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Financial and monetary policies in Ghana: A review of recent trends

Peter Quartey [a,*], Gloria Afful-Mensah [b]

[a] *Department of Economics, University of Ghana, Legon, Ghana*
[b] *University of Professional Studies, Accra, Ghana*

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 signalled 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 favourable to the private sector.
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1. 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 direct instruments[1] to the market-based approach where the main target of policy is the money supply (see Alexander et al., 1995; Roe and Sowa, 1997). 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 channelling resources to certain "priority sectors" of the economy), there were several 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

* Corresponding author.
E-mail addresses: pquartey@ug.edu.gh (P. Quartey), gloria.afful@upsa.edu.gh (G. Afful-Mensah).
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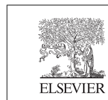

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[1] This was made up of interest controls, credit and sectoral credit controls and reserve requirements. Such policies contributed massively to financial repression in Ghana before the financial reforms in 1992.

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.

Globally, as economies developed, with corresponding developments in the financial sector, several substitutes for money emerged, which rendered monetary targeting not very effective, particularly in the short run. Eventually, Ghana, along with other countries, abandoned the monetary targeting framework and adopted inflation targeting as a strategy for conducting monetary policy. In Ghana, the Bank of Ghana Act 2002 specifically considers the BoG as an inflation-targeting central bank by indicating in the BOG Act 617, Section 33(2) that:

> "*The Bank, in counteracting unusual movements in the money and prices in the country, shall use any of the instruments of control conferred upon it under this Act or under any other enactment to maintain and promote a balanced growth of the national economy*"

The Bank of Ghana has since 2002 mimicked the policy of price stability,[2] particularly; low inflation and a fairly stable exchange rate (Sowa and Abradu-Otoo, 2007). 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 policy 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 modelling 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 analyze the current trends in monetary policies and movements in some of the key indicators. The rest of the sections are as follows: The next 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.

2. Developments in the monetary and financial sector

2.1. Banking laws and regulations

Ghana's banking sector appears vibrant compared to those in other countries of the sub-region. Despite the relatively well-developed and structured banking system, the sector was widely used by previous governments in their massive, state intervention programmes, particularly between the 1960s and 1970s. This led to significant losses for the banks in terms of the ratio of bad loans to their total portfolio. As part of measures to restructure the banking sector, reforms were instituted (including a market for securities) to ensure effective monetary policy. As a result, a weekly auction in Treasury bills was introduced in 1986. Gradual attempts were subsequently made by the central bank to move away from the direct control regime[3] to the indirect system of policy measures which was more market-oriented.

Given the negative consequences from the repressive measures, the Financial Sector Adjustment Programmes (FINSAP 1) was introduced between 1988 and 1990 to, *inter alia*, restructure distressed banks, increase the mobilization of savings and efficiency in credit allocation, and develop money and capital/securities markets (Gockel et al., 1997). Subsequently, the government amended the existing banking law in August 1989 in order to strengthen the banking system. Under this new law, banks were required to keep 6 percent of their net assets as their minimum capital base even though the Bank of Ghana had the discretion to increase the ratio for any specific bank or even for the entire banking sector. Among the measures of the central bank to improve its supervisory and regulatory framework, the new banking law also introduced limits to single borrowers. The period 1990/91 then witnessed the modified version of FINSAP 1 in FINSAP 2.[4] This was followed by the enactment of the Non-Bank Financial Institutions Law of 1993.[5]

As part of the liberalization process in the sector, a number of new laws[6] aimed at facilitating financial transactions, strengthening and deepening the financial system in general and the Bank of Ghana in particular, were laid before Parliament in 2000/2001. The implementation of the Financial Sector Strategic Plan which began in 2003 led to the passage of the Banking Bill and the Payments System Bill in 2003. While the Banking Bill was aimed at providing an effective supervision framework by the Bank of Ghana for the banking industry, the Payment System Bill was aimed at modernizing and improving the efficiency of the country's payment system. The following paragraphs discuss some of the new developments in the financial sector since the year 2000.

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[2] The Bank of Ghana's mission statement declares that, "Our mission is to pursue sound monetary and financial policies aimed at price stability and create an enabling environment for sustainable economic growth". See www.bog.gov.gh/.

[3] The period witnessed the use of unorthodox monetary policy measures especially in the 1970s and early 1980s. Examples of such policies included low interest rates (minimum deposit rates and maximum lending rates) set by the central bank to serve as incentives in order to increase investment in the country. There were also bank-specific credit ceilings and sectoral credit controls (between 1960 and 1990) purposively to promote a specific investment pattern by channelling funds into certain "priority sectors". The low interest rate policy used was based on the underlying assumption that the cost of capital and not the availability of loanable funds were the major determinant of investment (Khan and Hasan, 1998) and hindrance of access to funds by potential investors. Another major policy instrument was the imposition of a required reserve ratio by the Bank of Ghana averaging about 50 percent (by 1983) and 32 percent (between 1987 and 1989).

[4] FINSAP 2 was meant, *inter alia*, to finish any unfinished project in FINSAP 1, divest state-owned banks and promote and strengthen the non-bank financial institutions.

[5] See Gockel et al. (1997).

[6] The new laws included the Banking Law, the Bank of Ghana Law, the Bills and Cheques Bill and the Payment Systems Bill.

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