

RESTORING THE VALUE OF THE CEDI

DISTINGUISHED SPEAKER SERIES LECTURE

by:

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Ghana

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Mr. Chairman

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Ladies and Gentlemen

I would like to begin by thanking all of you who have taken time out of your busy schedules to make the journey to this beautiful and serene campus this evening. For me, it is an honor and a privilege to be delivering my first public lecture as visiting professor at Central University College on a topic that is literally on the minds of most Ghanaians today. What can we do about what appears to be a perpetually declining value of our currency, the cedi? I would like to say from the outset that this subject is very much one of economics and not politics. It is therefore important that we stick to

the empirical evidence and data¹ in reaching conclusions. I am hoping that at the end of this lecture, some light would be thrown on the issue for a dispassionate and non-partisan discussion by all stakeholders that would inure to the benefit of Ghana.

Mr. Chairman, the exchange rate is a price, just like the price of any good or service. It is the price of one currency relative to another. How much of one currency does one need to give up to get one unit of another currency? The rate of exchange generally reflects the purchasing power of one currency relative to another². Countries have a choice between two basic types of exchange rate regimes (fixed or floating and variations in between). A fixed exchange rate regime is one that is administratively fixed by the government or monetary authority with fiscal and monetary policy deployed to maintain the fixed exchange rate. In practice, countries devalue or revalue their currencies in line with changes in the economic fundamentals. The other type of exchange rate regime is the floating exchange rate regime where the exchange rate is determined by the forces of demand and supply in the foreign exchange market³.

Mr. Chairman, at independence, Ghana was operating a fixed exchange rate regime in under the colonial international economic arrangements. The British West African Currency Board (WACB) was constituted in 1912 to control the supply of currency to the British West African Colonies. The exchange rate of the West African Pound to sterling was fixed. Under this fixed exchange rate regime, a government could only increase its

¹Data from the Ghana Statistical Service, Ministry of Finance, Bank of Ghana, IMF and World Bank, are the primary sources of data for this lecture.

² See Michael Mussa (1984): "Theory of Exchange Rate Determination in John F.O. Bilson and Richard Martson, eds, Exchange Rate Theory and Practice, University of Chicago Press, for a detailed discussion of the determination of exchange rates.

³ See Michael D. Bordo (2003) "Exchange Rate Regime Choice in Historical Perspective" NBER working Paper No. 9654

money supply if it was backed by a similar increase in foreign exchange reserves. Under this framework, Ghana, like all the WACB countries, did not have an independent monetary policy. Government could not print money at will. The discipline imposed kept inflation barely noticeable. There was no exchange rate depreciation to worry about against the pound sterling⁴.

Ghana abandoned the WACB arrangement in 1963 and introduced the cedi in 1965 because the government could not adhere to the strict requirements of fiscal discipline that the currency board regime imposes. The exchange rate at this time was $\text{¢}1.04/\text{\$}$ and Ghana continued to operate a fixed exchange rate regime. Mr. Chairman, for any country to successfully operate a fixed exchange rate regime with free capital movement, there is one key rule that has to be followed, i.e. you cannot have an independent monetary policy at the same time. This is known in economics as the “Triffin Trilemma” or the “Impossible Trinity”⁵. Unfortunately, most governments want to eat their cake and have it at the same time so they try to have a fixed exchange rate along with an independent monetary policy. No government has so far been successful.

Subsequent governments after Nkrumah through to 1983 generally operated or attempted to operate a fixed exchange regime for the cedi. For the most part, these fixed exchange rate regimes failed because of the break down in fiscal and monetary discipline. This situation led to high inflation, a shortage of foreign exchange, imposition of exchange controls, and the emergence of a vibrant black market for foreign currency.

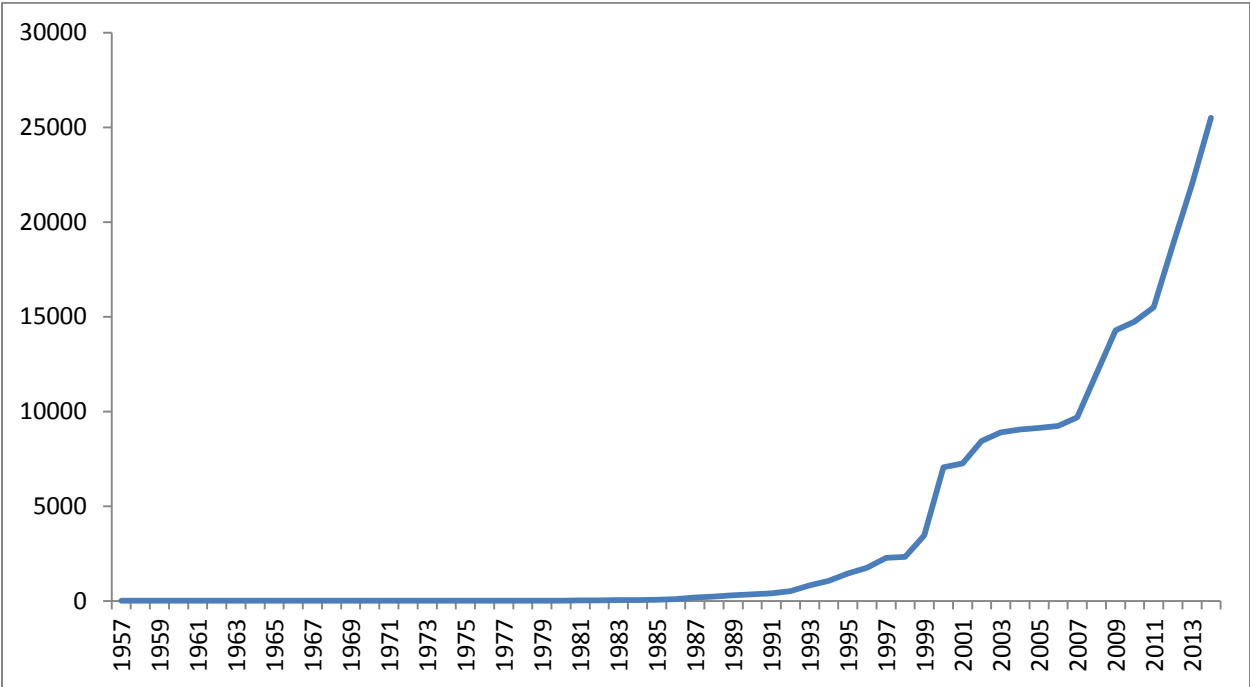
⁴Uche, Chibuiké Ugochukwu (1996) From Currency Board to Central Banking: The Politics of Change in Sierra Leone, *African Economic History*, No. 24 (1996), pp. 147-158

⁵Robert Triffin (1963) *Gold Exchange Standard Crisis and Reconstruction*. Yale University

Ghana moved away from the fixed exchange rate regime towards a floating (market determined) regime during the era of the Structural Adjustment Program (SAP) from 1983. Indeed, one of the most important reforms of the SAP was to allow a gradual liberalization of the market for foreign exchange. To bridge the gap between black market and official exchange rates, foreign exchange bureaus were established in February 1988, leading to the virtual absorption of the foreign exchange black market. The cedi exchange rate therefore became market determined with an increase in demand for foreign currency resulting in depreciation while the increase in supply of foreign currency results in appreciation of the cedi, other things being equal.

Mr. Chairman, notwithstanding some periods of stability, the cedi has been persistently declining in value since independence in 1957 (Figure 1).

Figure 1: CEDI/\$ EXCHANGE RATE BETWEEN 1957 AND MARCH 2014



At independence, when the West African pound was legal tender, the exchange rate was the equivalent of 73 pesewas to the US dollar. By 1983, the exchange rate was $\text{¢}52.6/\text{\$}$. By 1992, the exchange rate was $\text{¢}520.8/\text{\$}$. By 2000, the exchange rate was $\text{¢}7047/\text{\$}$. By 2008, the exchange rate was $\text{GH¢}1.19/\text{\$}$ ($\text{¢}11,900/\text{\$}$). By December 2013, the exchange rate was $\text{GH¢}2.20/\text{\$}$ ($\text{¢}22,000/\text{\$}$). As at March 21, 2014, the cedi exchange rate is $\text{GH¢}2.63/\text{\$}$ ($\text{¢}26,326/\text{\$}$).

Table 1. Cedi-US Dollar Exchange Rates (1965-2013)

Year	Exchange Rate ¢/\\$
1957	0.73
1965	1.04
1983	52.6
1992	520.8
2000	7047
2008	11,900(GH¢1.19)
2013	22000 (GH¢2.20)
2014 (March)	26,326 (GH¢2.63)

Cumulatively, between 1965 when the cedi traded at $\text{¢}1.04/\text{\$}$ and March 21, 2014, when it is trading at $\text{GH¢}2.63 (\text{¢}26,326)/\text{\$}$ the cedi has lost 99.9999% of its value relative to the US dollar.

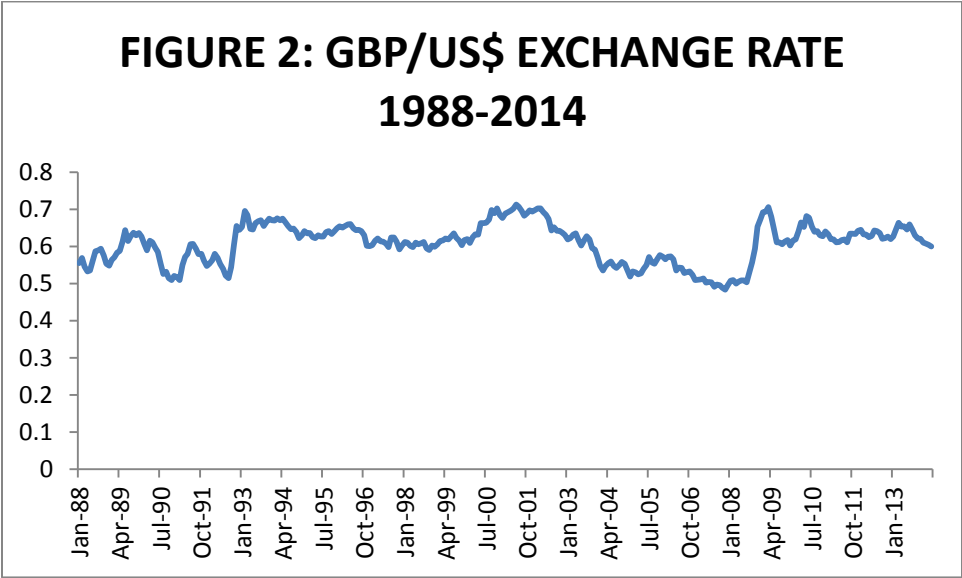
Mr. Chairman, the rate of depreciation of the cedi against the US dollar in 2014 has been at an unusually fast pace. The cumulative depreciation in 2013 was 14.5%. In the first quarter of this year it has already depreciated by 16% so far! For a small open economy like Ghana, this trend is worrying because these massive depreciations in the currency end up increasing the cost of living and the cost of doing business.

The exchange rate is a significant component of the pricing of utilities and petroleum products. It means that other things equal, if the exchange rate depreciates, we can all expect to pay more for utilities and petroleum products and virtually all other commodities. There is however the argument that exchange rate depreciation is good for the economy to the extent that it creates an incentive to increase exports relative to imports and thereby improves the balance of payments.⁶ Notwithstanding the massive nominal and real depreciation of the cedi over the years however, exports have not increased proportionately. This means that the exchange rate alone may not be sufficient as a policy tool to achieve export competitiveness.

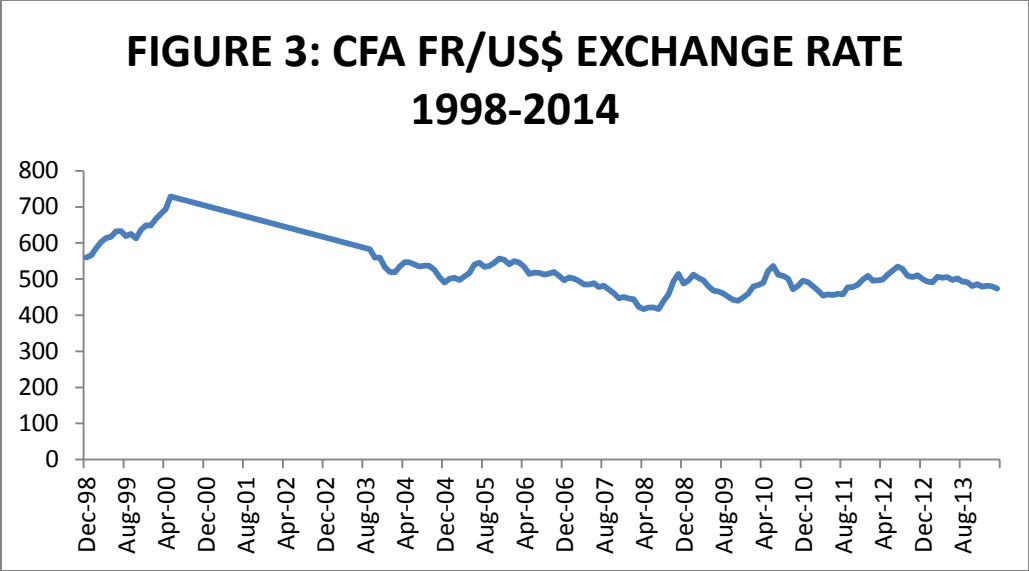
Mr. Chairman, this persistent rate of depreciation of the cedi must be looked at against what is happening to other currencies in the global economy. Take for example, the US dollar and the British Pound during the same period. At the end of 1965 the dollar-pound exchange rate was $\text{\$}1.590/\text{GBP}$ and by the end of 2012 it was $\text{\$}1.614/\text{GBP}$, a

⁶ This is generally the case if the sum of the elasticities of the demand for imports and exports is greater than 1 (this is known as the Marshall-Lerner condition).

cumulative pound appreciation of some 1.5% over a 48 year period (Figure 2). This compares with a 2,000,000% appreciation of the dollar against the cedi over the same period.



The CFA Franc zone countries such as Cote D'Ivoire, Senegal, Mali, Togo have also attained relative exchange rate stability underpinned by the fixed exchange rate arrangement with the French franc (and now the Euro). Between 1999 and March 2014, the CFA Franc has **appreciated** cumulatively by some 19% against the US dollar (Figure 3). Also, between 1983 and 2013, the Hong Kong dollar exchange rate under the currency board arrangements of the Hong Kong Monetary Authority has remained relatively constant at HK\$7.80/US\$.



The question we must ask ourselves is how come these economies with fixed and floating exchange rate systems are able to maintain such durable stability of their exchange rates while the cedi is continuously depreciating?

WHY HAS THE CEDI BEEN DEPRECIATING RAPIDLY RECENTLY?

Mr. Chairman the question we face in Ghana today is how to stop the on-going depreciation of the cedi. To get at the solutions to this problem however, one would have to make an appropriate diagnosis because a wrong diagnosis of the problem would lead to a wrong solution. The recent depreciation of the cedi has resulted in several explanations being offered from official and non-official sources alike. In our collective frustration to understand what is happening to our cedi, there has been a

sudden increase in the supply of economic analysts with all sorts of theories and pontifications. Some of the explanations for the current depreciation of the cedi include:

- Weak Economic Fundamentals and loss of confidence in the economy.
- Dollarization
- Colonial Structure of the Economy
- Redenomination
- Single Spine Salary System (SSSS)
- United States Monetary Policy- Tapering Quantitative Easing
- Dwarves and juju men, high rise buildings, and a sign of the end of the world.

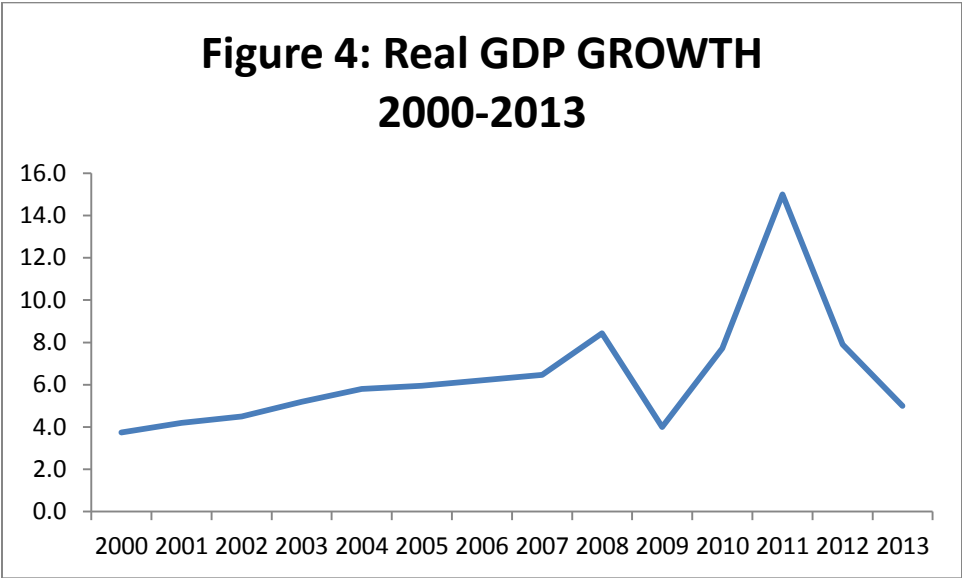
Mr. Chairman, I will start with the explanation that relates to weak economic fundamentals and a resulting loss of confidence in the economy as the factor explaining the recent depreciation of the cedi⁷. The fundamentals relate to developments in the real sector, public finance, monetary sector, and external sector.

Real GDP Growth

Mr. Chairman, at the heart of any effort to transform the economy is accelerated and broad-based growth. The reality however is that, real GDP growth in Ghana, notwithstanding the onset of oil production, has declined significantly since 2011. Data from the Ghana Statistical Service shows that from a real GDP growth of 8.4 percent

⁷ See Michael Mussa (1984): "Theory of Exchange Rate Determination in John F.O. Bilson and Richard Martson, eds, Exchange Rate Theory and Practice, University of Chicago Press

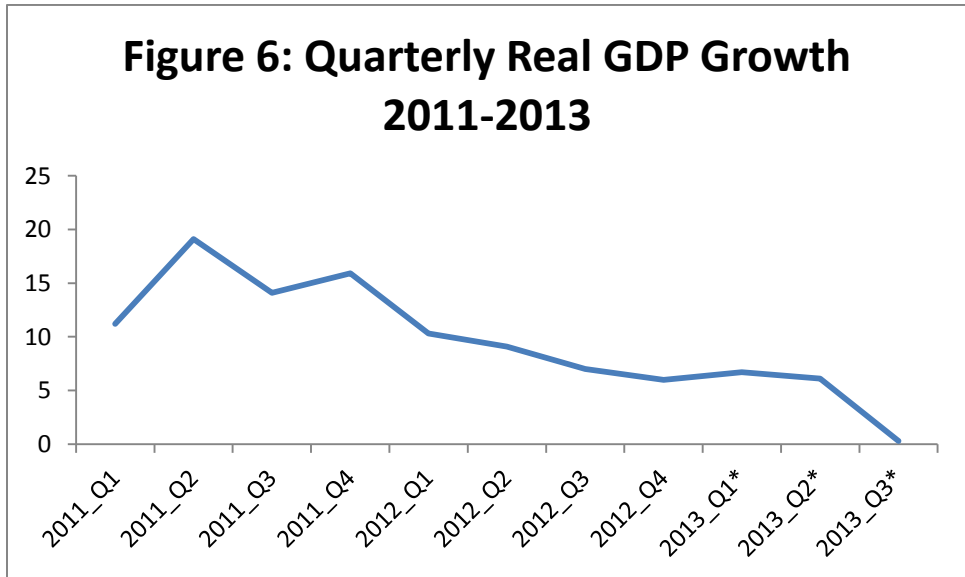
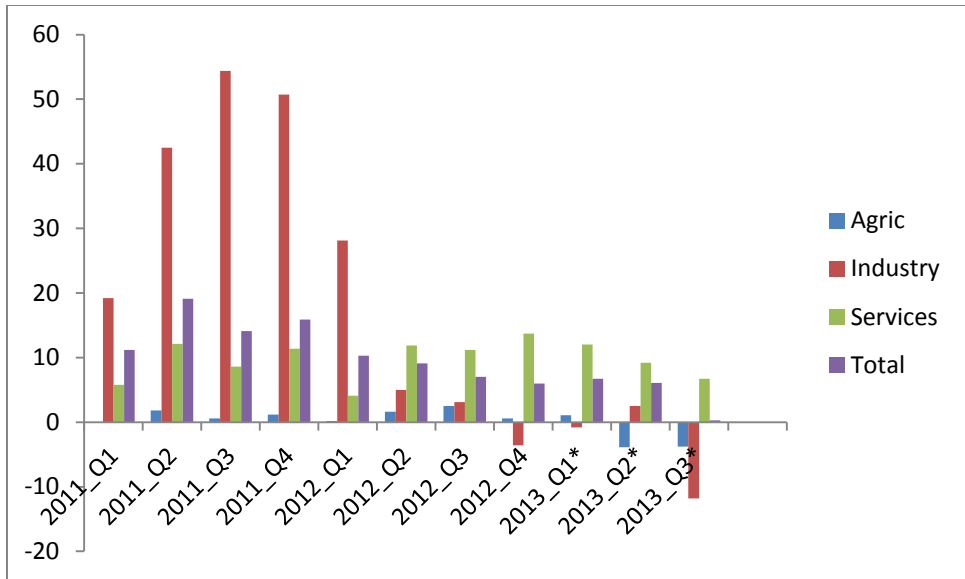
(without oil) in 2008, real GDP growth reached 15.0 percent in the year 2011 (amongst the highest in the world that year) as a result of oil production. Since 2011 however, real GDP growth has slowed down to 7.9 percent in 2012 and further down to a projected growth of around 5.0 percent for 2013 (Figure 4). Mr. Chairman, the data for non-oil growth shows that real GDP growth has declined from 9.4 percent in 2011 to 3.9 percent in 2013. This means that Ghana's economy (excluding oil) is growing at the same growth rate as the year 2000 and half the rate of economic growth in 2008.



The decline in the rate of real GDP growth is most noticeable in the agriculture and industry sectors. The quarterly real GDP numbers show that real GDP growth for the third quarter of 2013 (the latest data available) slowed down to 0.3 percent, with agriculture growth declining by 3.8 percent and industrial growth declining by 11.8 percent (Figures 5). This is the lowest quarterly growth recorded in recent history and

indicates that all is not well with the economy (Figure 6). Mr. Chairman, in terms of quarterly GDP growth, we have gone from “unprecedented” to zero, and this is reducing the confidence of investors in the economy and the cedi.

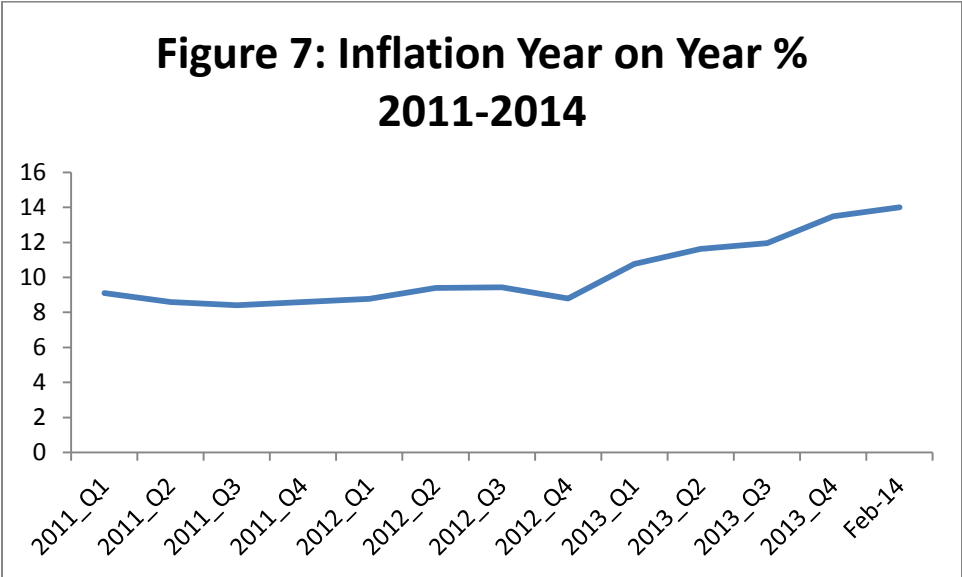
FIGURE 5: SECTORAL REAL GDP GROWTH 2011-2013



Declining economic growth is worrying because without an expanding economy we cannot create jobs and many of you students will find it difficult to find jobs when you complete your studies. Lower output also implies higher prices for goods. Unfortunately, the continued problems with electricity supply and load shedding would further undermine growth as businesses cut investment (as Fan Milk Ltd did recently) or close down.

Inflation

Mr. Chairman, with regards to price developments, inflation as reported by the Statistical Service has also been on the increase recently, and the talk of single digit inflation (after a review of the inflation basket) is now history. After declining from 18.1 percent in 2008 to 8.6 percent by 2011, inflation has increased steadily to 14.0 percent in February 2014 (Figure 7).

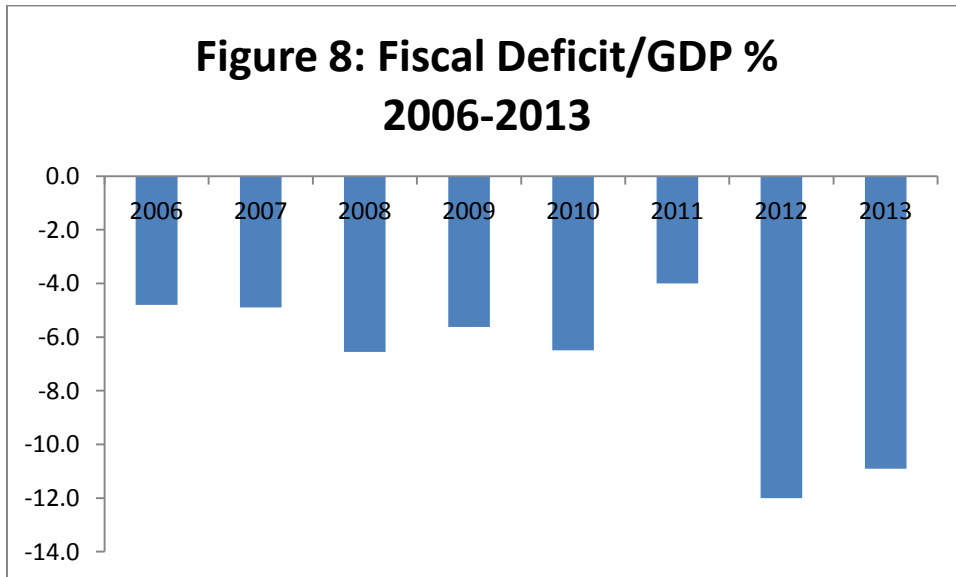


Non-food inflation which is affected more by exchange rate movements has also steadily increased to reach 19.0 percent by the end of February 2014.

Fiscal Developments

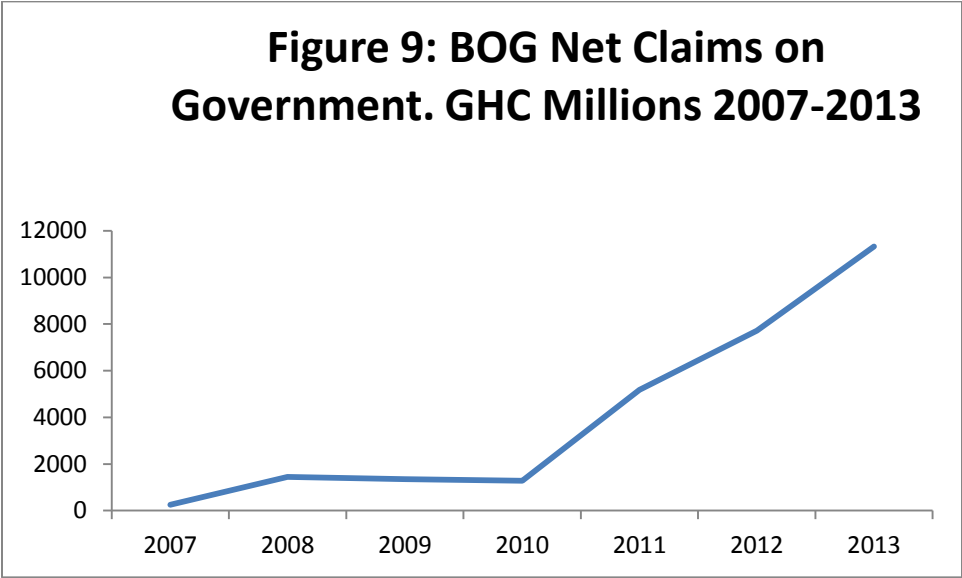
Mr. Chairman, recent fiscal developments indicate deterioration in the state of public finances, with government unable to meet statutory payments such as the GETFUND, DACF, NHIS, etc. Payments to contractors are also in arrears and there are problems with salary payments to government workers. This situation with regards to Ghana's public finances has arisen because of a major increase in government expenditures relative to revenues in the 2012 and 2013. While government tax revenue stayed constant at some 17.7% of GDP between 2011 and 2013, government expenditures increased by a whopping 6.6% of GDP from 20.1% of GDP in 2011 to 26.7% of GDP at the end of 2013. The bulk of the increase in government expenditure (94%) was in the area of recurrent expenditure. This has resulted in double digit fiscal deficits (12.0% of GDP in 2012 and 10.9% of GDP in 2013) over the last two years (Figure 8). Mr. Chairman, this is the first time in the history of Ghana that we have we have had double digit fiscal deficits two years in a row. With the current fiscal policy stance, it looks most likely that we would record a double digit fiscal deficit by the end of 2014 to make it three successive years in a row, notwithstanding measures such as the removal of petroleum and electricity subsidies, and an increase in the VAT and other taxes. This is

an indication that the fiscal quagmire in which the economy finds itself is not short-term one.



Mr. Chairman, excessive fiscal expansion creates problems in many developing countries because it tends to be largely monetized and the excess injection of liquidity results in exchange rate depreciation. This has been Ghana's experience during this latest period of exchange rate depreciation. There has been a dramatic increase in central bank financing of government recently (i.e. equivalent to the printing of money), in addition to borrowing to finance the fiscal deficit. Central bank financing (net claims on government) has increased from GH¢1,448 million in 2008 to GH¢11,327 million by 2013, a 700% increase (Figure 9). **Furthermore, the Bank of Ghana Act (Section 30 (2)) requires that total Bank of Ghana net domestic financing of government not exceed 10% of total revenue of the fiscal year in which the advances were made. In 2012, net domestic financing reached 45.0% of tax revenue and in 2013 it was**

35.5%, way above the required 10%. Unfortunately, the Bank of Ghana Act does not have an Accountability Mechanism for breaches of the Act.

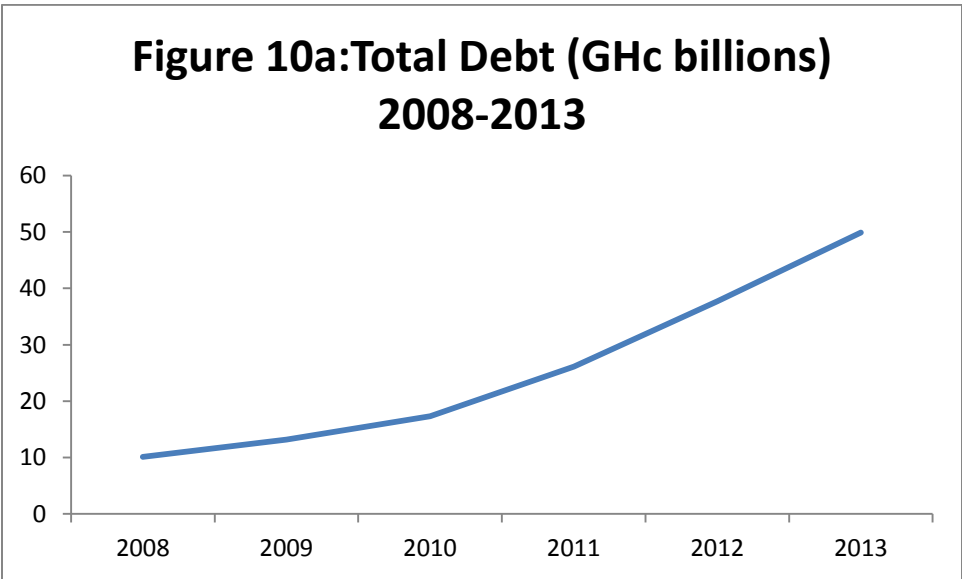


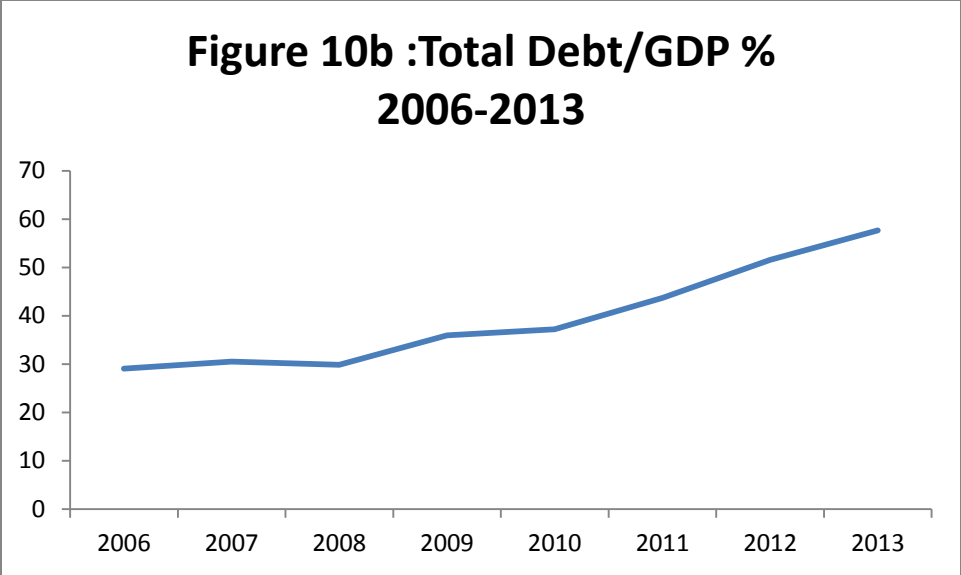
An expansionary fiscal policy accommodated by increased central bank financing of government is a sure recipe for increased inflation and exchange rate depreciation. The question that we should ask ourselves is what is this level of printing of money by the central bank actually financing? Have we reached the stage where we are resorting to the printing of money to pay government salaries and interest on government debt?

Public debt

Mr. Chairman, the developments relating to the growth of the public debt stock is even more worrying. We should keep in mind that Ghana was declared a HIPC country in

2001, being unable to service our debts on a sustainable basis. The debt relief obtained under HIPC and the accompanying fiscal and monetary policy stance resulted in a significant reduction of the debt burden. By the end of 2008, Ghana's total public debt stood at GH¢9.5 billion (33% of GDP). In the last five years however, the stock of public debt has seen a dramatic increase to GH¢49.9 billion (57.7% of GDP) at the end of 2013 (Figures 10a and 10b). This is an increase in the stock of debt by GH¢40.4 billion or the equivalent of \$20 billion using the average exchange rate for 2009-2013. This also represents an increase in the stock of debt by **426%** over a five year period (i.e. an average increase in the stock of debt by 85% a year). This is a frightening rate of accumulation of debt by any standard.

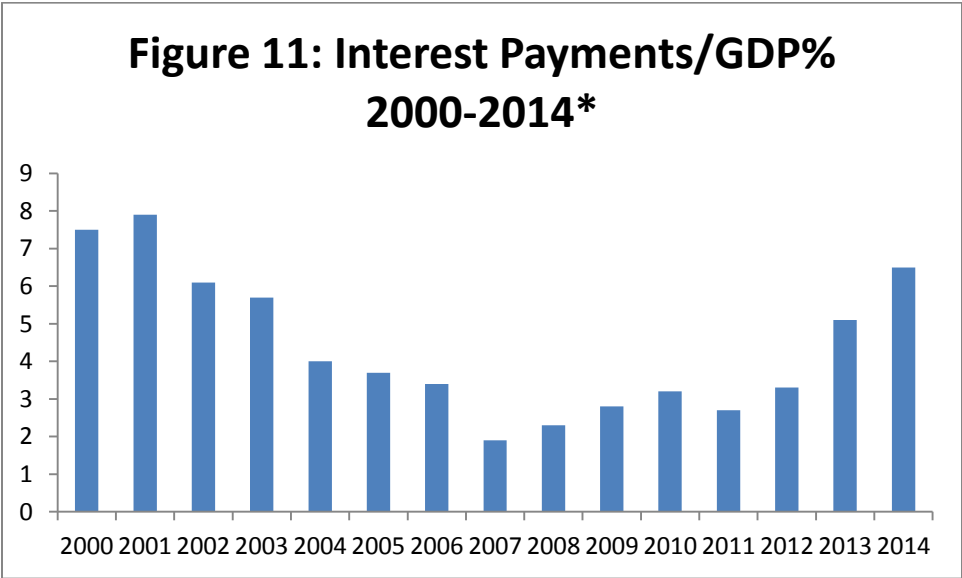




Mr. Chairman, sometime this year, Ghana’s debt stock would cross the 60% of GDP level that developing countries with limited access to capital flows should worry about in terms of debt sustainability. In fact, at this rate of debt accumulation, Ghana is headed back towards the debt unsustainability that led to HIPC. However, HIPC debt relief will not be available again and the earlier we recognize this, the better for all of us.

Mr. Chairman, it is not clear exactly what developmental projects all this \$20 billion borrowed has been used for. The increase in government debt over the last five years is an amount that can build at least 15,000 km of tarred roads. It is an amount that could have built 6,000 senior secondary schools even at the high cost of GH¢6.0 million each. It is an amount that could have built hundreds of first class hospitals. It is an amount that could have solved Ghana’s energy and water problems.

Mr. Chairman, the increase in Ghana’s debt has placed a major burden on public finances with regard to interest payments on the debt. Interest payments on domestic and external debt declined from 7.5% of GDP in 2000 to 2.3 percent by the end of 2008. Since then, interest payment has increased to 5.1% of GDP in 2013 and would reach 6.5% of GDP by the end of 2014 (Figure 11).



The increase in interest payments by 2.8% of GDP between 2008 and 2013 has taken away critical fiscal space that was available to government and that was created as a matter of deliberate strategy and policy choices.

Mr. Chairman, distinguished Ladies and Gentlemen, I want to put Ghana’s current interest payments on public debt in perspective. In the 2014 budget, the entire allocations to the Ministry of Roads and Highways (GH¢779 million), Trade and Industry (GH¢256.5 million) Ministry of Fisheries (GH¢279 million), Ministry of Food and Agriculture (GH¢128 million), Ministry of Water Resources and Housing (GH¢531 million) and Ministry of Transport (GH¢89 million) amounted to a total of (GH¢2062

million). Interest payments in 2014 would amount to some GH¢6604 million, three times what was allocated to these six key ministries combined! Also, as a result of the major increase in debt over the last five years, interest payments in 2013 ((GH¢4,397million) was more than twice the Ghana's revenue from oil ((GH¢1,633 million). In 2014 interest payments (GH¢6604 million) will be four times Ghana's revenue from oil (GH¢1,670 million). Mr. Chairman, the benefit of Ghana's oil discovery has been compromised by the increase in Ghana's borrowing.

Debt service alone absorbed 36.3 percent of total government revenue in 2013. With declining economic growth, the increase in interest payments has taken up the fiscal space or cushion that previously existed. We are in a very tight corner. Mr. Chairman, if you are travelling on our roads and you are sitting on a seat with no cushion you will feel any pothole in your bones. This is what we are collectively feeling now. It feels like we are travelling in a "boneshaker". Government appears to have overestimated Ghana's capacity to borrow by ignoring the fact that the rebasing of the economy, while increasing GDP, did not increase cash flows to service debt.

Mr. Chairman, Ghana's domestic debt at the end of 2013 amounted to GH¢27.7 billion (55.5% of the total debt stock). However, 21% of Ghana's domestic debt stock (some GH¢5.7 billion) is held by foreign residents in the form of three year bonds. This is the equivalent of \$2.2 billion. Maturities in 2014 and 2015 alone amount to \$1.3 billion. In the present circumstance of declining investor confidence in the economy, this level of holdings of domestic debt by foreign residents increases Ghana's vulnerability to further exchange rate depreciation. Ghana's net foreign exchange reserves are not sufficient to withstand a total pull out by foreign holders of government securities. This fact is

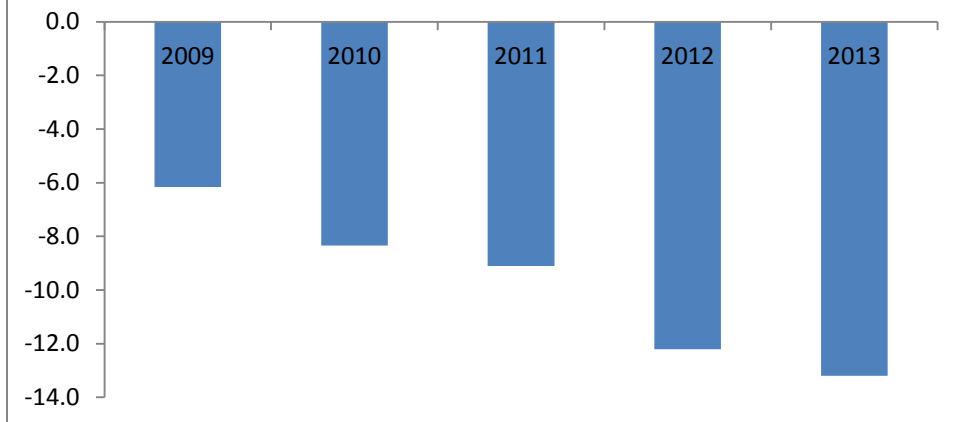
worrying because the indications are that the pull-out has begun. The most recent Government issue of 3-year bonds on 13th February, 2014 did not record any foreign investor participation. This suggests that maturities this year will not likely be rolled over by foreign investors.

In addition to burdening the budget, the increased government borrowing has resulted in an increase in interest rates on the domestic money markets, with the 91-day Treasury bill rate increasing from 10.30% at the end of 2011 to 22.8% by March 2014.

External Sector

Mr. Chairman, Ghana's external payments position has also deteriorated since 2011, with increasing current account deficits and a fragile foreign exchange reserves position. The current account of the balance of payments has seen a steady deterioration over the last four years, increasing from a deficit of \$2,769 million (8.3 percent of GDP) in 2010 to \$4,924 million (12.2 percent of GDP) in 2012 and \$5,839 million (13.2 percent of GDP) in 2013. As with the fiscal deficit, the current account has also recorded two successive years of double digit deficits with a likely third successive double digit current account deficit likely in 2014 given current developments (Figure 12).

Figure 12: Current Account Deficit/GDP % 2009-2013



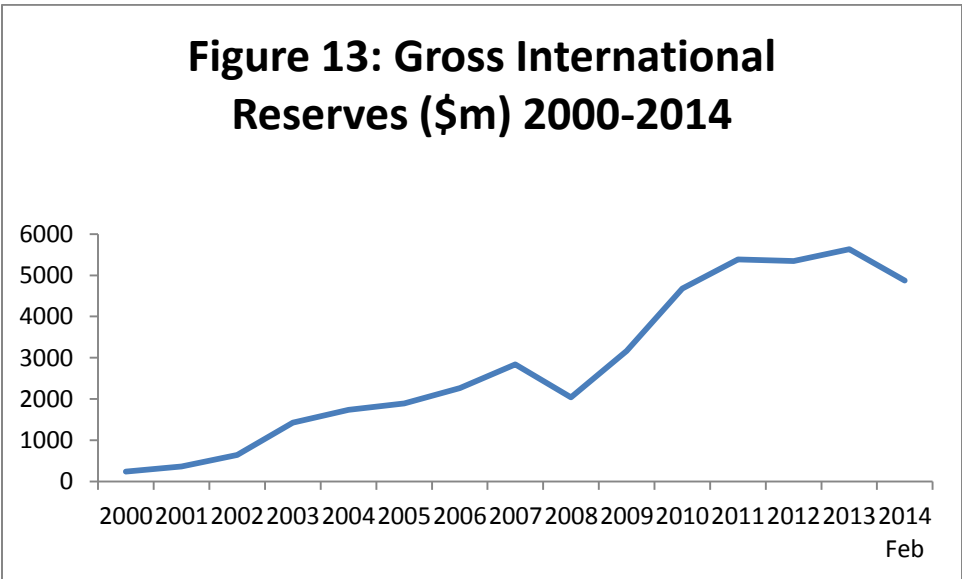
A current account deficit implies that the outflow of foreign exchange as a result of trade in goods and services exceeds the inflows of foreign exchange. This results in a net increase in the demand for foreign exchange and a resulting depreciation of the exchange rate, other things being equal.

Foreign Exchange Reserves

Mr. Chairman, I will now turn to the important issue of Ghana's foreign exchange reserves. Foreign exchange reserves are held to provide a buffer against adverse shocks to the balance of payments (BOP) and to enhance confidence in the country's economic management and ability to meet its international payment obligations, such as debt servicing, without disruption. Consequently, the level of foreign reserves is an important indicator used in the assessment of a country's sovereign credit rating, along with the size of central government budget deficit/surplus. The foreign reserves also provide a buffer against delays in disbursements of donor programme aid. This serves

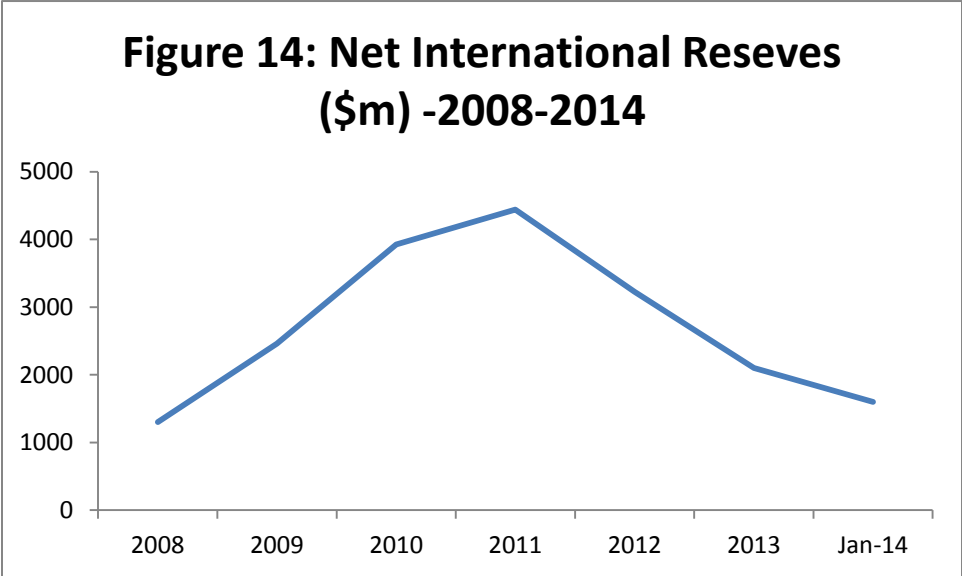
to insulate government spending somewhat from the short term volatility in aid disbursements, without which managing the government budget in tune with a stable macro environment would be very difficult. The foreign exchange reserves provide shock absorbers for the economy.

Ghana's gross international reserves increased from \$2.03 billion in 2008 (equivalent to 2.1 months of import cover) to some \$5.6 billion (equivalent 3.3 months of import cover including the stabilization and heritage funds which are encumbered) at the end of December 2013. By February 2014, the Ghana's gross international reserves have declined to \$4.8 billion, (Figure 13). This is equivalent to some 2.5 months of import cover.

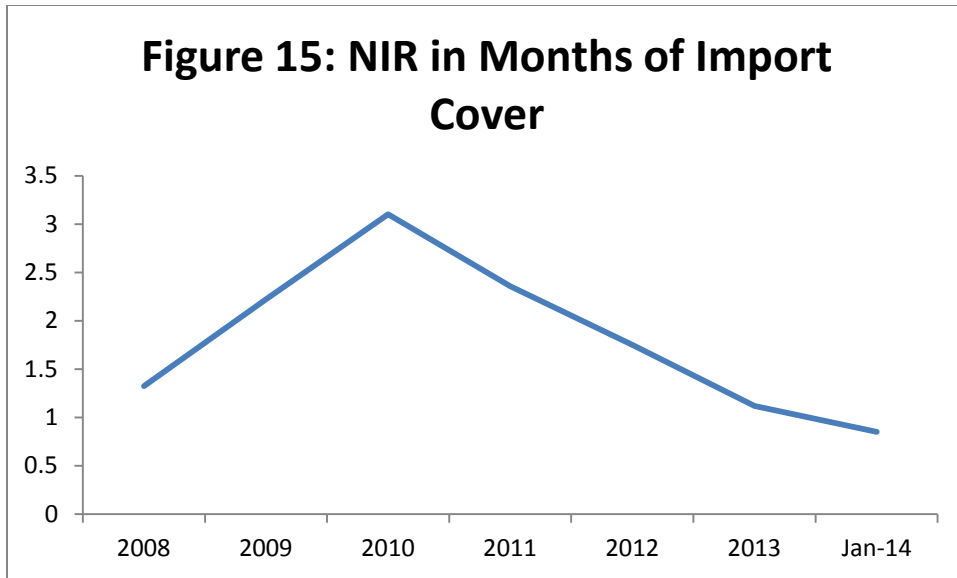


Mr. Chairman, an examination of the more important net international reserves (NIR) position tells a more worrying story. The NIR is gross foreign reserves less outstanding

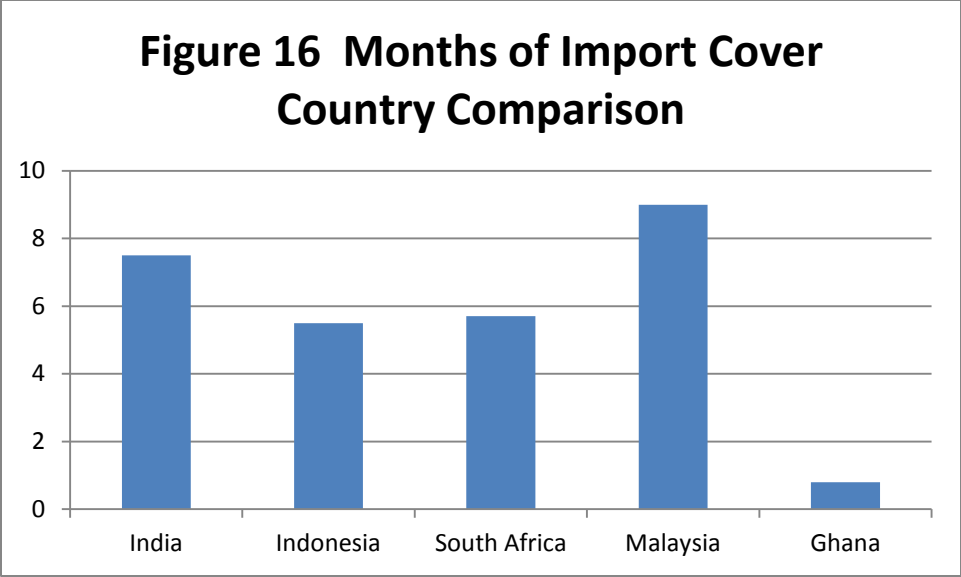
short-term liabilities of the central bank and any credit advanced by the International Monetary Fund. It is a measure of what a country's central bank effectively has available to make external payments. This is the measure that is of most concern to international investors.



Mr. Chairman, Ghana's net international reserves have declined from a peak of \$4.4 billion in 2011 (equivalent to 3.1 months of import cover) to some \$1.5 billion in February 2014 (equivalent to some 0.6 months of import cover or some two and a half weeks of import cover).



In terms of months of import cover, this is the lowest import cover for the NIR since 2000 and the lowest for any middle income or oil producing country in the world. Mr. Chairman, with this low level of NIR, it is clear that we are not only travelling in a boneshaker, but it also has no shock absorbers! (Figure 16)



Mr. Chairman, the low level of net international reserves means that the central bank’s capacity to effectively intervene in the foreign exchange market has been severely compromised. It also indicates that the ability of the government to meet its obligations is limited. At this rate of decline of Ghana’s net international reserves, the country will be on its knees before the end of the year if significant foreign exchange inflows are not forthcoming. The current net international reserve position is not sufficient to purchase five months of normal crude oil imports.

Mr. Chairman, when one examines the state of our public finances and net international reserves position, it is difficult not to conclude that that the ongoing dumsor dumsor problem (electricity blackouts) may be more financial than technical. When you add loan repayments and maturing bonds held by foreign investors that are not likely to be rolled over to the oil import bill, then the precarious nature of the situation becomes clearer. This situation of low foreign exchange reserves has contributed significantly to

the loss of confidence in the economy by both local and international investors, and has resulted in an increase in demand for foreign currencies and contributed to the cedi depreciation that we have seen recently.

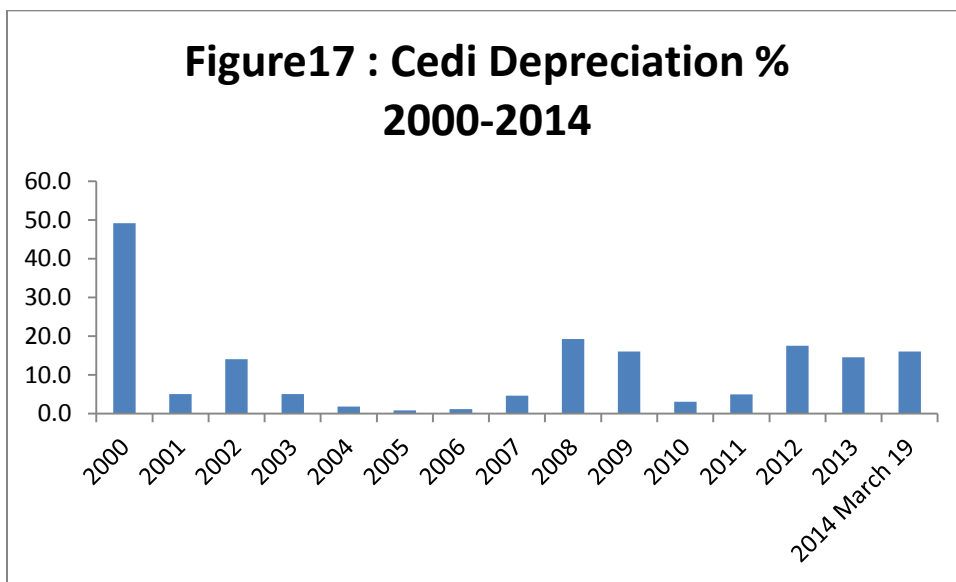
Mr. Chairman, the assessment of the fundamentals of the Ghanaian economy so far point to an economy with weak and deteriorating fundamentals, including:

- Declining Real GDP Growth
- Increasing Inflation
- Double digit fiscal deficits for two years in a row, and likely three years in a row
- Large and increasing central bank financing of government
- Double digit current account deficits for two years in a row, and likely three years in a row
- Massive increase in the public debt stock,
- Net international reserves at a precarious level
- Government unable to meet its statutory obligations
- Declining consumer and investor confidence

Mr. Chairman, the question we should all ask ourselves is how can any country expect its currency to be stable after this economic outcome? The depreciation of the cedi that we are observing is the result of the weakening fundamentals of the economy. There is no mystery here. At the heart of the problem is the lack of fiscal and monetary discipline. In fact virtually all the episodes of cedi depreciation since independence can be traced to this issue of fiscal and monetary indiscipline.

ALTERNATIVE EXPLANATIONS OF THE RECENT DEPRECIATION OF THE CEDI

Mr. Chairman, there have however been a number of alternative views about what is causing the depreciation of the cedi. These views have to be examined if we are to reach some consensus on how to stop this rampant depreciation. It is also important that the explanations for the current episode of cedi depreciation are not adhoc. This is because the cedi has also seen some stability during past periods.



Cedi exchange rate depreciation vis-à-vis the US dollar was 4.5 percent over the year 2003, and 2.2 percent for the year 2004, 0.9 percent in 2005, 1.1 percent in 2006 and 4.8 percent in 2007. Between 2004 and 2007, the cedi depreciated by an average of 2.25 percent against the U.S. dollar. Similarly in 2010 and 2011 the cedi depreciated by 3.1% and 4.9% respectively against the US dollar (Figure 17). The respective

governments have claimed credit for these achievements. Therefore, any adequate explanation of the current cedi depreciation must also be able to explain why in the periods where cedi exchange rate stability pertained, these factors disappeared.

The alternative views include:

Dollarization

Mr. Chairman, one of the key functions of money is to act as a store of value. Throughout history, when money ceases to perform this function, people have found refuge in other commodities as a replacement store of value. “Dollarization” is the replacement of a country’s legal tender with another currency e.g. the US dollar. This happens in countries with a history of high inflation and exchange rate instability. The resort to dollars for savings is essentially a risk mitigation measure. There is a vast empirical literature that supports the view that dollarization is a reaction by rational economic players to expected depreciation of a currency. It is not the cause of depreciation⁸. Ghanaians have over the years learnt the hard way that they cannot trust governments to keep the cedi stable. Cedi depreciation has become a fact of life and therefore Ghanaians have come up with coping strategies to deal with exchange rate depreciation, including the holding of foreign currency. For example, if you had GHC 100,000 in 2008, you had roughly the equivalent of US\$100,000, but today that same

⁸ See for example Eduardo Levy Yeyati and Alain Ize (1998) Dollarization of Financial Intermediation: Causes and Policy Implications. International Monetary Fund. Washington DC

GHC100,000 is only equal to US\$38,500 meaning that through no fault of yours and just by deciding to hold on to your assets in cedis, you would have lost over US\$60,000 or 60% of your assets in just 5 years.

Mr. Chairman, on the issue of pricing goods in foreign currency in Ghana, it is the law that firms should be required to quote their prices in cedis, the legal tender. It is a good law and should be enforced. While that is so, as long as the economic fundamentals are weak, there is no law that can stop any firm or individual from wanting to hold dollars as a store of value or thinking in dollar terms even though they price in cedis. Shakespeare said in Macbeth that “There is no art to find the mind’s construction on the face”⁹. So if a trader thinks in dollars and prices in cedis, how would you know? Once they receive the cedi equivalent of the black market dollar price, they would immediately buy dollars to save either from forex bureau or black market. People will buy dollars if they want dollars. There is not much a government can do about this once people lose confidence in the cedi. Even in the revolutionary days of military enforcement of foreign exchange laws, the black market thrived. We have come to learn that price controls, exchange controls, interest rate controls, and import controls don’t generally work. Governments should rather focus on pursuing policies that would stabilize the cedi and make the dollar irrelevant in domestic transactions.

Mr. Chairman, exchange rates fundamentally reflect the purchasing power of one currency relative to another for a given basket of goods. So if for whatever reason the value of the cedi declines (e.g. because of high inflation), we can expect, other things being equal, that its value relative to other currencies would fall. There is no

⁹ King Duncan in Macbeth, Act 1, Scene 4

requirement that these other currencies be even present in the country for such an exchange rate depreciation to take place. This is why the cedi has been depreciating recently against the Hong Kong dollar, East Caribbean Dollar, Korean Won and the Chinese Yuan recently even though there is very little trading of these currencies on the Ghanaian market. In fact, I am sure very few people in this hall tonight have seen the Chinese Yuan or Hong Kong dollar even though the cedi has been depreciating at similar rates against these currencies as it has been against the US dollar. It is important to note therefore that the dollar does not even need to be present in Ghana for the cedi to depreciate against the dollar.

Mr. Chairman, we should ask ourselves why dollarization disappeared in the five year period between 2002-2007 when the exchange rate of the cedi was very stable? And if the argument is that it didn't disappear, then why did dollarization not cause a similar rapid depreciation of the cedi? Why is dollarization suddenly rearing its head again at an unprecedented rate? The fact is that dollarization only rears its head when the economic fundamentals are weak and people lose confidence in the ability of the cedi to maintain its value. Dollarization is and has been a consequence of weak economic fundamentals and not the cause of poor economic performance¹⁰. Persistent depreciation of a currency would result in dollarization. The lesson here is that, trying to solve the problem of cedi depreciation by focusing on de-dollarization is attacking the effects of a problem and not its causes; it is ultimately an exercise in futility¹¹.

¹⁰ See for example Michael Melvin and Bettina Peiers (1996) "Dollarization in Developing Countries: Rational Remedy or Domestic Dilemma?" Contemporary Economic Policy, Vol. 14, Issue 3, pages 30-40

¹¹Kokenye, Levy and Veyrune (2010) "Dedollarization" .IMF Working Paper, WP/10/188. Washington DC

The Colonial Structure of the Economy

Mr. Chairman another popular explanation for the depreciation of the cedi is the structure of production of our economy. The argument is that Ghana since the colonial era continues to produce raw materials for exports and imports manufactured products. If only we can become producers of manufactured goods, we can stop exchange rate depreciation. Mr. Chairman, this argument is suspect for a number of reasons. Simply because a country exports raw materials like oil, cocoa or gold does not mean that it is consigned to persistent exchange rate depreciation. Dependence on primary product exports makes us more vulnerable to external shocks but how we manage and anticipate those shocks is what matters. As a country we need to move to transform the economy from primary commodity exports to manufactured exports but it is not because of the exchange rate per se. It is about jobs, and development.

Interestingly, Ghana experienced the best period of exchange rate stability during the colonial era under the WACB arrangements. The value of the currency was virtually unchanged between 1912 and 1957. What maintained the value of the currency was the fiscal and monetary discipline imposed to keep the exchange rate fixed. Also, the CFA franc zone countries like Cote D'Ivoire, Burkina Faso, and Senegal, have similar production structures like Ghana but are operating under a fixed exchange rate arrangement which requires fiscal and monetary discipline to work. Furthermore, Mr.

Chairman, the economic structure that we have in Ghana today is the same structure that we have used to achieve exchange rate stability at different points in time for which different governments have claimed credit. It is the same economic structure under which the cedi depreciation averaged 2.25% a year between 2004 and 2007 and less than 5% a year between 2010 and 2011. Why is it that we want to blame the economic structure of when the cedi starts to depreciate in 2012, 2013, and 2014?

The Asian Financial crisis of 1998 which saw major depreciation in the currencies of countries like South Korea, Thailand, Indonesia etc. also demonstrated that simply being a producer and exporter of manufactured goods would not make you immune to exchange rate depreciation if the fundamentals of your economy are perceived to be wrong.

Mr. Chairman, there is also the view that our imports are too high and we need to impose import controls in order to protect the currency from depreciating. It is in fact the case that Ghana's imports make up 56% of GDP whereas exports are 46% of GDP. How does this compare internationally?

**TABLE 2: IMPORTS AND EXPORTS AS A % OF GDP (2013)
IN SELECTED COUNTRIES**

COUNTRY	IMPORT/GDP %	EXPORT/GDP %
Botswana	50	44
Equatorial Guinea	63	84
Hong Kong	224	225
Malaysia	75	87
Brazil	14	13
Mauritius	67	55
Netherlands	80	88
Rwanda	31	13
Singapore	178	201
Thailand	78	77
Tanzania	74	30
UAE	74	95
Vietnam	77	80
Argentina	17	20
Ghana	56	46

Table 2 shows that countries like Hong Kong and Singapore which have very stable currencies also have the highest import/GDP ratios in the world. They have however matched their high import/GDP ratios with even higher export to GDP ratios. Argentina and Brazil on the other hand have relatively low import and export to GDP ratios. That notwithstanding, Argentina has had higher exchange rate depreciation than Brazil because the latter has had stronger economic fundamentals recently.

The evidence therefore is that having high import/GDP ratios does not mean that your currency would automatically depreciate. It depends on the extent to which those imports are leveraged to produce exports. In the case of Ghana, 77% of the country's imports at the end of 2013 were made up of intermediate and capital goods while consumer goods accounted for 23% of imports (This proportion has not changed much

over the years). The question we should be asking as a country is why we are not transforming the 77% of imports of intermediate and capital goods sufficiently in to production for exports? What are the factors inhibiting the productivity and global competitiveness of the private sector? What incentives are we giving to local industries to assist them become globally competitive? Why are we not exporting toothpicks and other products that we are currently importing? Why is the Tema Oil Refinery not processing most of our crude oil production? These are the issues to be addressed. Any attempt to impose import controls, as the Minister for Trade and industry has suggested, would not work and would be counterproductive. As a country we have been there and done that. It was not successful in controlling the cedi depreciation of the past and is unlikely to be successful in the future. Let us remember that the cedi recorded its fastest depreciation as recorded on the black market during the kalabule era of the 1970s when exchange and import controls were in place. In any case, if a decision has been made to sign the Economic Partnership Agreement (EPA) with the EU, as seems to have happened, import controls as an effective policy option in the future would be very limited.

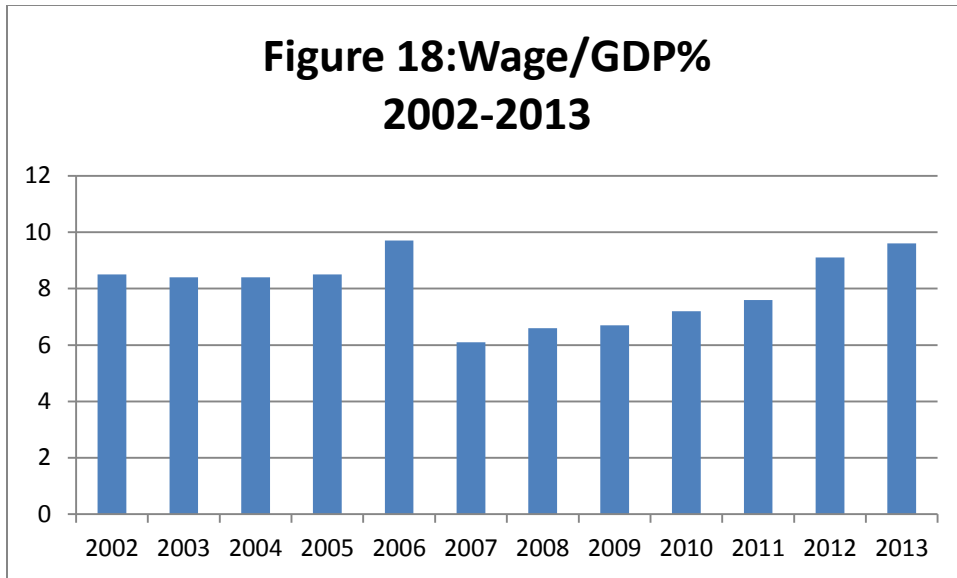
SINGLE SPINE SALARY SYSTEM

Mr. Chairman, another explanation for the on-going cedi depreciation has been placed at the door of the Single Spine Salary System (SSSS). The argument is that the wage bill following the implementation of the SSSS is responsible for the fiscal expansion.

The refrain from Government is that wages and salaries of government workers account for over 70% of government revenue. What is the evidence?

Mr. Chairman, at the end of 2008, the Government wage bill amounted to GHC1.98 billion, representing 41.3 percent of total domestic revenue of GHC 4.8 billion. By the end of 2012, after 99% implementation of the single spine salary system, the government wage bill jumped by some GHC4.6 billion to GHC6.6 billion. While the government wage bill increased by some GHC4.6 billion between 2008 and 2012, total government revenue also increased from GHC4.8 billion to GHC15.5 billion over the same period. The increase in domestic revenue by GHC10.7 billion was more than twice the increase in the government wage bill. Indeed, by the end of 2012, the government wage bill following the implementation of the single spine salary system was 42.9% of total domestic revenues. This is not significantly different from the 41.3% in 2008. At the end of 2013 the government wage bill absorbed 53% of government revenue, underpinned by a weak tax revenue performance.

Mr. Chairman, the current economic difficulties can therefore not be attributed to the single spine salary system which had been 99% implemented at the end of 2012. Furthermore the wage bill as a % of Ghana's GDP (total income) even though high, is not new. It is within Ghana's historical standards. Between 2002 and 2005 the wage bill averaged 8.5% of GDP. Following the statistical rebasing of GDP, the wage bill as a percentage of GDP declined to 6.1% in 2007, and has risen steadily to 9.6% of GDP in 2013.



Mr. Chairman, economic management is about making policy choices and all governments have to make these choices:

- The SSSS is a good policy choice that was planned, studied and agreed upon by stakeholders prior to implementation
- The quadrupling of the national debt with an increase of GH¢40.0 billion in 5 years was a policy choice
- The payment of judgment debts amounting to some GH¢600 million was a policy choice
- GYEEDA payments of close to GH¢1 billion was a policy choice
- SADA and SUBAH payments were policy choices

Unfortunately, it appears as though government does not appear to have done a holistic analysis of the impact of its policy choices on the budget and fiscal outlook. If it had done so, it should have been clear that the policy of accelerated borrowing which increased the debt stock by 426% in five years for example would take away some of

the cushion or fiscal space that was available to the economy in terms of increased interest costs. The same conclusion would also have been reached with regard to the accelerated payment of judgment debts, GYEEDA, etc.

Between 2008 and 2013 the wage bill increased from 6.6% of GDP to 9.6% of GDP (i.e. an increase of 3.0% of GDP). At the same time, interest payments on government debt increased from 2.3% of GDP in 2008 to 5.1% of GDP by 2013 (an increase of 2.8%). The additional interest costs (of 2.8% of GDP) resulting from the massive borrowing that has been undertaken by government would have provided sufficient cushion for the economy. At the current rate of borrowing the additional interest cost would increase by 1.5% of GDP (an increase from the 2008 level by 4.2%) by the end of 2014. The problem is therefore not with the SSSS which was planned for, even if poorly implemented. The problem is with the fiscal space that has been eliminated by the high levels of borrowing, dubious payments under GYEEDA, SADA, SUBAH, and questionable judgment debt payments all of which were not planned for at the time the single spine salary system was designed. Mr. Chairman, the SSSS is therefore not the cause of the depreciation of the exchange rate or the current economic woes and therefore should be left alone.

REDENOMINATION

Mr. Chairman, there are some who have argued that the cedi exchange rate depreciation is the result of the redenomination of the cedi that took place in 2007. It is a mindboggling argument. The exchange rate reflects the relative purchasing power of

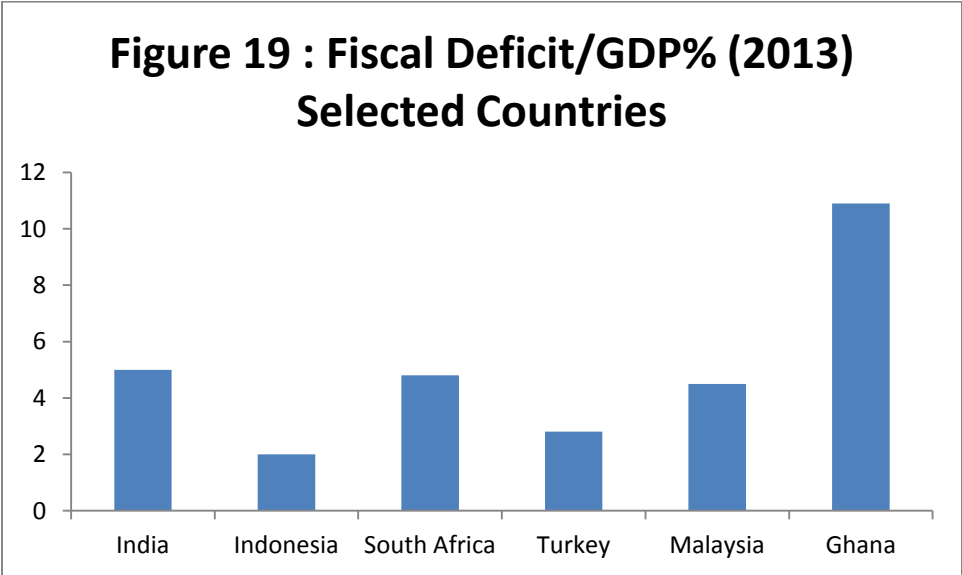
two different currencies at a point in time. It is a relative price. Depreciation of a currency is the change in the value of the currency over a period of time. Redenomination does not affect the relative prices of goods in an economy and therefore cannot result in exchange rate depreciation which measures changes in the relative prices across countries.

Mr. Chairman, we should note that in the years preceding the redenomination in 2007, macroeconomic stability had taken root; inflation was falling; interest rates falling; the currency was stable; the cedi's role as a store of value had been restored, and the country had built a good cushion of external reserves, under a policy of commitment to fiscal and monetary prudence. Inflation recorded single digit levels in 2006 (April (9.9 percent) and May (9.5 percent)) and hovered around 10.1 percent through to October 2007. The cedi exchange rate was relatively stable over a period of about 24 months, fluctuating within a narrow band against the three major currencies. Between 2004 and 2007, the cedi depreciated by an average of 2.25 percent against the U.S. dollar.

In any case, how can an event (redenomination) which took place in 2007 suddenly rear its head in 2012, 2013 and 2014? Where was the impact of redenomination when the exchange rate was stable in 2010 and 2011?

United States Monetary Policy- Tapering Quantitative Easing

Mr. Chairman, another explanation for the recent depreciation of the cedi is that this is a global phenomenon that is affecting all emerging market economies like Malaysia, India, South Africa, and Turkey. The reduction in bond purchases (tapering) by the US Federal Reserve, by increasing US interest rates would make US investment more attractive to investors relative to emerging market economies. While this is a good argument, it would have been more persuasive had the depreciation in Ghana been happening in the context of strong fundamentals. Ghana has very significantly weaker fundamentals compared to all key emerging market countries (Figure 19) and is not as integrated into the global capital market. Without the US tapering, the cedi would still have depreciated given the developments in the fundamentals. At the time many, including myself, predicted that cedi would depreciate, the US had not yet announced its tapering policy.



DWARVES, JUJU MEN, HIGH RISE BUILDINGS AND THE END OF THE WORLD

Mr. Chairman, amongst the explanations offered for the cedi depreciation is the action of dwarves, spirits juju men, high rise buildings and the end of the world. I do not want to delve much further into these explanations except to say that they have provided comic relief even though this is not a laughing matter. Again, where were the dwarves when the cedi was stable? It looks like they go into hiding whenever there is disciplined and sound economic management.

Mr. Chairman, it is clear from the analysis so far that the most credible, consistent and sustainable explanation for the depreciation of the cedi is the weakening of Ghana's economic fundamentals; slower growth, large fiscal and current account deficits, rising interest rates, rising inflation, rising debt levels, and low foreign reserves. All these have combined to result in a loss of confidence by investors and a downgrading of Ghana's credit rating by international rating agencies.

Mr. Chairman, the sad fact is that Ghana's economy is in a crisis. I do not use the term "crisis" lightly. This is not some short term blip that will just pass over if we can just muddle through. The problem we have is that there appears to be an unwillingness to face the truth and admit that we are in a crisis. In fact, we appear to be in a state of denial. At this rate, one should expect much more depreciation of the cedi this year.

Mr. Chairman, the measures so far taken by the Bank of Ghana through the imposition of foreign exchange controls, despite all the good intentions, have rather added an element of uncertainty to Ghana's exchange rate regime and this discourages the very investment needed to grow the economy. For the sake of brevity, I will just highlight two new directives that require that :

1. Exporters have their export proceeds repatriated within 60 days and such earnings should be converted into cedis within 5 days of receipt.
2. Withdrawals from foreign currency accounts (FEA and FCA) would be paid in cedis except for \$10000 for travel purposes.

Mr. Chairman these two directives are problematic. In putting together the Foreign Exchange Act of 2006 (Act 723) and its accompanying regulations, the Bank of Ghana sought to encourage individuals and firms to have the confidence to bring their dollar and other foreign currency holdings into the banking system. Since 1988, successive efforts have been undertaken to make the banking system the conduit for foreign exchange transactions and not the black market. The Bank of Ghana at the time of the passage of the Foreign Exchange Act (2006) assured exporters (other than cocoa farmers who were required to) that the repatriation requirements in the Foreign Exchange Act were not meant to force them to surrender their export earnings to the Bank of Ghana. Exporters were assured that their foreign exchange earnings would be as safe in Ghana as they were in London or New York.

Forcing exporters to now surrender their earnings within 5 days means that they would likely have to buy foreign exchange at higher price to import raw materials at a later date. It is a tax on exporters that will have the effect of discouraging the repatriation of export earnings.

Mr. Chairman, the Bank of Ghana also encouraged people to bring their foreign exchange into the banking system as Foreign Exchange Accounts (deposited in Ghana with restrictions on transfer) and Foreign Currency Accounts (deposited from abroad and without restrictions on transfer). To give people the confidence to bring their foreign currency holdings into the banking system, the rules allowed them to withdraw their deposits in foreign currency. After all it is their money. If they want to withdraw it and put it on their center table to look at it all night, that is their prerogative. Forcible conversion into cedis and restrictions on dollar withdrawals amount to a breach of contract which would undermine confidence in the banking system. It would discourage people from bringing in their foreign exchange holdings into the banking system and drive foreign exchange transactions into the black market. If these two new directives are meant to stop the depreciation of the cedi, then they are bound to fail because dollarization, as I stated earlier, is not the cause of depreciation but rather a vote of no confidence in the local currency. Unfortunately these directives are retrogressive steps that have destroyed so much of the hard work on the foreign exchange market going back 30 years.

So What Should Government do to restore some value to the cedi?

Mr. Chairman the following measures may be considered:

1. The government has to admit that the economy is in crisis so that it can carry the country along and get public support for the tough remedial measures it may have to take. The denial must stop. The problem will not go away by refusing to acknowledge it. There must be policy credibility to assure markets and investors that Ghana is a safe bet. In this regard, the government should resist the temptation to make new promises and commitments of expenditure for new programs when it is unable to even meet statutory expenditures. Such promises only serve to signal a lack of appreciation of the current situation and reinforce the loss of confidence in the economy.

2. Mr. Chairman, government should restore fiscal discipline by ensuring that we cut our coat according to our size. Revenue enhancing and expenditure reducing measures such as:
 - a. ensuring value for money in the award of government contracts through a transparent and competitive procurement process that minimizes sole sourcing
 - b. Reducing revenue leakages with respect to tax exemptions
 - c. Expansion of the tax net through the formalization of the economy. The issue of biometric National ID cards and the implementation of a working

street address system are critical to the formalization of the economy. This can be completed in less than one a year.

- d. Dealing effectively with corruption in the management of public finances
 - e. Government should immediately undertake a biometric based payroll audit to eliminate ghost workers as well as implement biometric-based payment system for all public sector workers to deal with fraud in government payroll.
3. Mr. Chairman, while the government must restore fiscal discipline as a matter of urgency, that alone will not be enough going forward. Restoring the confidence of investors and financial markets requires a policy framework that would provide assurance that the fiscal excesses would not happen in the future. Successive governments have acquired the skill for restoring fiscal discipline for short periods only to engage in the fiscal indiscipline again, especially in election years. Ghana must therefore put in place an **EFFECTIVE** legal framework to make sure the politicians on all sides are discouraged from wreaking havoc on the poor people of Ghana for their own selfish interests. There must be a price to pay for such fiscal indiscipline. We need a legal framework to anchor fiscal discipline. When the suggestion was made a few months ago that we needed a Fiscal Responsibility Act, the refrain was that there were existing laws such as the Financial Administration Act, but these are obviously not effective because they were unable to prevent the fiscal excesses of 2008 and 2012. The immediate passage and enforcement of a Fiscal Responsibility Act that has bite

will be important in this regard if it is supported by political will. A Fiscal Responsibility law will require governments to declare and commit to a fiscal policy that can be monitored. It will include fiscal rules (including rules governing election year spending), provisions for transparency and sanctions (including sanctions on the Executive). An announcement to this effect along with actual follow through will boost the confidence of the markets and investors

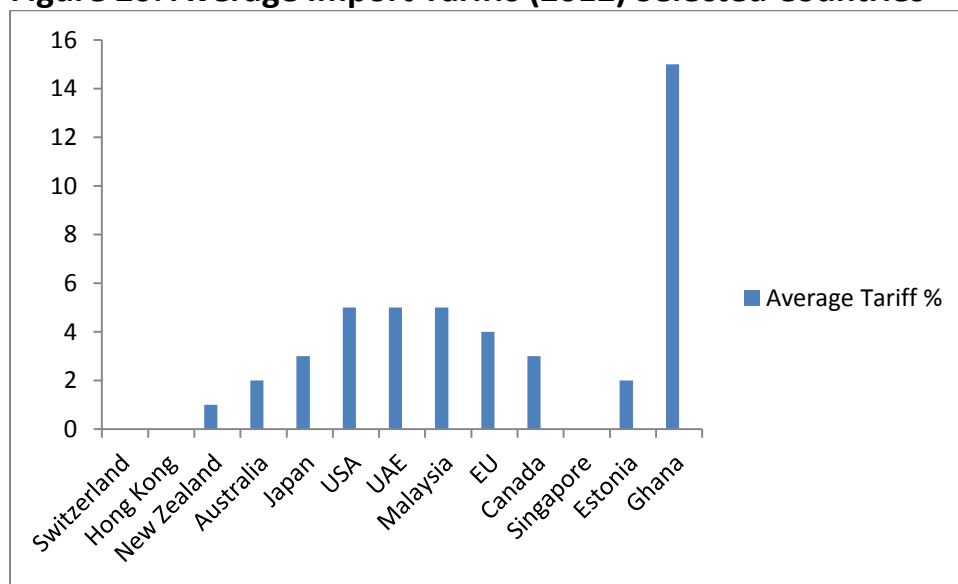
4. In the medium term, Ghana should also consider the establishment of a politically neutral and independent fiscal institution where the Executive can be held accountable through rigorous analysis of the budget and fiscal risks, controls on commitments and expenditures.

5. Mr. Chairman, to enhance the confidence of the markets in monetary policy while at the same time strongly preserving the independence of the Bank of Ghana, the Bank of Ghana Act should be amended **to introduce an accountability mechanism or process for breaches of the Act.** In addition, to increase transparency, the Act should provide for regular reporting (say twice a year) by the Governor to Parliament on the fulfillment of its responsibilities under the Bank of Ghana Act, including especially on the issue of central Bank financing of government. The Governor could appear before the Parliamentary sub-committee on finance for example, in the same way as the Chairman of the Federal Reserve in the United States regularly appears before Congress. This

will enhance transparency and provide some insulation to the Bank from the pressures of politicians.

6. Mr. Chairman, in response to the economic difficulties, government has resorted to increasing taxes on virtually every good or service. These higher taxes have served to increase the cost of doing business in Ghana compared with neighboring countries and would reduce economic growth. The fact is import duties in Ghana are too high and discourage production and investment. In the globally competitive world that we find ourselves today, most countries that manufacture goods for export also import a significant proportion of its raw materials.

Figure 20: Average Import Tariffs (2012) Selected Countries



These countries have come to understand that high import tariffs can increase their cost of production and make them uncompetitive globally and therefore to support higher production and exports, import tariffs are kept relatively low. Singapore and Hong Kong for example have zero average import duties (Figure 20). The philosophy of taxing everything to raise revenue must be re-examined. Sometimes you can actually make more revenue by reducing taxes to stimulate production. In the medium term, Ghana should re-engineer the import-tariff regime to boost production and exports.

7. Mr. Chairman, government should as a matter of policy and urgency, significantly cut down on borrowing for now. **The government should anchor fiscal policy on a debt reduction target and immediately announce it. Fiscal policy currently has no effective anchor.** The announced intention to borrow an additional \$1billion from the capital market this year should be shelved because it would only be achieved at very high cost which would worsen the fiscal and current account situation and make Ghana's debt unsustainable. With low net international reserves, a double digit fiscal deficit, double digit current account deficit, and double digit inflation, Ghana would have had to pay a double digit interest rate for any sovereign bond issue this year.

8. Mr. Chairman, the country should have a serious discussion about the exchange rate regime that is optimal for Ghana going forward. As economists, we can design and implement an exchange rate regime that would keep the cedi stable

over the long term, if government commits to a legal framework that assures fiscal discipline. If we are willing to live by strict fiscal discipline we could consider the adoption of a Currency Board exchange rate regime as pertained under the WACB during the colonial era, and is currently being used by Hong Kong, or Bulgaria for example. Hong Kong for example has had the same exchange rate to the US dollar since 1983. A variation of this arrangement is also being practiced by the CFA franc zone countries in Central and West Africa. Technically, this is not difficult to do if the political will is there. Whether we opt for a fixed or floating regime, the same amount of discipline would be required to keep the exchange rate stable.

9. Mr. Chairman, to restore confidence in the banking system and a degree of certainty in the foreign exchange regime, the Bank of Ghana should immediately reverse the new directives relating to the forced conversion into cedis of repatriated export earnings and forced conversion into cedis of withdrawals from FCA and FEA accounts. There is no problem with repatriation of export proceeds but there must not be forced conversion of those proceeds into cedis. During the years 2002-2007 and 2010-2011 the cedi was relatively stable even though exporters were allowed to retain their repatriated earnings in dollars and foreign account holders were allowed to withdraw their savings in dollars. This was therefore not responsible for the depreciation of the cedi. However, the new directives are based on what in my humble opinion is the rather wrong view that

dollarization is responsible for depreciation of the cedi¹². International experience shows that regulations such as those issued by the Bank of Ghana tend to be short-lived in effect as market participants find ways to circumvent them. Zambia just last week abolished similar foreign exchange controls because they found out that the controls were counterproductive.

CONCLUSION

Mr. Chairman, in conclusion, I would like to repeat without exaggeration that the Ghanaian economy is in a crisis. It is time for serious action. If government does not take the right decisions and soon, then Ghana would likely have to approach the IMF for a bail out before the end of the year. At the end of the day, the obvious lesson is that, we cannot run away from fiscal and monetary discipline no matter how hard we try.

I thank you for your attention. God bless you all and God bless our homeland Ghana.

¹² See for example Michael Melvin and Bettina Peiers (1996) "Dollarization in Developing Countries: Rational Remedy or Domestic Dilemma?" *Contemporary Economic Policy*, Vol. 14, Issue 3, pages 30-40.

See also J. Atsu Amegashie (2012). "Is banning dollarization in Ghana sound economic policy?" University of Guelph, Canada.