that produce financial distress. This study examines the efficacy of monetary policy in controlling inflation rate and exchange rate instability. As a means of achieving this, a simple monetary model with rational expectation that emphasizes the fiscal role of the real exchange rate is used.

GLOBALISATION AND MONETARY POLICY

Nowadays, globalization is a notion frequently used in the economic debate and in fact it would be difficult to find an area of economic research that would be globalization-free. However, the term is so broad that every person taking part in the discussion on globalisation may refer to totally different phenomena.

Therefore, any discussion on globalisation and the monetary policy should commence with defining the term. One of the definitions is provided by the International Monetary Fund, which defines globalisation as ‘the increasing integration of economies around the world, particularly through trade and financial flows’. Moreover, an element of globalisation that is worth emphasizing is the fast flow of information and knowledge, which is the driving force of globalisation processes. One should also remember that globalisation is not a completely new phenomenon (Mussa 2000). Considering the existence of political barriers to international trade, the flow of capital and goods was equally possible one hundred years ago as it is today. It is beyond doubt, however, that as a result of the rapid development of technology, especially information technology, which significantly decreased costs of the exchange, international integration of trade, investments, financial and other services is much more advanced today than before.

RELEVANCE OF THE MONETARY POLICY RATE

In May 2007 the Bank of Ghana formally adopted inflation targeting (IT) as the framework for stabilizing prices within the economy. Since then, significant progress has been made in developing the policy framework as well as the institutions and markets that underpin its implementation – money and capital markets have been developed, there is a framework for forecasting liquidity, and a broad range of instruments with which to conduct monetary policy is available.

The monetary policy tool of the BOG is the monetary policy rate (MPR) – the rate at which commercial banks can borrow from the central bank – and it is set at a level that is consistent with meeting the BOG’s inflation target. The MPR, thus, is expected to communicate the stance of monetary policy and act as a guide for all other market interest rates.

The monetary transmission mechanism – the process by which monetary policy decisions affect the real economy and inflation – operates through several channels.

When monetary policy tightens, for example, and market interest rates rise, the financial position of firms may weaken – either because of an increase in their interest payments which reduces their net cash

flows or because of a fall in the value of their assets and thus collateral – causing the terms of credit that they face (the cost of external funds) to rise. This is the “balance sheet channel”.

Monetary policy changes may also affect the supply of credit, particularly by commercial banks. Because banks rely on demand deposits as an important source of funds, monetary policy tightening, by reducing the aggregate volume of bank reserves will also reduce the availability of bank loans. When a significant number of firms and households rely on banks as a major source of financing, then a reduction in loan supply will depress aggregate spending and reduce total output and price. This is the “bank lending channel”.

In conventional macroeconomic models, the primary mechanism believed to be at work in the transmission of monetary policy is the “interest rate channel”. In this case, an increase in the MPR, for example, is expected to directly impact on some short-term wholesale market interest rate (the interbank interest rate – the rate at which banks borrow from each other – or Treasury bill interest rates) and then transmitted to retail market interest rates – bank lending and deposit rates. Assuming that prices remain fixed for some period of time, the increase in the nominal market interest rates would translate into an increase in real (inflation adjusted) market interest rates and, hence, an increase in the real cost of capital. This, in turn, would result in a reduction in overall consumption and investment spending (i.e. a decline in aggregate demand) such that total output and prices would fall.

The effectiveness of the monetary transmission mechanism is important for the credibility of monetary policy – the relevance of the MPR in determining market interest rates and hence the level of economic activity and prices.

MONETARY POLICY AND REAL STABILIZATION

During the past two decades, maintenance of low inflation, .price stability,. has become the principal focus of central banks around the world. At the same time, the view has emerged that monetary policy is better suited than fiscal policy for short-run stabilization purposes.

This paper examines to what extent monetary policy can be directed at both .monetary stabilization, stabilizing inflation at a low level and .real stabilization,. stabilizing output or, rather, the output gap and whether there are significant limitations on the use of monetary policy for real stabilization purposes. This Section discusses what a realistic view of monetary policy is, what monetary policy realistically can and cannot achieve, what the long-run and short-run tradeoffs are between inflation and output, what the appropriate objectives for monetary policy are, and what the role of credibility is for the tradeoff between inflation and output stabilization. This Section discusses how central banks can make the objectives of low and stable inflation and a stable output gap precise and the benefits thereof, how central banks can achieve the best outcome relative to these objectives by a procedure called .forecast targeting,. and how this procedure is best implemented.

The monetary policy literature has also discussed a so-called credit channel to aggregate demand. It works in the same direction as the pure real-interest rate effect on aggregate demand. For simplicity, we can therefore include the credit channel in the above real-interest rate channel to aggregate demand. The real-interest rate channel also includes the effect on aggregate demand of wealth changes of interest rate changes, for instance, effects via changes in the stock market value.

PRICE STABILITY EFFECT OF MONETARY POLICY AND OUTPUT GROWTH IN GHANA

In the past decade, significant changes in the design and conduct of monetary policy have occurred around the world. Many developing countries, including Ghana have adopted various policy measures to achieve targeted objectives. The monetary policy is essential to achieve desired objectives which traditionally include promoting economic growth, achieving full employment level, reduction in the level of inflation, maintenance of healthy balance of payment, sustenance of growth in the economy, increase in industrialization and economic stability.

The monetary policy is essential to achieve desired objectives which traditionally include promoting economic growth, achieving full employment level, reduction in the level of inflation, maintenance of healthy balance of payment, sustenance of growth in the economy, increase in industrialization and economic stability. The smoothing of the business cycle, preventing financial crisis and stabilizing long term interest rates and the real exchange rate have been identified recently as other supplementary objectives of monetary policy because of the weaving global financial crisis which engulfed major developed and emerging economic in the world (Mishra and Pradhan, 2008).

The central bank is responsible for the conduct of monetary policy to pursue those objectives. Central banks in the world such as the Central Bank of Ghana (CBG), often employ certain monetary policy instruments like bank rate, open market operation changing reserve requirements and other selective credit control instruments. Central bank also determines certain targets on monetary variables.

Although, some objectives are consistent with each other's, while others are not, for example, the objectives of price stability often conflicts with the objectives of interest rate stability and high short run

employment. This often constitutes problems of policy mix in achieving a certain macroeconomic objective such as price stability. Such conflict motivates this paper.

The causal relationships between money and income and between money and prices have been an important area of investigation in economics particularly after the provocative paper by Sims (1972). Monetary policy plays an important role in boosting the economic growth of any country provided money is exogenously determined in the economy. Its impact on income and prices has been widely examined in the developed and developing countries in the context of Monetarists and Keynesians controversies (Abbas and Husain, 2006).

PRICE STABILITY AND THE GROWTH MAXIMIZING RATE OF INFLATION FOR GHANA

The maintenance of low inflation and or price stability has been the focus of many countries since evidence abound that sustained and predictable high rates of inflation can have adverse effects on economic growth or real sector activities. Although there is no general consensus on the effect of inflation on growth, several empirical studies have found that inflation negatively affect the real sector. Of particular interest is a study on both industrialized and developing countries on the inflation growth nexus which found the existence of a thresh-old level of inflation beyond which the inflation growth relationship is negative.

Many developing countries have historically recorded persistently high rates of inflation particularly from early 1970 to the 1990s. Similarly, Ghana has had a long his-tory of very high rates of inflation over the same period. In 1971, inflation measured as the change in the consumer price index was 9.6% but rose consistently and by 1977 it had reached 116.4%. Although the rate of inflation declined thereafter, it was short-lived and by 1983 it had reached 122.9%. The introduction of the Economic Recovery programme (ERP) saw inflation declining to 40% in 1984. Subsequently, the rate of inflation has been within 10% to 40% except in 1995 when the rate of inflation increased to 59.5% but declined consistently to 12.4% in 1999. The year 2000 was an election year and many of the macroeconomic fundamentals including inflation were unstable. It is not surprising that the high inflationary era also coincided with low real sector performance in Ghana.

In view of the inverse relationship between inflation and economic performance, the Bank of Ghana has consistently pursued low inflation policies in order to accelerate real sector performance. Since 2002, consistent with its mission statement, the Bank of Ghana has followed the policy of price stability1, particularly; low inflation and a fairly stable exchange rate It must be emphasized that although the Central Bank has been pursuing low inflation policies as of 2002 it does not follow an explicit inflation targeting framework. The earlier framework however mimics an inflation targeting regime in which a specific level of inflation is set and targeted jointly by the Central Bank and the Ministry of Finance, but the target does not involve the usual model-ling and minimizing of the loss functions as is typically done under inflation targeting regimes. The ration-ale for promoting price stability is that it will enhance private sector activities which will in turn increase real sector economic activities through increased output, employment, income and consequently lead to poverty reduction. The outcome of the policy of price stability on the real sector critically depends on the extent to which private sector activities respond to these incentives. However, the absence of this will imply that short-run trade-off between inflation and unemployment will occur. As Fischer argued, while there may be good political reasons to wish there were no short-run trade off, empirical evidence confirms its existence.

CONCLUSION

This study has outlined the monetary and financial policies pursued over the past decade as well as the trends in key monetary indicators to ascertain possible inter-relationships. Monetary policies have been pursued in Ghana to reorient the economy towards the path of growth. Consequently, the conduct of monetary policy in Ghana has moved away from the use of direct control measures to indirect, market-oriented tools and recently to inflation targeting. It appears that the main objective of monetary policy in Ghana has been to stabilize prices and subsequently create an enabling environment for both foreign and domestic investors. In this regard, there has been a number of medium-term development plans (MTDPs) aimed at turning the long-term development objective (attaining middle-income status by 2020) into a reality.

The study therefore looked at the various monetary policy strategies and trends in key indicators and made interesting findings. First, given that any effective monetary policy should be accompanied by fiscal discipline, fiscal policies in the period were also designed to ease those monetary difficulties associated with huge budget deficits that compel governments to resort to large-scale borrowing at high interest rates, which crowds out the private sector. Within the period 1996-2000. M2+ grew at about 31 percent on average and inflation averaged about 22.7 percent. Thereafter. Ghana recorded its highest growth in M2+ (about 50 percent) immediately after joining HIPC in 2002. The growth in M2+ in recent years has slowed down with 2012 recording a growth rate of about 24.32 percent.

Inflation, on the other hand, has seen a remarkable improvement averaging around 14.65 percent within the same period. The economy is currently operating with the GSGDA which is expected to be completed by the end of 2013. Several strategies have been implemented under the GSGDA and key among them are the passage of the National Pension Act 2008 (Act 766) and the Anti-Money Laundering Act 2008 (Act 749).

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