

Inflation-Targeting in Sub-Saharan Africa: Why Now? Why at All?

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The IMF Survey Magazine (February 14, 2008) announced: "In May 2007, Ghana formally adopted an inflation targeting framework for its monetary policy, announcing price stability as the central bank's primary objective". Ghana is only the second country in sub-Saharan Africa, after South Africa, to adopt such a regime. Ghana's inflation target is five per cent while South Africa's is a 3-6 per cent band. Such low rates are common among countries in the region, even those without explicit targeting regimes.

Why choose such a policy regime? Especially when the global economy hovers on the brink of a significant slowdown (likely to be triggered by a U.S. recession)? This Development Viewpoint comments on these issues.

In 2002, the Bank of Ghana began moving toward inflation targeting but still continued to manage the exchange rate—a priority in countries subject to frequent external shocks. However, Ghana's new monetary regime requires focussing on the inflation rate, not the real exchange rate. Inflation targeters prefer, in fact, full exchange-rate flexibility.

Also, the Ministry of Finance has to restrain its fiscal policies in order to support the central bank's inflation target. The IMF has already encouraged Ghana to adopt a 'fiscal responsibility law' as a means to ensure strict budget discipline.

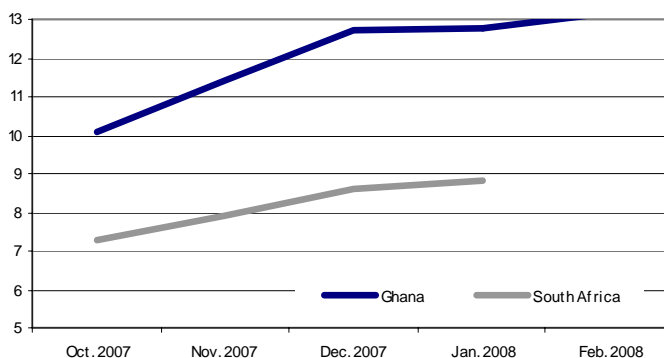
Will such a policy regime produce either price stability or growth? Not likely. Its chances look particularly bleak now. On March 18, 2008, the Central Bank announced an increase in its prime interest rate from 13.5 per cent to 14.25 per cent. Last November, it had hiked this rate a full percentage point, from 12.5 per cent. Why?

Inflation in Ghana has been on the rise since October 2007 (see Figure), driven by rising food and oil prices and increases in utility rates. The inflation rate rose to 13.2 per cent by the end of February—a 30 per cent increase over its October 2007 level and 2.6 times its five per cent target.

Is South Africa doing any better? In January 2008, its food prices were increasing by almost 14 per cent, with a markedly higher rate for imported food. Overall inflation had already exceeded its target range, rising to almost nine per cent, about one fifth higher than in October 2007 (see Figure), and the highest level since 2003. The central bank governor pointed to increases in food and oil prices, combined with domestic capacity constraints (e.g., electricity shortages), as the main factors.

The price increases faced by Ghana and South Africa—and many other countries in sub-Saharan Africa—are supply-side problems, mostly externally imposed. They cannot be blamed on excessive domestic aggregate demand. But policymakers in both

Recent Increases in Inflation in Ghana and South Africa (CPI % change)



countries still insist on raising interest rates in order to squelch inflation. Such tightening of monetary policies is a singularly bad idea during the onset of a global slowdown.

Ghana is a big exporter of cocoa and gold (whose prices are on the upswing), and expects to produce oil in a few years. However, it still runs very large trade deficits, covered fortunately by remittances and ODA. South Africa has also run consistently large trade deficits (e.g., over seven per cent of GDP in 2007), financed until now by private capital inflows. But a global slowdown (combined with high food and oil prices) could quickly widen such deficits and make financing them even more difficult.

Terms-of-trade shocks have been so frequent and severe in the region that inflation targeting is bound to fail, especially in economies becoming increasingly open. Recent price shocks are likely to depreciate exchange rates, which will, in turn, intensify inflationary pressures. The depreciation of the Ghanaian cedi already intensified in early 2008. The South African rand declined in value by 14 per cent for the first two months.

Rising food prices have already been battering the purchasing power of poor Ghanaians. And the recent jump in oil prices will surely slow growth in 2008 as well as hike inflation. Moreover, a U.S. recession will dampen, directly or indirectly, the growth of Ghana's primary commodity exports. The debilitating impact of these combined factors could sweep across many countries in the region.

Managing the exchange rate will become critical in responding to this imminent turmoil. Ghana should focus on stabilizing the real exchange rate instead of the inflation rate. And fiscal policies should be freed to cushion domestic investment and consumption in the face of intensifying external shocks that will markedly worsen trade balances, growth prospects and mass poverty.

Note:

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