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Monetary Management in Ghana

Stephen Younger

CORNELL FOOD AND NUTRITION POLICY PROGRAM

MONETARY MANAGEMENT IN GHANA

Stephen D. Younger

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The Cornell Food and Nutrition Policy Program (CFNPP) was created in 1988 within the Division of Nutritional Sciences to undertake research, training, and technical assistance in food and nutrition policy with emphasis on developing countries.

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FOREWORD

Increasing concern is being raised over the effectiveness of orthodox macroeconomic policy in Africa, particularly when that policy is accompanied by sectoral policies for structural adjustment of economy. CFNPP is therefore undertaking a number of studies of macroeconomic policy to complement its work on the causes and characteristics of poverty, food insecurity, and malnutrition in sub-Saharan Africa. This, in addition to an analysis of household behavior and decision making, is designed to set the stage for further research that will examine how macroeconomic and sectoral policy reform measures have affected welfare.

Ithaca, New York
March 1991

David E. Sahn
Deputy Director, CFNPP

1. INTRODUCTION

It seems that Ghana has always been one step ahead of the rest of sub-Saharan Africa. The first country to gain independence after the colonial era, Ghana also led the way in economic policy, choosing a nationalist path with heavy emphasis on centralized state planning. Those policies gradually strangled the Ghanaian economy in a pattern that was repeated, albeit in a less-dramatic fashion, across much of the continent. GDP per capita, which peaked in 1974, declined by a third in the decade to 1983, the nadir of Ghana's economic history. Exports declined from a high of US$ 1,580 million (constant 1985) in 1977 to a mere US$ 474 in 1983. Given Ghana's increasing lack of creditworthiness, imports were forced to decline as well, leading to such acute shortages of parts and materials that capacity utilization rates fell to 15 percent in 1983. Ironically, the crisis became so severe that even the state, the supposed driving force of the planned economy, began to shrink as its tax revenue declined dramatically in real terms because it was based on increasingly unrealistic controlled prices and exchange rates. In the end, the legal economy became largely irrelevant as black markets dominated the country.

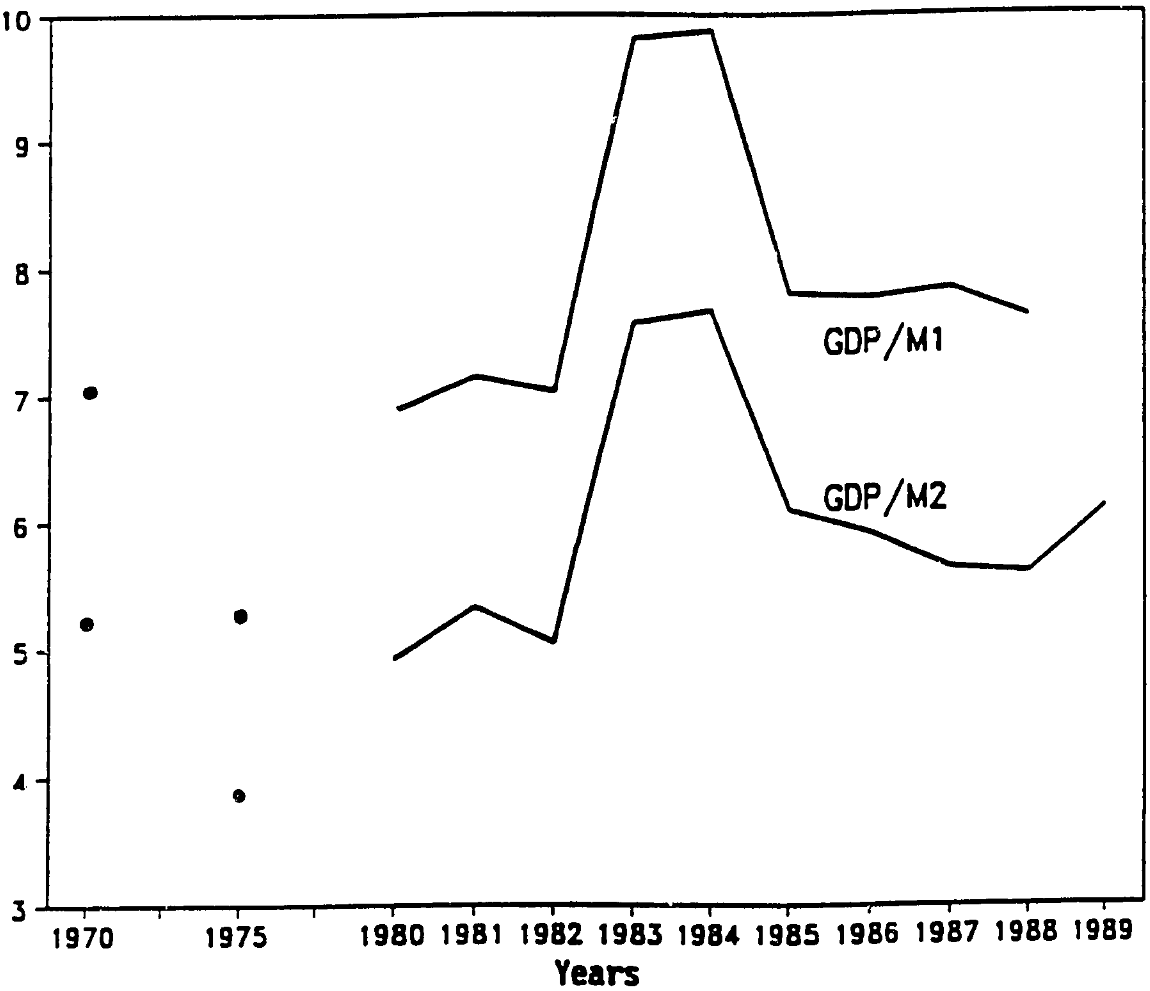
Faced with the collapse of its economy, Ghana again took a lead role in African policy making. Beginning in 1983, the government first undertook a major macroeconomic stabilization program, virtually eliminating the public sector deficit, removing price controls, and drastically devaluing the *cedi* (the Ghanaian currency). The strength of the macroeconomic stabilization effort was sufficiently impressive that Ghana gained considerable international financial support. This permitted the government to turn its attention to issues of structural adjustment, with an eye toward unwinding its complex controls of the economy and relying much more on market forces. At first the focus was on rehabilitation of Ghana's dilapidated economy, especially the reconstruction of infrastructure necessary for export-oriented sectors and the purchase of spare parts for industry. The initial success of those policy changes is now widely documented (see, for example, Alderman 1990 or Younger 1989). Ghana has become an oft-cited example of the benefits of responsible macroeconomic management combined with market-oriented structural adjustment, policies that are favored by international institutions and bilateral donors. The economy is growing again (6 percent per year since 1984, with no recession years); export values are rising despite declines in major export prices; and even though the government fiscal position is nearly balanced, strong increases in government revenues have allowed the public sector to grow, thereby providing much needed health and education services along with development expenditures for the rehabilitation of infrastructure.

Yet despite these accomplishments, Ghana has a long way to go on the road to recovery--one cannot expect to rebuild in a few years what it took two decades to destroy. While most rehabilitation projects have been completed and macroeconomic policy is still firm, many issues of genuine structural change remain to be resolved. One of those issues, the restructuring of the financial sector and the methods of monetary control, is the subject of this paper.

Several important current problems in the Ghanaian economy--including the low rate of national savings (10.6 percent of GDP in 1988), the low rate of private investment (4.9 percent of GDP), and the persistence of inflation--are closely related to problems in the financial sector. Just like the real sector, the financial sector of the Ghanaian economy has suffered from years of distortionary policies that are designed to direct cheap credit to favored borrowers (mostly the public sector itself) at the expense of economic efficiency and productive investment. This caused a decline in the importance of financial intermediation in the economy as people abandoned banking deposits that yielded highly negative real rates of return, preferring to hold their wealth in physical assets or foreign exchange. Even holdings of demand deposits declined as individuals and firms faced with poor service and uncertain treatment of bank accounts by the government chose to use cash rather than checks for their transactions. As one can see from Figure 1, the income velocity of money increased substantially during the period before the current policy reforms. Despite six years of solid economic growth in a stable macroeconomic environment, the Ghanaian economy remains at low levels of monetization and financial intermediation.

It is logical, then, that the government has selected development of a competitive financial sector as one of its priorities for the current phase of the economic recovery program (ERP). While certain key features of a smoothly functioning, market-based financial sector were put into place early on in the ERP, that sector has received special attention since 1988 when a World Bank credit for financial sector reform was negotiated. Since that time, the government has taken steps to strengthen the financial sector and, concurrently, to change the focus of monetary policy toward indirect control of the monetary aggregates. Considerable progress has been made, but because the shift in policy is recent and has not been completed, it is difficult to evaluate it in this article. Nevertheless, the case of Ghana should be interesting to policy makers insofar as many problems that Ghana has encountered in its transition to a liberal financial system are likely to affect other economies as well. One can learn much from Ghana's experience. The remainder of this paper attempts to draw out those lessons.

Figure 1 - Income Velocity of Money, 1970-1989



Sources: Republic of Ghana (various years); World Bank (1989).

2. FINANCIAL STRUCTURE IN GHANA

Ghana has 13 commercial banks, and all but 3 are partly or wholly owned by the state (see Table 1). The largest institution, Ghana Commercial Bank, is 100 percent state owned. It is followed by Barclay's and Standard Chartered, which are 60 percent owned by their British namesakes and 40 percent by the government of Ghana. These three banks were once the only commercial banks in Ghana and were referred to as "primary" banks. Most remaining banks are state owned and were at one time specialized development or merchant banks. But the limited profitability of their restricted portfolios led those banks to seek out other commercial activities. All banks now function as general commercial banks, though the one-time development banks remain more or less committed to their specialized missions. Two new banks have recently been chartered, one private and one owned by the Economic Community of West African States (ECOWAS).

The Bank of Ghana is the nation's central bank; it generally restricts its activities to the classic role of a central bank–issuing currency, holding commercial banks' reserve deposits and some government deposits, and managing the country's foreign exchange reserves. In addition, the Bank of Ghana carries out bank examination and supervision, insuring both minimum liquidity and capital adequacy. There is very little lending to nonbanks or rediscounting of loans made by commercial banks.

In addition to primary and secondary commercial banks, there are more than 100 rural banks. These are unit banks, jointly owned by the Bank of Ghana and by local residents of the area in which each bank is located. Their activities must be limited to the local community. These banks are generally considered to be in poor financial shape–estimates of nonperforming loans range up to 60 percent of their portfolio. Their small size limits the macroeconomic importance of this, but the impact is more pronounced in rural areas left wanting for financial services.

Despite the large number of banks, competition appears to be minimal. For many years, banks in Ghana were subjected to interest rate restrictions along with general and sectoral credit controls as part of the government's planning process. Credit ceilings were placed on total loans and on loans to each sector, except agriculture, where a credit floor applied. These controls were adjusted on an annual basis, more or less in line with existing market shares. As a result, banks had very little incentive to compete for borrowers or depositors, and financial intermediation was limited. In addition, most banks in Ghana are state-owned institutions whose managers were more likely to be bureaucrats responding

Table 1 - Structure of the Banking Sector as of 1987

Banks	Branches	Government-Owned (percent)	Loans	Assets	Deposits	Liabilities	Equity
Primary Banks	-	-	**27,553**	**92,257**	**48,684**	**84,903**	**6,798**
Ghana Commercial Bank	150	100	15,716	60,808	27,499	58,212	2,596
Standard Chartered Bank	25	40	6,919	14,390	10,263	11,678	2,080[b]
Barclays Bank	30	40	4,918	17,059	10,922	15,013	2,122[b]
Secondary Banks	-	-	**28,431**	**75,762**	**32,816**	**72,749**	**2,986**
Bank for Housing and Construction	10	100	9,948	14,614	5,411	14,129	484
Social Security Bank	44	100	6,337	23,390	15,322	22,399	991
National Investment Bank	10	100	3,881	14,976	2,747	14,420	556
Ghana Cooperative Bank[a]	76	100	1,236	n.a.	1,242	n.a.	n.a.
Agricultural Development Bank	34	100	3,509	9,288	1,925	9,060	228
National Savings and Credit	18	100	1,175	3,784	2,114	3,544	240
Merchant Bank	3	30	1,924	7,540	2,706	7,116	398[b]
Bank for Credit and Commerce	1	13	421	2,170	1,349	2,081	89
Rural Banks	**117**	**25**	**1,156**	**3,537**	**2,203**	**3,301**	**236**

Source: Technoserve (1989).

[a] The Ghana Cooperative Bank was being restructured in 1987 after falling into bankruptcy.

[b] Discrepancies between assets and liabilities are unexplained in the source document.

to political pressures of the day rather than bankers attempting to compete for deposits and creditworthy clients.[1]

Since the advent of the ERP, the government has gradually removed these controls. At present, interest rates on savings deposits, time deposits, and loans are restricted and all sectoral credit limits have been removed, except that 20 percent of all loans must go to the agricultural sector, a regulation that is scheduled to be lifted before the end of 1990. The Bank of Ghana continues to use global limits on each bank's credit as a means of monetary control, but it plans to phase out those limits in the future. Nevertheless, this liberalization has not yet had the impact on competition in the banking industry that one would expect and hope for, for reasons that I will discuss in the section on recent reforms.

Nonbank financial markets were virtually nonexistent before the ERP. The government did issue debt, but almost all of it was purchased by captive buyers (the Bank of Ghana, the commercial banks, and the Social Security and National Income Trust) at uncompetitive rates. Banks did sometimes use an interbank market to trade reserves, but even this use was rare because penalties for insufficient reserves were mild. Despite the formation of the Accra Securities Market, Ltd., in the 1970s, no equities, corporate debt, or other assets are traded regularly. Reportedly, firms arrange for short-term credits between clients and suppliers on an ad hoc basis, but no information on this practice is available.

Given the underdeveloped nature of the banking system, it is not surprising that several active informal markets exist in Ghana, particularly for small firms and investors. Because banks have had little incentive to compete for deposits, interest rates have been low (even after deregulation) and services have been very poor, leading most people to avoid the banking system whenever possible. This problem is compounded by the fact that bank accounts have been frozen and/or opened for tax and criminal investigation in the past. Not only do people do everything possible to save in real (physical) assets, most business is conducted in cash. Traditional *susu* systems of savings are reported to be widespread. In one of these schemes, which is popular among shopkeepers and market women, the *susu* collector comes each day to the participants' workplace and collects a fixed amount of cash. At the end of the month, the amount is returned, less one day's payment. This scheme allows the saver to accumulate enough funds to make a relatively costly purchase of a real asset at the end of the month. While it has been argued that this negative nominal rate of interest shows that saving is insensitive to interest rates, a more likely explanation is that the transactions costs of going to the bank to make daily deposits of receipts are high–it can take hours to make a deposit–and the *susu* collector performs the collection service

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1 The government recently replaced most of the managers at state-owned banks in an effort to improve banks' performance.

(and provides safe keeping) for a fee. Nevertheless, the fact that people view this unsecured form of savings as preferable to a bank account reflects the deep distrust of banks that exists in Ghana.

RECENT REFORMS

The general aim of the ERP is to convert the Ghanaian economy from a system of state controls to one in which markets are relied upon to allocate resources, with the hope that this transition will increase economic efficiency and will further economic development. While most early reforms dealt with either macroeconomic issues (for example, reducing the public sector deficit and devaluing the exchange rate) or the real side of the economy (for example, eliminating distortionary trade and price controls and rehabilitating the country's infrastructure), it has become increasingly clear that the Ghanaian economy will have difficulty sustaining the gains from the ERP if the financial system does not improve. For that reason, a comprehensive program of financial sector adjustment was planned in 1988 and was supported by credits from the World Bank and other donors. At the same time, the government began consultations with the IMF over changes in the way that monetary policy is conducted. In general terms, the goal of the reforms is to scrap the system of direct credit controls that existed before the ERP and replace it with one of indirect monetary control in which financial institutions are free to make decisions on purely economic criteria, subject only to the requirements of prudent banking and the general control of the money supply by the Bank of Ghana. In short, Ghana is attempting to accomplish the transition that is the theme of this book.

It was clear from the outset that several key policies and institutions had to be put in place or reformed before liberalized financial markets could be expected to work well in Ghana. First and foremost, if the central bank is to control the money base with an eye toward macroeconomic management, it must be free of demands by the central government to finance its deficit. This requirement has been met in Ghana by the fiscal and macroeconomic reforms of the ERP, so there is little need for further discussion of it at present. Nevertheless, the section on problems encountered will show that one aspect of foreign-financed development projects continues to cause problems of monetary control.

At a more technical level, the Bank of Ghana cannot control the money base if it has no money market in which to intervene in order to control the level of bank reserves. Thus, the current program of reforms includes the development of key asset markets that were previously absent in Ghana. First, eight banks and six insurance companies formed the Consolidated Discount House under government guidance. The Discount House is to serve as a market maker in the interbank market for reserves, trading a variety of approved securities with the banks to adjust their reserve positions. It will also have access to lender of last resort facilities at the Bank of Ghana, and the commercial banks are expected to go to the Discount

House for reserves rather than directly to a discount window. Beyond the establishment of important securities markets, this arrangement also places the Discount House between the commercial banks and the discount window at the Bank of Ghana, preventing the expansion of base money that would come if the banking system could borrow reserves freely from the central bank (a practice that was too common in the past).

As for securities, the central government has begun a weekly auction of Treasury bills despite the fact that it does not need the funds to finance a deficit. (Proceeds are deposited in banks or used to reduce the government's existing debt to the banking system.) In addition, the central bank has instituted an auction of Bank of Ghana bills,[2] which can be held only by banks and are used to adjust the banks' level of cash reserves.[3] Finally, the Cocoa Marketing Board issues cocoa bills to smooth the heavy seasonal fluctuations in credit associated with the cocoa harvest.

The emergence of these markets has met with mixed results. Secondary trading is virtually nonexistent, which, combined with the unpredictable rate of inflation, has meant that maturities must be kept short—mostly 90 days. In particular, control of the money base must be accomplished by adjusting the amount of new bills issued each week rather than intervening in an existing market for liquid securities via sales, purchases, or repurchase agreements. While this technique is common in economies with thin securities markets, it obviously restricts the Bank of Ghana's ability to respond to short-term fluctuations in the money markets. Even on a weekly basis, the fact that banks' reserve positions are known only with a three-week lag means that there is a fair amount of guesswork in determining the amount of bills to be sold.

This level of uncertainty, along with the instability in money demand that surely accompanies the changes in financial and economic policy, might lead one to argue that the interest rate would be a more appropriate short-run target than a monetary aggregate, yet there are problems here as well. Yields in both the Treasury and Bank of Ghana auctions have been remarkably stable and consistently negative in real terms. It is believed that the government has used moral suasion to maintain that stability by

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[2] This second market is necessary because the monetary authorities generally want to sell securities (absorb reserves) in the current situation, yet Ghana's agreement with the IMF limits the gross amount of central government debt that banks may hold. As a result, some asset other than treasury securities must be sold.

[3] Banks face two reserve requirements in Ghana. Primary or cash reserves are currency or deposits with the Bank of Ghana. Secondary reserves include central government bills, Bank of Ghana bills, and government stocks. Current regulations require that 27 percent of deposits be held in primary reserves and 15 percent in secondary.

cautioning auction participants not to make "ridiculous" bids. Further, the novelty of these markets may mean that participants are not yet accustomed to pricing securities aggressively. Whatever the case, yields in Ghana do not necessarily convey useful information about the short-run status of money markets, thereby further limiting the central bank's ability to gauge current conditions.

The development of the Consolidated Discount House (CDH) as a conduit for a smoothly functioning market in bank reserves has met with limited success. When operations began in 1988, the banks were subject to tight credit ceilings on their loan portfolios, which left them with considerable excess reserves. As a consequence, banks rarely needed to borrow reserves and there was low market volume. More recently, increases in the reserve requirements and more aggressive sales of Bank of Ghana bills have reduced excess cash reserves to 4 or 5 percent, a level that appears to be desired by banks,[4] and volume has begun to pick up. Still, bankers complain about the Discount House. They claim that the CDH it is slow to respond to requests for transactions and does not always meet demands, apparently because it is reluctant to take an open position and has never used the lender-of-last-resort facility that it is supposed to have at the Bank of Ghana.[5] Instead, it canvasses other banks for a matching offer before returning to the requesting bank with a response. This approach creates some uncertainty for the bank as to whether or not it will be able to meet its reserve requirements through recourse to CDH. The Discount House also charges wide margins (which may be a result of its quasi-monopoly position). The spread is large enough that an informal inter-bank market apparently continues to operate with direct lending of reserves at rates that split the difference.

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4 Some recent auctions of Bank of Ghana bills have received very few bids, indicating that banks are not interested in further lowering their cash reserve levels despite the interest differential between bills and cash. This reluctance is probably due to the volatility of the cash-to-deposit ratio in the economy, and to the fact that the reserve requirement must be met on a contemporaneous basis (every Wednesday afternoon) with no provisions for averaging over weeks or being able to make up a current shortfall with future excess reserves. In addition, the mechanism for check clearing is slow—a three-week float is average—and unpredictable. These conditions force banks to hold a significant amount of excess reserves to avoid penalties for insufficient reserves.

5 Using the facility has been discouraged because the Bank of Ghana has been trying to reduce the amount of reserves in the system. Further, the authorities are attempting to distance themselves from the past practice of virtually automatic discount window loans that led to loss of monetary control by forcing banks to look to each other or the CDH for reserves rather than the central bank.

One area in which the CDH has done well is the collection and dissemination of information about conditions in the financial markets. Because it must set interest rates on assets that it trades, CDH has developed links with the major financial institutions that it uses effectively to gauge the level of excess demand for money market securities. While this expertise has not yet been exploited by the monetary authorities in deciding credit policy, it should provide a useful complement to information on banks' reserve positions and interest rates in the future.

Developments in the market for foreign exchange have outpaced those in the domestic asset markets in many respects. As early as August 1986, the authorities began to use a weekly auction to price foreign exchange for a subset of international transactions. In February 1987, all licensed imports were included in the auction, and all exports used the auction price for conversion of foreign receipts into cedis. Use of the auction market increased further as the government gradually removed remaining import controls. By January 1989, only five merchandise items–beer, cigarettes, cement, roofing sheets, and asbestos and fibers–were prohibited from the auction, and import licensing was abolished. In the near future, all current account transactions (including invisibles) should be conducted at the auction rate.

As exports and foreign aid inflows have increased, access to the auction has expanded and the quantity of foreign exchange sold has grown (from an average of US$ 3.9 million per week in 1987 to US$ 4.9 million in 1988 and US$ 6.2 million in 1989). While the auction exchange rate is technically a market-determined rate, it is not freely floating. The authorities decide how much foreign exchange to sell each week (and thus the marginal price) only after seeing the week's bids. This knowledge enables them to absorb short-term fluctuations in demand or supply with quantity changes rather than exchange rate adjustments. Thus, while the exchange rate has not been fixed–it has depreciated in real terms during the past three years (usually in association with newly widened access to the auction market)–weekly volatility has been limited.[6]

The fact that import licensing existed and was restrictive led to an active parallel market for foreign exchange in Ghana. In February 1988 the authorities decided to legalize this market. Anyone with a minimal amount of capital (US$ 5,000) can apply to open a foreign exchange bureau, which can trade several foreign currencies at market-determined rates. Transactions are anonymous, which has encouraged the repatriation of funds that were previously smuggled abroad, along with remittances from the

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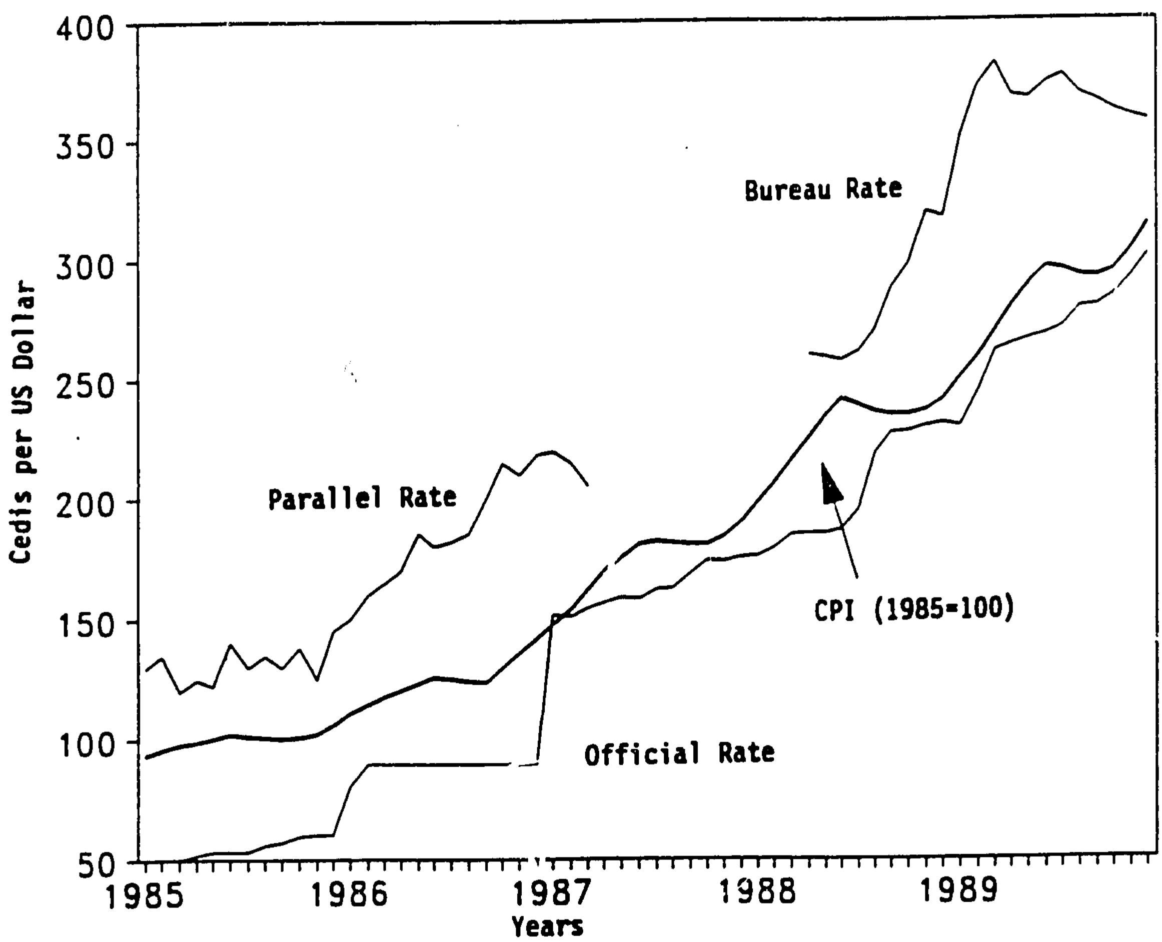
[6] It is interesting to note the analogy to short-term fluctuations in the money market. Rather than allow the price (the interest rate) to absorb all changes in excess demand, more active intervention in the form of interest rate targeting could smooth these fluctuations in much the same way that the dirty float smooths fluctuations in the foreign exchange market.

Figure 2 - Nominal Exchange Rates, 1985-1990



Sources: Republic of Ghana (various years); Pick Publishing Corporation (various years) large number of Ghanaians living abroad. Foreign exchange acquired in the bureaus can be used for any import and foreign travel, though capital account debits (transfers abroad) are not permitted. Significantly wider access to the auction has reduced demand in the bureau market in the past two years so the rate there has been remarkably stable. The margin between the auction and bureau rates has decreased to about 5 percent. In the near future, remaining restrictions on current account transactions should be lifted, at which time foreign exchange will be traded in an unrestricted interbank market that includes commercial banks, the bureaus, and the Bank of Ghana.[7]

In addition to these reforms to markets, several legal and institutional reforms have taken place in the banking system, particularly inside the Bank of Ghana. To enhance the central bank's ability to intervene effectively, banks are now required to report their deposit and reserve positions weekly, and a new banking law requires more detailed financial reporting on a monthly and annual basis, with the Bank Examination Department of the Bank of Ghana now performing at least one on-site audit of banks' portfolios each year. The new law also establishes uniform accounting standards for all banks for the first time, as well as prudential restrictions on minimum capital and loans to individual clients. Foreign donors have provided technical assistance in auditing techniques to bank examiners in both the Bank of Ghana and the private sector.

PROBLEMS ENCOUNTERED

Given the considerable reforms that have taken and will take place in Ghana, it is perhaps surprising to find that deposit mobilization remains weak, the national savings rate is low, and private firms complain of a credit crunch that limits their ability to invest. While the poor degree of financial intermediation is due in part to deep-seated suspicions about the confidentiality and security of bank accounts (a problem that only time and continued good policy can alleviate), a series of problems (which are likely to afflict any economy that has had long experience with repressed financial markets) has slowed progress and limited the benefits of the planned liberalization.

The perception is widespread that credit is unavailable in Ghana. While it is true that the Bank of Ghana maintains credit ceilings on individual banks and those ceilings are binding (a topic I will turn to later), this perception is also partly due to the dramatic changes in

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7 The exchange rate will not float in the traditional sense; the Bank of Ghana will continue to intervene in this market to maintain the value of the cedi at the level it feels is appropriate. In fact, because foreign exchange surrender requirements will remain in effect for traditional exporters, the central bank will continue to be a large net seller in the market.

relative prices and the elimination of many explicit and implicit subsidies that existed prior to the ERP. Both of these changes have surely meant that firms which were able to borrow from the banks before are no longer creditworthy, making it impossible for them to get credit. Such firms may complain about scarcity of credit, but there is nothing wrong with the credit market's decision to turn them away. At the same time, new firms that are competitive under current policies may not be readily identifiable by the banks, partly because they are new and partly because most banks are not used to seeking out customers. Competitive banking is a new phenomenon in Ghana, and it will take time for the participants to learn the ropes.

But the reforms have run up against more fundamental structural problems as well. Most banks in Ghana had been poorly run for a long time so that they are undercapitalized and a large portion of the loan portfolios of commercial banks is nonperforming.[8] There are several reasons for this. Before the ERP, loan decisions often were based on political rather than financial criteria, especially in state banks. This problem was exacerbated by the fact that external audits and bank examinations by the Bank of Ghana were very weak, allowing a variety of imprudent banking practices—most notably, the capitalization of interest due and the declaration of profits on an accrual rather than a cash basis—to pass without comment or control over an extended period of time. In addition, it is likely that the same private sector borrowers who were favored by the overvalued exchange rate and import protection that prevailed prior to the current reforms were also those with access to the controlled credit markets. Thus, a significant proportion of banks' borrowers have probably suffered from the change in relative prices and increased competition that have accompanied the ERP.[9]

The problem that this situation presents for the monetary authorities is that creditors with delinquent clients often have an incentive to continue to lend to those clients in order to avoid being forced to write off the value of the outstanding loans. This incentive is especially strong for creditors who are near bankruptcy themselves, since they have nothing to lose by making further bad loans. While if their clients are lucky enough to see business turn up, the creditors may, in fact, be able to service the loans. Under such circumstances, the government would be

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8 Solid data on the extent of the problem have not been made public, but I was told that all the banks combined have been required to put more than 40 percent of the value of their total loans into loan loss reserves. It is probably true that some state-owned banks are technically bankrupt and will continue to function only because they receive significant injections of capital from the central government.

9 Many state-owned banks had borrowed abroad to finance their lending, so they suffered major revaluation losses when the exchange rate depreciated.

ill-advised to free the credit ceilings on banks, since they might well expand credit to their least creditworthy customers. So the ceilings remain in place, restricting credit to undesirable borrowers and creditworthy ones alike. Yet bad loans must be cleaned up before credit controls can be removed.

The government has moved forward on this front, calling in external auditors of international repute to review the quality of all banks' portfolios, strengthening the banking laws to allow more careful scrutiny of banks' future loan decisions, and using a part of the financial sector adjustment credit for technical assistance. Such assistance is designed to fortify the Bank Examination Department of the Bank of Ghana and to improve the quality of internal and external audits in commercial banks. The government has also worked out a sensible and fair mechanism for cleaning the banks' portfolios. The Non-Performing Assets Recovery Trust (NPART) will relieve the banks of all loans to state-owned enterprises (SOEs) judged to be nonperforming, and the Bank of Ghana will issue bonds in their stead. These bonds have a coupon of only 12 percent, so unless inflation falls substantially before the bonds mature in five years, a portion of the cleanup costs will be borne by the banks despite the fact that they received the full face value of the bad loans in bonds. For loans to the private sector, NPART will absorb only nonperforming portfolios of banks that are threatened with insolvency, leaving healthy banks to fend for themselves (as they would under normal circumstances). Interest rates on bonds issued for these assets will be lower–7 to 9 percent, depending on the quality of the asset–since it is presumed that more of the fault lies with the banks in this case. After accepting the banks' bad debts, NPART will be charged with the role of collection agent. Its financial fate and the final budgetary burden of the program for the government depend on how effective NPART is at squeezing payment from delinquent clients.

Despite these steps, the government has been forced to postpone the full liberalization of credit markets because cleaning up the mess has proved to be a time-consuming process that remains incomplete.[10] Even though the task is conceptually simple–determine which loans are bad and replace them with Bank of Ghana bonds so that banks can begin to function normally–the actual determination of which loans are nonperforming and the probability of eventual repayment is difficult and involves careful financial analysis of both the banks and their debtors. This process has been complicated in Ghana by the existence of off-the-books assets and liabilities as well as by certain interlocking claims that have made the legal rights of both creditors and debtors unclear in many cases.

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10 As of September 1990, I was told that the bad debts of state-owned enterprises had been dealt with and counterpart bonds issued, but treatment of private sector debts remains. Government officials hope to be finished by the end of 1990.

Before I finish discussing nonperforming assets, it is worth noting that some of the disappointing results of earlier changes in financial sector policy are partly due to the bad debts that banks hold. The fact that it is difficult to cut credit to delinquent borrowers reduces the flexibility that banks have in selecting new clients. This lack of flexibility has probably reduced the competitiveness in the market for loans and also prohibited banks from extending credit to new enterprises that are in a better position to take advantage of the ERP's policy changes. Even those banks that do have excess reserves (and are below their credit ceiling) seem reluctant to make loans to the private sector after having been burned so badly in the past.

The fact that the credit ceilings prevent banks from lending the funds they already have means that they have no incentive to mobilize more deposits. Thus, deposit interest rates remain low[11] and services for depositors are poor, doing nothing to revive the moribund public interest in bank accounts. Thus, savings and financial intermediation remain low.

In addition to these structural problems, Ghanaian authorities face a curious problem resulting from the strong capital inflows that Ghana now enjoys from official aid, remittances from Ghanaians living abroad, and returning "flight capital" (see Table 2). Part of these inflows have been monetized as the recipients cash in their dollars for cedis at the central bank. That is, not all resources coming from aid and capital account inflows are being spent on imports; some are used for local purchases of home goods (in cedis). In turn, this local expenditure has put upward pressure on the money supply that the authorities have tried to check with ever-tighter ceilings on *domestic* credit. Even though this effort has been helped by the fact that government has been improving its position vis-à-vis the banks and is now a net creditor to the banking system, the surge in net foreign assets has been so strong that domestic credit ceilings are ever tighter in real terms and are crowding out credit to the private sector, contributing to the credit crunch. Yet the credit controls have not been sufficient to control the growth of M2, so inflation persists despite the much-touted fiscal discipline. Finally, the growth of base money combined with credit ceilings has meant that banks are sitting on large amounts of reserves. This accumulation of reserves has made authorities reluctant to remove credit ceilings, because existing reserves would surely fuel a strong expansion in domestic credit and the money supply.

Much effort has been made to mop up these reserves, including the sale of Bank of Ghana bills and a substantial increase in the reserve requirement (see Table 3). On paper, this effort has worked in the sense that excess reserves have been reduced. But the Bank of Ghana bills pay low yields (probably because of the authorities' extra-market lobbying to

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[11] Interestingly enough, when controlled interest rates were freed in 1988, commercial banks actually *lowered* their savings deposit rates.

Table 2 - Balance of Payments

Item	1982	1983	1984	1985	1986	1987	1988	1989
				(millions of U.S. dollars)				
Current Account	**-74**	**-158**	**-111**	**-157**	**-85**	**-102**	**-104**	**-97**
of which:								
Exports (f.o.b.)	641	439	567	632	749	824	881	808
Imports (c.i.f.)	-631	-539	-681	-729	-805	-1,025	-1,088	-1,102
Interest payments	-84	-82	-79	-103	-101	-122	-127	-110
Official transfers	84	72	103	105	118	122	174	214
Private transfers	-1	17	73	32	72	202	172	202
Capital Account[a]	**101**	**-85**	**148**	**41**	**28**	**240**	**229**	**224**
of which:								
Private capital	-5	12	4	6	7	2	4	12
Official capital	113	28	173	32	123	218	187	192
Official Settlements	**-27**	**243**	**-37**	**116**	**57**	**-139**	**-125**	**-128**
of which:								
IMF	-5	259	214	122	16	-25	-46	4
Other	-22	-16	-251	-6	41	-114	-79	-132

Source: Government of Ghana, various years; IMF(1989); World Bank(1989).

[a] Includes errors and omissions.

Table 3 - Some Monetary Indicators for Ghana, 1984-1989

Item	1984	1985	1986	1987	1988	1989
			(percent)			
Reserve Ratios[a]						
Minimum required cash ratio	10.0	13.4	8.1	21.7	19.0	22.4
Actual ratio	26.3	24.6	25.2	25.3	25.1	27.5
Minimum required secondary ratio	35.0	26.6	15.0	6.7	10.0	15.0
Actual ratio	31.5	26.9	22.4	15.0	14.6	17.1
Proportion of Growth in M2 Coming From:						
Change in net foreign assets	-	-25.3	30.8	77.7	80.2	59.1
Change in private and SOE credit	-	58.4	55.5	28.0	22.9	58.6
Change in net other assets	-	66.9	13.8	-5.7	-3.1	-17.7
NFA/Total Assets[b]						
Bank of Ghana	1.7	-2.9	21.4	59.0	83.2	n.a.
Monetary survey	-3.9	-11.3	2.5	26.5	41.8	44.9
Domestic Credit/GDP						
Private sector	4.6	6.2	7.3	6.3	5.5	6.6[c]
State enterprises	0.5	1.4	1.0	1.2	1.0	-
Central government (net)	8.9	7.9	5.8	3.0	1.0	-0.7
Cocoa financing	1.3	3.9	3.3	2.2	2.0	1.8
Money and Inflation						
Growth in M2	45.0	59.5	53.7	53.0	43.0	22.9
CPI inflation	39.6	10.4	24.7	39.7	31.4	25.2
Growth in nominal GDP	47.0	26.8	49.1	45.9	41.8	34.3

Source: Bank of Ghana; IMF(1989); World Bank(1989).

[a] Required ratios are a weighted average of primary and secondary banks' reserve requirements.

[b] Net foreign assets include losses incurred when net foreign exchange liabilities' value changes with the exchange rate (the revaluation accounting account).

[c] Includes both private sector and state-owned enterprise credit.

keep rates down), so that if banks were given the option to stop buying the bills and start making loans, they would probably take it. An even more important shortcoming of this strategy is the high reserve requirement. If banks are forced to carry a large percentage of their assets in non-interest-bearing reserves, the banks will have to maintain large spreads, thus discouraging financial intermediation.[12]

While policy makers from countries with overvalued exchange rates and controlled imports may find it odd to think that a strong inflow of foreign exchange could cause difficulties in macroeconomic management, that is Ghana's current problem. The situation is analogous to a case of the Dutch Disease,[13] where the strong inflow of foreign loans and transfers plays the role of the booming export sector. Because foreign exchange is relatively abundant, there is downward pressure on its relative price--the real exchange rate. If the nominal rate is not allowed to appreciate, then the inflow of foreign exchange reserves will increase the money supply and fuel inflation, producing an appreciation in real terms. At the same time, there is a redistribution of real purchasing power away from other sectors and toward the beneficiaries of the foreign exchange inflows.

In Ghana's case, a principal beneficiary of the boom in foreign aid is government expenditure, which should come as no surprise to observers of Ghanaian economic events: government has been a genuine boom sector in recent years, and some of its resurgence has been financed by foreign borrowing, which is squeezing credit to the private sector. In this regard, it is worth noting that the fiscal position is not as sanguine as is often portrayed. The budget data are generally presented without accounting for projects that are financed with foreign aid tied directly to them. If these expenditures are included, then the small surplus reported in recent years becomes a deficit of 2.5 to 3.0 percent of GDP. So fiscal policy is still putting demand pressure on the economy, and that pressure is driving up the money supply (and thus inflation), albeit via the accumulation of net foreign assets in the central bank as the government cashes in its dollar receipts from foreign credits for cedis rather than the more usual expansion of domestic credit to the public sector.

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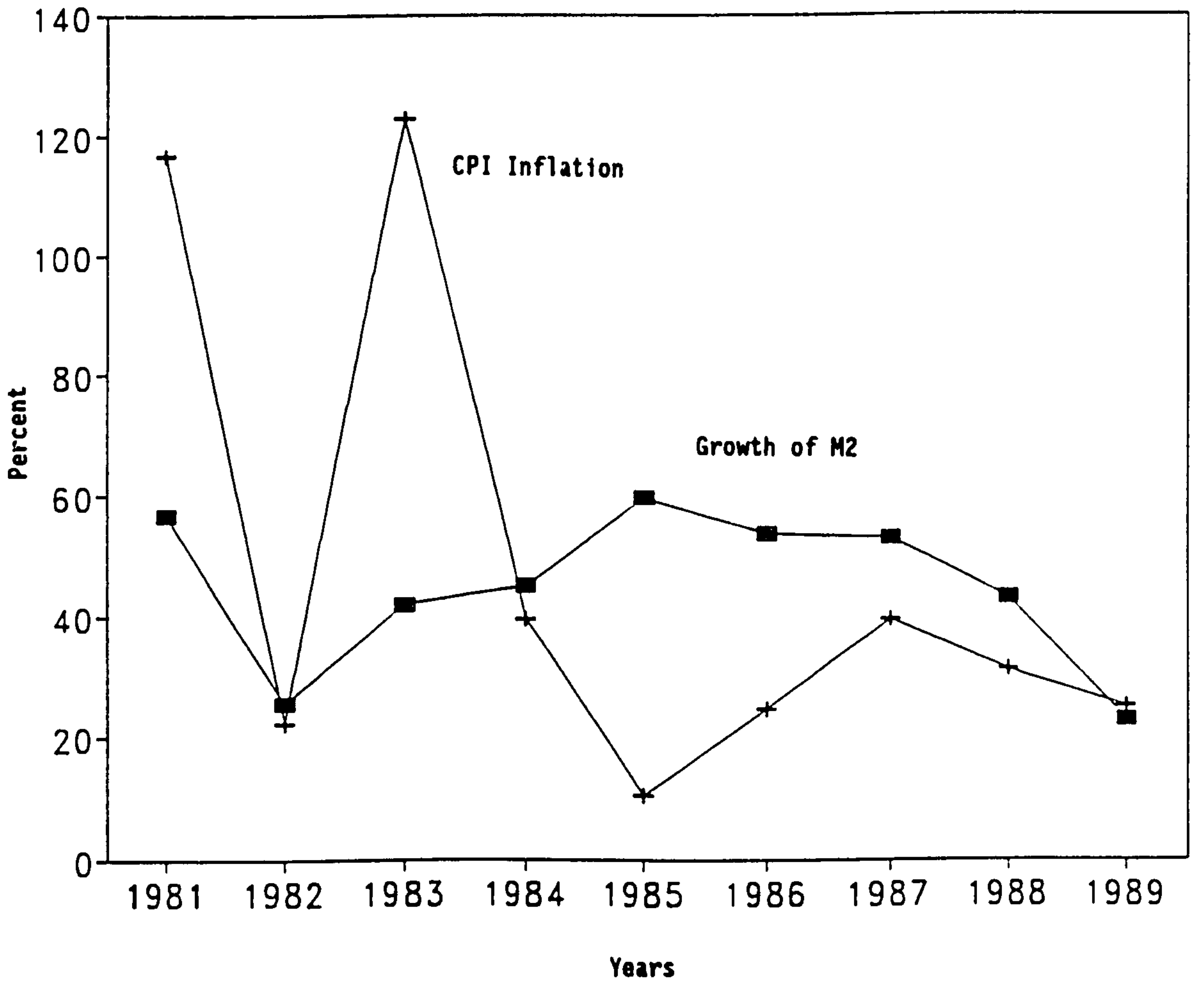
[12] The fact that high reserve requirements serve to tax financial intermediation in the presence of inflation is well known (see, for example, Brock 1982).

[13] See Cordon and Neary (1982) for an explanation of the Dutch Disease, and Cuddington (1989) or Hill and Mokgethi (1989) for discussions of the macroeconomic consequences of temporary boom sectors.

Figure 3 - Money Growth and Inflation, 1981-1989



Sources: Republic of Ghana (various years); IMF (1989); World Bank (1989).

3. THOUGHTS ON POLICIES FOR THE FUTURE

The liberalization of interest rates and the cleansing of banks' portfolios that is supposed to be completed soon via the sale of questionable loans to NPART means that some important obstacles to a competitive, efficient financial sector have been removed. But other obstacles remain that stifle the incentives for competition among banks. Further policy changes will be needed if Ghana is to reap the benefits of improved financial intermediation. Eventually, credit ceilings on individual banks' loans must be eliminated so that banks have an incentive to seek out and compete for new borrowers on the one hand and for new depositors on the other. In addition, the reserve requirement must be lowered so that banks do not have to operate with large spreads between deposit and lending rates, thus discouraging both depositors and borrowers, in order to cover the cost of carrying interest-free reserves. Until this happens, the competitive forces that a liberalized financial system relies on to function efficiently will remain dormant, and savings mobilization via the banks will be disappointing.

Even after the regulatory environment has been liberalized, some peculiarities of the current situation in Ghanaian financial markets might impede effective competition, at least in the short run. First, many banks in Ghana are owned by the state so that their goals may not be to maximize profits through aggressive marketing of financial services, but rather to satisfy certain political goals of their managers or of those who influence them. Even though the management personnel of most state-owned banks has been changed recently, the incentives that they face remain the same, and some attention should be paid to changes that would encourage efficient behavior of new managers. These changes include more careful auditing and more clearly defined public policies, both of which are already a part of the financial sector reform, but the government might also consider more direct incentives to the managers such as tying their pay to the profitability of the bank that they run.

A further problem with increasing competition lies in the fact that the three banks that appear to be in the best position to pursue new clients and expand their business are owned to a greater or lesser degree by foreigners. Fearing political repercussions, these banks too may refrain from seeking a rapid change in the status quo for market shares, thereby limiting competition from that quarter. This need not be the case, of course, but the upper limit on these banks' market share is a policy decision that the government should make, and make publicly, so that the rules of the game are clear.

Table 4 - Government Finance, 1982-1989

Item	1982	1983	1984	1985	1986	1987	1988	1989
Surplus/GDP								
Standard def.	-0.046	-0.027	-0.018	-0.022	0.001	0.005	0.004	0.007
With projects	-	-	-	-0.030	-0.033	-0.024	-0.028	-0.028
Revenue/GDP								
Standard def.	0.061	0.056	0.084	0.118	0.144	0.149	0.145	0.151
With projects	-	-	-	0.124	0.159	0.167	0.160	0.167
Current Expenditures/GDP	0.093	0.074	0.086	0.112	0.119	0.108	0.105	0.105
Capital Expenditures/GDP								
Standard def.	0.009	0.006	0.012	0.021	0.019	0.025	0.028	0.027
With projects	-	-	-	0.035	0.068	0.073	0.074	0.079

Source: Republic of Ghana (various years); IMF(1989); World Bank(1989).

The changes inherent in a switch to indirect monetary control have their risks, of course, and they bear repeating. In the short run, abandoning credit ceilings as a means of monetary control threatens a rapid expansion of the money supply, causing inflation to accelerate. This fear of inflation seems to be behind the government's reluctance to do away with direct controls.[14] Given this problem, it may be wise in the short run to look for an intermediate step that will promote greater competition in the banking sector while maintaining direct controls over credit as a guarantee of macroeconomic stability. One possibility would be to change the way in which the ceilings are distributed among banks. Rather than using past market share of credit or assets as a guide, the government could allocate the ceilings based on past share of *deposits*. Although this change would not expand the overall amount of credit in the economy, it would give the banks more incentive to compete for deposits through improved services and attractive interest rates, providing a first step toward better financial intermediation.[15] Such a step would improve the current situation, but it is obviously an intermediate step because it would not allow credit to flow freely from bank to bank. Eventually, the direct controls will need to be abandoned entirely.

When this happens, effective bank examination will be crucial. As any observer of the United States' savings and loan debacle knows, deregulated and unmonitored bankers are capable of highly imprudent lending practices precisely because they know that if their loans turn sour, they usually can pass the losses off to the government. In a liberalized financial system, it is particularly important that banks be held to prudential guidelines on the general structure of their balance sheets, even though the government does not interfere with the particulars of credit allocation.

In Ghana, this responsibility rests with the Bank Examination Department of the Bank of Ghana. While part of the World Bank's credit for the financial sector was used to train these examiners, they are a small group (41 examiners in three teams) and their effectiveness remains untested. It would seem wise to foster some "parallel examination" on the part of other parties by making public more information about the banks on a timely basis. Financial and economic policy tends to be secretive in

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14 More precisely, the IMF's reluctance. The Fund continues to insist on credit ceilings in its negotiations with the government, apparently because they give it an easily monitored performance criterion.

15 It might be possible to set up a more elaborate scheme that first set the economywide credit ceiling and then forced banks to compete for a share of it (see Younger 1990 for a discussion of several possible alternatives). The government might also distribute the shares according to each bank's share of deposits, but allow the banks to trade their right to a share of credit so that banks with better borrowing customers could buy up other banks' quotas.

Ghana, depriving market participants of information they need to function effectively in liberalized markets. This secrecy puts an extra burden on the few officials who do have important information to make good decisions, since very few people are in a position to review or challenge their judgments. So far in the ERP, those officials have, in fact, made good decisions, but this record does not guarantee that they or their successors will continue to do so in the future. In the case at hand, for example, requiring banks to publish accounts audited by competent external examiners would help depositors make their own judgments about the soundness of a bank's lending policy and would allow someone besides the Bank of Ghana examiners to raise a red flag at the sign of problems.

Another new responsibility that will fall to the Bank of Ghana is short-term liquidity management. Monetary control has been a fairly simple process in Ghana to date: GDP growth, inflation, and balance-of-payments targets are prepared; an income velocity of money is assumed; and the appropriate general expansion in domestic credit is derived. This credit target is then distributed among the commercial banks as a credit ceiling. With the removal of ceilings, however, the central bank will have to control the money supply via open-market operations, influencing banks' reserves through the newly developed markets for short-term government (and Bank of Ghana) bills. This, in turn, will force the authorities to pay more attention to daily developments in the credit markets as they try to ascertain current market conditions by conversing with market participants and watching daily movements of interest rates, prices, and the exchange rate.

I have already argued that simply targeting a monetary aggregate is likely to produce sharp short-run swings in financial prices as a result of the instability in money demand that will accompany structural changes in financial markets. The Bank of Ghana needs to respond to other variables, including the interest rate. But the interest rate must contain information about market conditions; it must be allowed to float without the government twisting traders' arms over their auction bids. At the same time, participants in the securities markets will find it difficult to set interest rates if more economic and financial data are not made available on a timely basis. Much could be gained by making an effort to collect and disseminate, as quickly as possible, information on banks' reserves; on various key interest rates; and on basic economic data about inflation, growth, and so forth.

In the current macroeconomic context in Ghana, both removing the credit ceilings and lowering the reserve requirements threaten a loss of monetary control in the short run. As I have shown, the authorities have attempted to offset the effect of a strong inflow of foreign exchange reserves on the overall rate of money growth by sitting on the growth of domestic credit through lower credit ceilings and higher reserve requirements. If these two policies are changed, the government will have to resolve the problem of foreign exchange inflows in another manner.

What are the policy options available to the government within a liberalized financial structure? As other authors writing on the macro-economic effects of boom sectors have argued, it is important first to distinguish between higher flows of foreign exchange that are permanent and those that are temporary. If an increase in foreign exchange revenues is permanent, as the increased export earnings in Ghana probably are, then it is appropriate to allow expenditure levels to rise concurrently and, at the same time, to accept the fact that the real effective exchange rate must appreciate, thereby reflecting the greater supply of foreign exchange.[16] One obvious response is to encourage more imports, since that would offset the inflow of foreign exchange and eliminate the monetary (and inflationary) impact of the increased foreign exchange receipts. To a great extent, the Ghanaian authorities have done this: substantial liberalization of imports has been a cornerstone of recent trade policy and imports have indeed risen, but not enough to sterilize the capital inflow completely.

At the same time, it is surely true that part of the recent inflows of foreign exchange in Ghana—the jump in foreign loans and grants and perhaps the apparent increase in capital repatriation—is temporary, so that the appropriate policy is to attempt to save the windfall rather than burn it up in an import-driven consumption binge (see, for example, Hill and Mokgethi 1989, or Cuddington 1989). The question then becomes, what is the best investment to make with the funds? One possibility is the accumulation of foreign assets. For the aid inflows, this could be accomplished directly by the government if it used the resources it receives from increasing its foreign liabilities (by accepting foreign aid loans) to accumulate foreign assets itself or to retire other foreign liabilities with less-attractive terms.[17] It could also negotiate with donor governments to stretch out the disbursement of aid commitments, thus smoothing the impact of inflows on aggregate demand. Alternatively, the government could permit private individuals to accumulate foreign assets for investment purposes, but opening the capital account in an economy with such poorly developed financial markets would surely create violent movements in foreign exchange holdings and/or the exchange rate.[18]

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[16] In an economy with significant import restrictions, this increase need not imply a revaluation of the real effective exchange rate for exporters. Trade liberalization can reduce the rate for importers alone, thus absorbing the inflow of foreign exchange.

[17] Note that the current practice of receiving a loan, converting (part of) it into cedis to spend domestically, and having the central bank accumulate reserves will not work; the inflow is monetized in this case, and the problem described earlier would persist.

[18] Some movement in this direction has occurred, however. Ghanaians are permitted to open two types of accounts denominated in foreign currencies (continued...)

While purchases of foreign assets would completely sterilize the monetary and real exchange rate effects of the surge in dollar inflows, it is possible that investment opportunities within Ghana have better rates of return. If these opportunities are in the public sector–roads, communication, education, health, etc.–then the current policy in Ghana is, in fact, appropriate. The funds should be used for government capital (not current) expenditures with high rates of return and policy makers must recognize that two side effects of this expansion will be the crowding out of some private investment (because the government will use a larger proportion of newly created money supply) and an appreciation of the real exchange rate to the extent that these investments demand home goods rather than imports. If rates of return are higher in the domestic private sector, then the government should transfer the resources to private firms by balancing its budget *inclusive* of foreign project aid. Because the government is receiving sizable foreign loans, this policy implies that it would lend an equal amount–about 3 percent of GDP–to the financial markets either as deposits or by retiring current debts. This would allow a much more rapid increase in credit to the private sector.[19]

All of these policy changes are aimed at forcing commercial banks to compete for deposits and borrowers, thus improving financial intermediation and mobilizing savings. But in addition to having banks seek out depositors, depositors must have confidence in the banking system before they will place a significant portion of their assets with the banks. History is not on Ghana's side in this instance. Account confidentiality has not been respected in the past. The banks, as we have seen, have not been financially stable. And because banks have rarely had an incentive

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[18](...continued)
within Ghana. The first, called a foreign account, can be funded with repatriated foreign exchange (including receipts held in exporters' foreign exchange retention accounts) and with funds received as remittances. These accounts can be used for any purpose, including the purchase of foreign securities, but this account does not permit the general public to *accumulate* foreign exchange because the funds feeding the accounts are already denominated in foreign currency. The second, a foreign exchange account, can be funded with foreign currencies from any source except the auction (but can include the foreign exchange bureaus). This account does provide a vehicle for nonexporters to accumulate foreign assets, but the accounts are permitted only inside Ghana and can be used only to fund current account transactions (imports), not the purchase of assets abroad. This restriction impedes rapid outflows of capital that could be destabilizing in a small economy.

[19] Incidentally, a large stock of government deposits in the banking system can also be used to help control liquidity. The Finance Ministry (in coordination with the central bank) can move its funds between deposits in commercial banks and the central bank, depending on whether or not it wants to expand credit creation in the commercial banks.

to generate deposits, service is poor and people are accustomed to making their transactions with cash and to using real assets as a vehicle for saving. Once the banks' incentives change, this situation should begin to improve, but it will take time to change the way that people do business.

One policy that authorities might consider for building confidence is deposit insurance. There are, of course, moral hazard risks associated with deposit insurance—again, the United States' savings and loan banks serve as a reminder—but the fact is that the banks in Ghana and their depositors have been bailed out in the current NPART program, even though no deposit insurance was given. Because there will always be incentives for it to do the same in the future, the government might benefit by making the program explicit, both from collecting insurance premiums and by giving depositors greater confidence in the safety of their deposits.

4. CONCLUSIONS

It should not be surprising that the process of financial restructuring is frustrating to Ghanaians, both inside and outside government. Although Ghanaian authorities have moved forward decisively in their attempts to reform the financial sector, progress has been slow and the benefits of efficient banking and finance are yet to be realized. The first conclusion that one can draw from this experience is that financial liberalization is more complex than lifting interest rate ceilings and imploring the banks to compete. On the one hand, there are restrictions other than interest rate controls—credit ceilings and high reserve requirements, for example—that must be cleared away as well, with due care and planning for the macroeconomic consequences. On the other, it is likely that banks in a severely distorted financial sector will not be in a position to compete effectively in a financially prudent manner. Before banks are turned loose in a liberal market, the authorities must be sure that the banks' portfolios are healthy to begin with (a condition that has required significant restructuring and expense in Ghana), and they must have the means to monitor the banks in the future to ensure the solvency of the financial system.

A second conclusion is that the process of financial restructuring, especially cleaning up banks' portfolios and training personnel for the new tasks that are essential to a liberal financial regime, takes time and resources, and that the corresponding benefits are not likely to be evident in the short run. Nevertheless, it is inconceivable that an economy can show strong and sustained growth with a badly distorted and underdeveloped financial system. Ghana is moving in the right direction—and at a steady pace. With continued patience and perseverance, it should begin to realize the returns on this investment in the future of its economy.

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