

**FOREIGN EXCHANGE MARKET DEVELOPMENTS IN THE FIRST HALF OF 2013:
NEED FOR CARE IN INTERPRETATION AND POLICY ADVOCACY.**

Introduction

The importance of the US dollar as the reference currency for transaction purposes in Ghana cannot be overemphasized. Even though the United States is not the most important trading partner of Ghana, in terms of payments the US dollar currently accounts for 55 percent of the weights in the reference basket of currencies used in computing the nominal effective exchange rate (NEER) of the cedi. The exchange rate of the cedi against the US dollar is therefore watched closely by the general public, businesses and investors alike, and rightly so because of its impact on the wellbeing of Ghanaians and the economy at large.

The very fact that Ghana trades in other currencies, particularly the European Union's euro and the British pound sterling, makes it important not to focus solely on the cedi/US dollar exchange rate. This is the more reason to increase public understanding of the determinants of the performance of the cedi on foreign exchange markets, and in particular to inform the public's demand for the policy responses to developments that are deemed to have potentially adverse consequences for the economy. In turn, such a deeper understanding of market developments would not only influence our advocacy but help to appreciate the considerations of the Monetary Policy Committee (MPC) of the Bank of Ghana as to the policy directions in its deliberations.

The MPC of the Bank of Ghana (BoG) is the institution responsible for policy directions of the exchange rate of the cedi. In its deliberations it is expected to consider a wide range of data as well as developments in the global economy that also impact on foreign exchange markets. This is because, as between any two trading currencies, either major, (like the euro, pound sterling, the Japanese yen, and the Chinese yuan) or smaller trading currencies (like the cedi, the francophone West African CFA, the Nigerian Naira, and the Kenyan shilling), to say that currency A is gaining strength in value (appreciating) against currency B in foreign exchange markets is equivalent to saying that currency B is weakening in value (depreciating) against currency A. Moreover, the sources of causality may not be so obvious.

It is important to stress that it is not always the case that the fortunes or demise of the Ghana cedi against the US dollar — or indeed against any international currency — are indication of the domestic policy stance. In our present circumstances, there is no fixed relationship between the Ghana cedi and the US dollar. The exchange system is free of restrictions on payments and transfers for current international transactions.

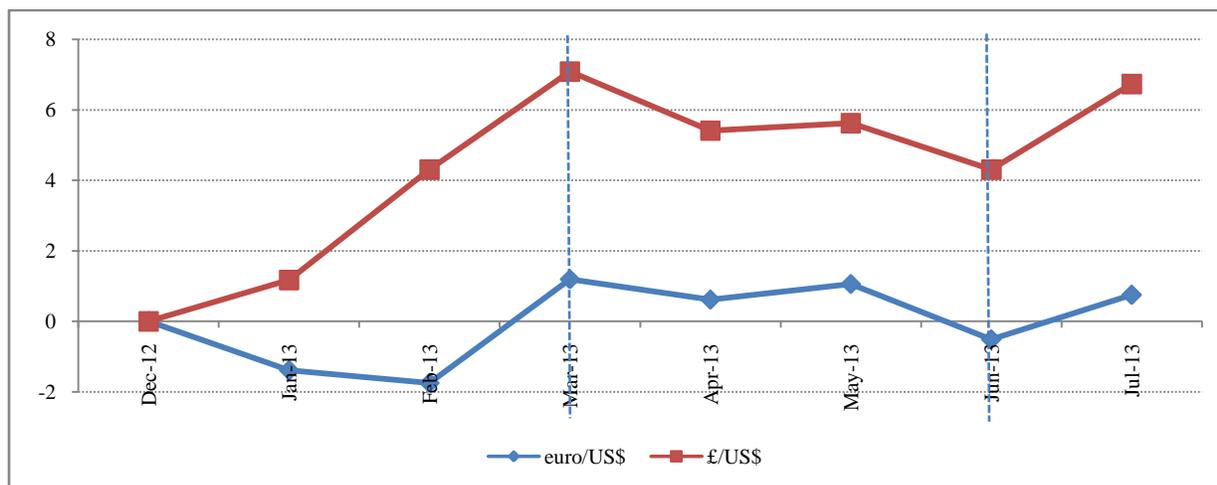
In a recent Press Release from a *Bloomberg Business Weekly* dated July 22, 2013 and titled "Ghana Cedi Sinks to Low as State-Owned Shares Fall on Vote Trial", the cedi was reported to be sinking to record lows on "*prospects that Ghana's Supreme Court will cancel President John*

Dramani Mahama's selection win and put at risk an improving economy". The report stated that "the cedi fell to a record low on July 19 and is Africa's worst performer against the US dollar after Kenya's shilling". The reasons given for the poor performance of the cedi were of a domestic origin, particularly referring to the uncertainty about the outcome of the forthcoming Supreme Court verdict on the Presidential elections of 2012; the massive current account and fiscal budget deficits of 2012; speculation or precautionary actions of importers regarding buying dollars ahead of the Supreme Court's ruling, and investors holding on to dollars as a precautionary measure. Of some significance, however, are the references to the Kenyan shilling. The latter is indication of the possibility that there were factors beyond the domestic that may help to unravel an understanding as to why the Kenyan shilling was doing even worse than the Ghana cedi.

Developments on Foreign Exchange Markets

A survey of foreign exchanges showed that in the month of July (the month under reference), two major currencies in the trade basket for computing the nominal effective exchange rate (NEER) for Ghana — the pound sterling and the euro — interestingly like the Kenyan shilling, were depreciating faster still against the US dollar than the Ghana cedi (see Chart 1).

Chart 1: Cumulative Monthly Changes in Cross Rates of major currencies from end-December 2012 (%)



Data sources: Based on data from the Bank of England website—bankofengland.co.uk

Chart 1, which is based on officially published data from the Bank of England, illustrates the cumulative changes in the value of the US dollar vis-à-vis the pound sterling and the euro. As presented, a rising trend reflects an appreciation in the value of the US dollar vis-à-vis the pound sterling and the euro, while a falling trend points to a depreciating trend in the value of the US dollar with respect to either the pound sterling or the euro.

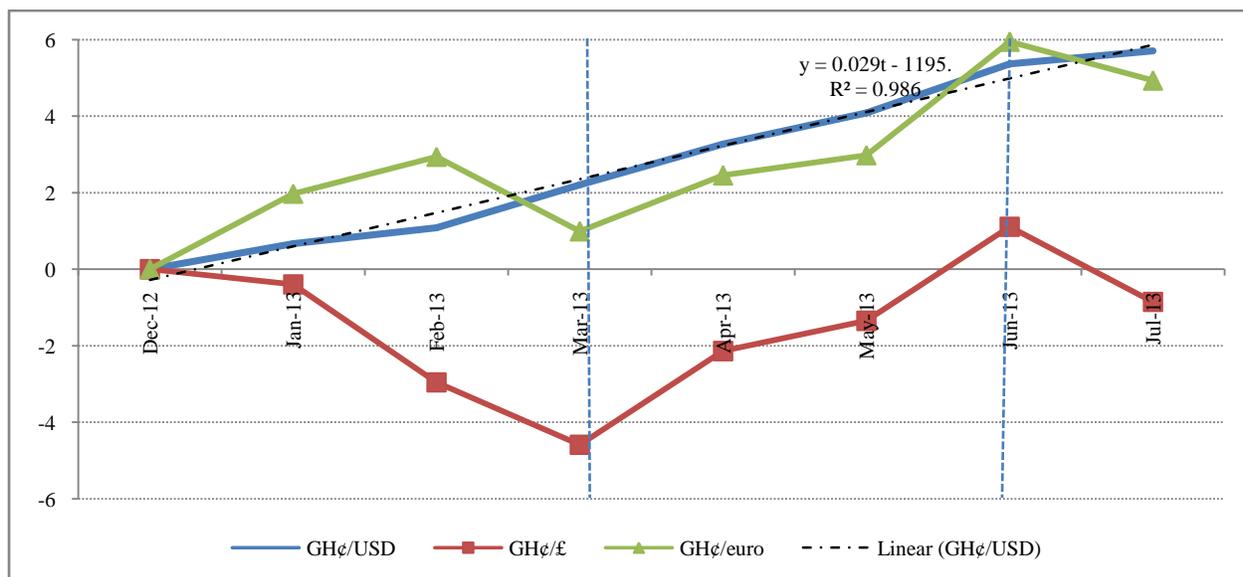
The Chart also shows that what happened in July was also reproduced in March 2013 with depreciations of both the euro and pound sterling against the US dollar—i.e., an appreciation of the US dollar against both currencies. In the second quarter of the year, however, there was a reversal as both currencies appreciated against the US dollar — in other words, the US dollar depreciated against both currencies in the second quarter of 2013.

The point to note in all of this is that as between any two currencies, an appreciation of the dollar against the euro or the pound sterling can also be described as a depreciation of the euro or the pound sterling against the US dollar. Thus in our advocacy, there is the need to be circumspect in our call for what needs to be done.

Developments in the Local Foreign Exchange Markets

Turning to the domestic economy, there were indications from published data of the Bank of Ghana that during the first seven months of this year the Ghana cedi depreciated (on a cumulative basis) against both the US dollar and the euro, but for the most part of the same period appreciated against the pound sterling.

Chart 2: Changes in the Ghana Cedi Exchange Rate with respect to the Core Currencies in 2013



Data sources: CEPA staff estimates based on data from Bank of Ghana website — bog.org.gh

Chart 2 presents developments in the domestic foreign exchange markets in the first seven months of 2013 in respect of the cedi vis-à-vis the three major currencies in the trading basket of Ghana. It shows that over the seven-month period the cedi broadly depreciated (lost value) against the US dollar, on average, by 2.9 percent per month. However, over the same period, the cedi showed more movements against the euro and pound sterling. Broadly speaking, in the first

quarter of the year the cedi appreciated against the pound sterling but depreciated against the euro until March when there was a trend reversal with a sharp appreciation against the euro. In the second quarter, the cedi depreciated against both currencies—more against the pound sterling than the euro. This was followed by a sharp cedi appreciation against both currencies in the month of July.

We find that in the two months of March and July, even as the cedi depreciated against the US dollar, it appreciated against both the euro and the pound sterling. In both of these months what is described as a depreciation of the cedi against the US dollar is in a fundamental sense better described as an appreciation of the US dollar against the cedi. The difference is that in both of these months, the euro and the pound sterling also depreciated against the US dollar, or again perhaps more correctly, the US dollar appreciated against the two major currencies in our trade baskets.

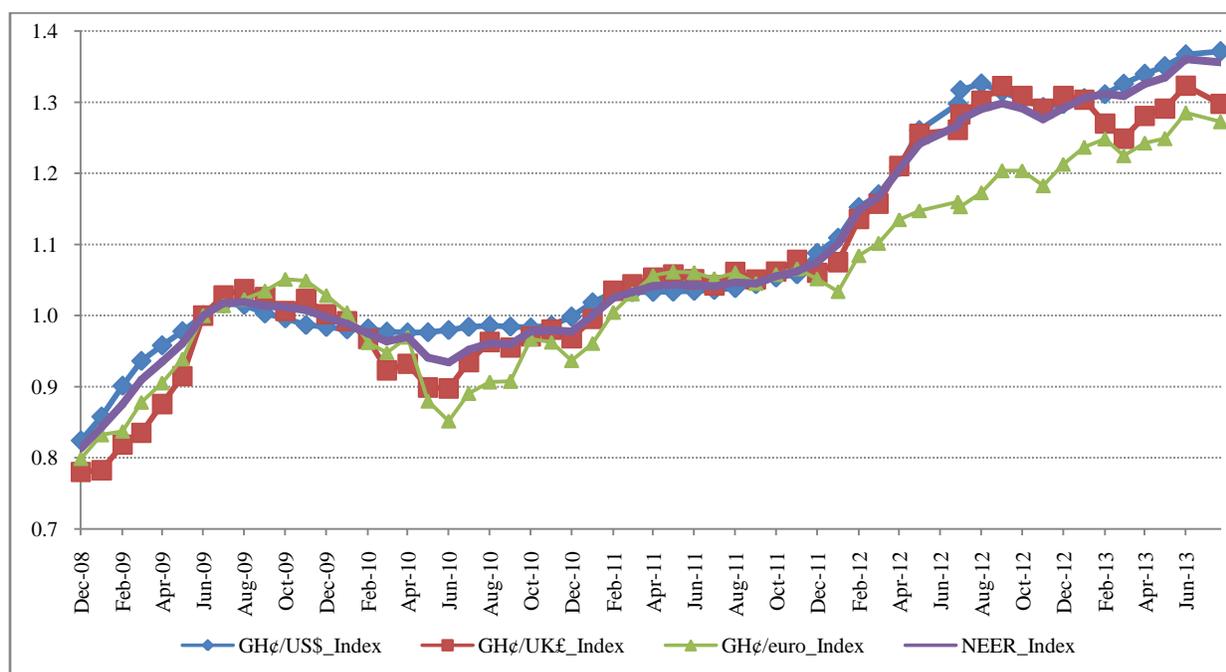
There is the suggestion that whatever may be happening on the local foreign exchange markets, what we should perhaps be highlighting in our observations is the dominance of the strength of the US dollar on global foreign exchange markets. This dominance in the strength of the US dollar has generally reflected in the moderate pace of economic expansion and tapering off of quantitative easing in the United States, leading to the tumbling in the prices of Ghana's key export commodities like gold and cocoa on global markets.

A more careful assessment of the situation would have pointed to the significant change in the policy direction of the United States rather than developments in the Ghanaian economy. The Bank of Ghana has rightly pointed out in the MPC Press Release of July 31, 2013 that the announcement by the US Federal Reserve of a possible slowdown in quantitative easing “led to some volatility in global financial markets and this impacted on capital flows to emerging markets and yields on long-term bonds”. Furthermore, “*developments in the external environment continued to impact on the domestic economy as declines in commodity prices affected external sector performance; the announced slowdown in quantitative easing in the US also affected the yield on the new Ghana Eurobond*” [MPC Press Release, July 31, 2013; paragraphs 4 and 7, pages 1 and 2; emphasis added].

The economics literature suggests that it would be erroneous from a policy perspective to gauge, for example, the fortunes of the cedi by considering its bilateral relationship with only one of the currencies of its trading partners. Rather than use a bilateral exchange rate, it recommends the use of an effective rate such as the nominal effective exchange rate (NEER) — a weighted combination of the relevant bilateral exchange rates with trading partners into a single summary index. One such summary index, which was constructed for Ghana, is presented in Chart 3.

As measured the NEER is a combination of the three bilateral exchange rates with the United States, United Kingdom and the European Union and the weights are the shares in total trade (imports plus exports) with these trading partners. It needs pointing out that the currencies of these trading partners have evolved to become the dominant international trading currencies for transactions with the rest of the world. This is partly on account of the colonial ties with Great Britain but also because of the changing patterns of the country's trading relations with the rest of the world, especially the European Union. In the event, the United States dollar has become the dominant currency for transaction purposes — even with China and South East Asian countries such as Japan, Singapore and South Korea.

Chart 3: Ghana's NEER and bilateral Exchange Rate Indices (June 2009 = 1.0)



Data sources: CEPA staff estimates based on data from Bank of Ghana website and Statistical Bulletin

Consistent with standard practice elsewhere — such as in the euro-zone and India — the respective trade shares used in calculating the NEER for Ghana over the period from December 2008 to December 2011 have been kept unchanged to reflect the 2009 annual revision of trade shares as published by the Bank of Ghana. The weights have been revised from 2012 to reflect the changing trade patterns of the country with the rest of the world. A rising trend in the NEER denotes a depreciation of the exchange rate, while a falling trend reflects an appreciation of the exchange rate.

Our measure of the NEER showed that on a cumulative basis from end-December 2012, the cedi exchange rate depreciated by 4.9 percent at the end of July 2013, after peaking at 5.1 percent a

month earlier. This is in sharp contrast to the statement from the *Bloomberg Business Weekly* dated July 22, 2013, that “*Ghana’s cedi is sinking to record lows ...*”

Conclusion

Technically speaking, a change in the relationship between the cedi and the US dollar could be described as either an appreciation of the US dollar against the cedi or a depreciation of the cedi against the US dollar. The point to stress, however, is that the choice of words to describe the same phenomenon — as also in the case, for example, as to whether the cup is ‘half empty’ or ‘half full’—may be suggestive of the policy response that is required. Because of the consequences for inflation, for example, the choice of words could be suggestive that there is a need for the Bank of Ghana to intervene decisively when the problem is of external origin and the immediate solution is beyond our control.

While the suggestions may be useful, policymaking requires in-depth analysis and wider consideration of many other developments in the economy. This is why the MPC of the Bank of Ghana (BoG) meets bi-monthly to examine a wide range of economic data and uses a number of economic criteria — including, but not limited to prospects and potential risks to growth and inflation both globally and domestically; the reserves position of the central bank; and external current and capital account flows etc. — before responding with the appropriate policy instruments.

Going forward, successful policymaking would require restoring policy credibility and building and strengthening institutional resilience to the political business cycle. True independence is required for the central bank policymaking and implementation but this must not be seen in isolation from fiscal policy shocks. An expansionary fiscal policy that relies directly on BoG financing, as occurred in the past two elections of 2008 and 2012, makes it extremely difficult to achieve and sustain lower rates of inflation and a stable currency. The central bank must be given the flexibility and resources to do its work effectively.

CEPA’s advocacy is for institution building and capacity development for effective policymaking and implementation. As President Barack Obama firmly stated to Ghana’s Parliament in Accra on July 11, 2009 on his first visit to sub-Saharan Africa as President of the United States, it is important (for African countries) to build strong and reliable institutions and strengthen capacities to support “a broader base for prosperity”. This involves helping governments uphold transparency, accountability, human rights and the rule of law. These appear to be the gist of President Obama’s message to the Parliament in Ghana when he observed that:

“In the 21st century, capable, reliable and transparent institutions are the key to success — strong parliaments, honest police forces, independent judges; an independent press; a vibrant private sector and civil society. Those are the things that give life to democracy, because that is what matters in people’s everyday lives.”