ECON 216
Economy of Ghana II

Session 4: Inflation in Ghana: Causes and Remedies

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Session Overview

- Inflation has the tendency of impeding economic growth and perpetuates poverty in many developing countries. It is imperative to identify what causes of inflation and be able to develop appropriate strategies in solving the problem.

- This session discusses factors that cause inflation in Ghana and attempt to understand measures used by various governments to achieve price stability.

- At the end of the session, the student will be able to:

Session Overview

- ❑ Identify and explain the two broad factors causing to inflationary pressures in Ghana over the years.
- ❑ Understand the mechanism under which demand and supply pressures lead to inflation in Ghana.
- ❑ Assess the effects of inflation in the Ghanaian economy.
- ❑ Evaluate whether inflationary pressures in Ghana is a monetary phenomenon or a result of structural rigidities.
- ❑ Identify and evaluate the various strategies used in combatting inflation in Ghana and understand inflation targeting as a tool for controlling inflation

Session Outline

The key topics to be covered in the session are as follows:

- ❑ Topic One : Types and Causes of Inflation
- ❑ Topic Two : The Effects of Inflation
- ❑ Topic Three : The Remedies to Inflation
- ❑ Topic Four : Inflation Targeting in Ghana

Reading List

- Alagidede, P., Coleman, S., & Adu, G. (2014). A Regional Analysis of Inflation Dynamics in Ghana.
- Harvey, S. K., & Cushing, M. J. (2014). Separating Monetary and Structural Causes of Inflation. *Journal of Finance & Economics*, *2*(3), 01-16.
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- Osei, V. (2015). Inflation Dynamics in Ghana. *International Finance and Banking*, *2*(1), 38. (http://www.macrothink.org/journal/index.php/ifb/article/view/7913)

Topic One

TYPES AND CAUSES OF INFLATION

Types and Causes of Inflation

- In general inflation may result from either **Demand** pressures (Demand-Pull) or **Supply** pressures (Cost-Push) .

- Demand pressures result when there is an increase in Aggregate Demand for any existing Aggregate Supply conditions. In other words, when aggregate demand exceeds aggregate supply.

- Supply/Cost pressures arise from factors that result in an increase in the cost of production for firms. In this case there a shortfall of aggregate supply over demand resulting from increases in cost of production.

Types and Causes of Inflation

- Despite these demand and supply pressures discussed earlier, the main arguments put forward to explain inflation can be distinguished into two schools of thought:
  - **Monetarists and Structuralists camps.**

- Monetarists contend that inflation is a monetary phenomenon. That is a rise in the money in circulation causes price levels to rise resulting in inflation.

- The Structuralists, on the other hand, contend that inflation is the result of structural rigidities (bottlenecks) that characterize many developing-country economies.

- These rigidities largely constrain supply within these economies thus pushing prices upward.

Types and Causes of Inflation

- Inflation in Ghana arises from a mixture of monetary and structural factors.
- The key drivers of inflation in Ghana are:
  - Money supply: Expansion of the monetary base in order to accommodate huge budget deficits over the years.
  - Cost of borrowing: High interest cost leading to high production costs and consumer prices.
  - Declining food production: The consistent decrease in food output, especially cereals exerts upward pressures on food prices and food inflation in Ghana.

Types and Causes of Inflation

- Exchange rate depreciation: Continuous and persistent depreciation of the domestic currency leads to higher domestic prices.

- Imported inflation: Increasing world market prices of crude oil exerts cost pressures on domestic production. Related is falling export earnings leading to foreign exchange shortages.

- Inflation inertia: Refers to a situation where prices keep rising because of past inflation.

Topic Two

THE EFFECTS OF INFLATION

The Effects of Inflation in Ghana

- So far, we have assessed the types and causes of inflation in Ghana. Let us now pay attention to the effect of inflation in any economy.
- Inflation has the potential to exert both positive and negative effects on an economy. Thus, there are gainers and losers during periods of high inflation.
- However, high inflation is generally seen as bad news for any economy.
- Inflation may have adverse effects on economic growth, poverty reduction, income redistribution and macroeconomic stability.
- Inflation may be anticipated or unanticipated.

The Effects of Inflation

- Inflation may lead to redistribution of income between debtors and credits.
- Debtors gain from inflation because they repay creditors with Cedis that are worth less in terms of purchasing power. Creditors on the other hand lose out.
- However, fixed income earners like pensioners and monthly salary earners lose because inflation reduces their purchasing power.
- Inflation discourages savings as it erodes the value of savings.
- High inflation may temporarily as it makes businesses profitable and thus they increase investments.

The Effects of Inflation

- Unanticipated inflation may lead to an increase in nominal tax revenues to government.
- High inflation makes economic planning quite difficult, as it creates uncertainty thus hindering long-term investment planning.
- Inflation leads to a higher cost of borrowing (interest rate), which leads to a reduction in investment.
- Inflation stimulates capital flight. Domestic investors put their funds into foreign assets instead of investing in domestic assets.

The Effects of Inflation

- Menu costs – firms incur cost in changing price lists, which becomes more frequent during high inflation.
- High inflation may have severe social and political implications especially rising food prices.
- Inflation may weaken the banking and financial system as people would prefer to buy assets rather than hold cash or a financial instrument.
- Inflation leads to currency substitution – people would prefer to hold unto foreign currency rather than the local currency leading to the domestic currency losing value.

Topic Three

REMEDIES OF INFLATION

Remedies of Inflation

- From the previous topic, we learnt the effects of inflation on an economy.
- Governments therefore adopt policies to control inflation. These policies are a mixture of fiscal and monetary policy tools.
- The most common fiscal policy tool is the reduction of government budget deficits and bank financing. During high inflation periods, government spending may be reduce to curb upward pressures on price.
- Government may also use tax policies to wipe excess spending and control inflation. Increases in taxes reduce households' disposable income and hence a decline in their demand for goods and services.

Remedies of Inflation

- The monetary policy tools for controlling inflation include:
  - The bank rate (policy rate)
  - Open market operations
  - Reserve ratios and direct credit control regimes
- Through these tools, monetary authorities make credit more costly. High cost of credit reduces money supply and contract aggregate spending.

Remedies of Inflation

- Inflation arising from structural bottlenecks require policies aimed at increasing output. Improving production technology is essential for improving agricultural production and controlling food price inflation.

- Controlling wages and other cost of production is central to cost-push inflation.

- Reducing imports to stabilise the exchange rate and control increases in the prices of imported goods.

Remedies of Inflation

- Several inflation management schemes have been implemented in Ghana.
  - Domestic credit control (up to 1992)
  - Open Market operations era (1992-2006)
  - Monetary target regime (up to 2006)

- The current inflation management regime in Ghana is the Inflation Targeting (IT) framework

Topic Four

INFLATION TARGETING IN GHANA

Inflation Targeting in Ghana

- We have previously noted that the Bank of Ghana, through its Monetary Policy Committee (MPC) is in charge of the fight against inflation in Ghana.
- In this framework, the Central Bank estimates and makes public a projected or “target” of inflation rate, and then attempts to steer actual inflation toward that target, using its primary tool – the Bank/Prime rate.
- Advocates of inflation targeting think this leads to increased economic stability as it stablises inflation which enable businesses to plan into the long term.

Inflation Targeting in Ghana

- Ghana adopted the inflation targeting regime in 2007.

- Inflation targeting was adopted because other measures to fight inflation, such as monetary targeting or exchange rate targeting were unsuccessful.

- Several central banks in the past turn to target the money supply in order to control inflation levels. But this approach works well if the central bank can control the money supply reasonably well and if the money growth is stably related to inflation over time.

Inflation Targeting in Ghana

- But monetary targeting had limited success because the demand for money has become unstable largely because of innovations in the financial markets.

- Consequently, many countries with flexible exchange rates began to target inflation directly, based on their understanding of the links or ‘transmission mechanism’ from the central bank’s policy instruments, such as interest rates, to inflation

Inflation Targeting in Ghana

- Let us try to illustrate how the transmission mechanism can affect inflation.
  - suppose the central bank desires to lower inflation. It would increase its primarily tool (prime rate in the case of Bank of Ghana), This increases the cost of borrowing, consumers are less likely to buy things they would normally finance and businesses are less likely to invest in new equipment or buildings.

- The effect is a reduced level of economic activity that would be consistent with lower inflation because lower demand usually means lower prices given supply levels.

Inflation Targeting in Ghana

- Inflation targeting is a monetary policy strategy used by central banks for maintaining prices at a certain level or within a specific range.
- Central bank forecasts the future path of inflation and compares it with the target inflation rate (determined by government and central bank).
- Difference between forecast and target determines how much monetary policy has to be adjusted.
- The Objective of IT is to achieve single-digit inflation rate for Ghana.

Inflation Targeting in Ghana

- For inflation targeting to be successful, two requirements must be meet:

  - A central bank able to conduct monetary policy with a high degree of independence from central government. *Bear in mind, no central bank can be completely independent of government influence*.

  - The second is the willingness and ability of the monetary authorities not to target other indicators, such as wages, the level of employment, or the exchange rate.

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