


THE WORLD FINANCIAL CRISIS AND ITS IMPLICATIONS FOR GHANA

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1 Introduction

What started as a financial crisis in July 2007 in the U.S. degenerated into a full blown global economic crisis in subsequent months. A financial crisis, also known as a credit crunch, occurs when there is an uncontrollable reduction in money supply and wealth with people losing confidence and refusing to honour their debt obligations. This creates disincentives for further credit creation, and incites lenders to recall existing loans. It was this phenomenon that was unleashed with loss of confidence by investors in the value of securitised mortgages including default on highly rated financial instruments in the United States and the first run on a U.K. bank in 150 years. Reverberations quickly spread beyond financial centres in the U.S. and the U.K. to other industrial countries in the world. What started in the U.S. as a mortgage crisis has degenerated into a global financial and economic crisis that compelled the United States Federal Reserve, Bank of England and the European Central Bank to inject unprecedented amounts of capital into the financial markets. The question that begs itself for an answer is why this crisis could occur in the 21st century?

2 Nature of the Global Economy

To fully appreciate the wider global implications of the crisis, and its impact on the economy of Ghana in particular, it is pertinent to outline the nature of the world economy, especially the increasing interdependence among countries on one hand, and the dependence of LDCs on the industrialised countries in North America and Europe as well as the emerging economies as major markets for their primary commodities and suppliers of their final and intermediate products. Referred to as Globalisation, this increasing interdependence is the process by which the people of the world are unified into a single society and function together as such, in a global village. This global village epithet connotes integration of world economic, technological, socio-cultural and political forces across countries, which are reflected in assimilation of national economies into the international economy through trade, foreign direct investment, capital flows, migration, and the spread of technology. As a global village, globalisation entails a huge variety of intertwined micro-processes that denationalise what had been constructed as national. For

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example legal and regulatory policies in international finance, political subjectivities, urban spaces, temporal frames a variety of dynamics and domains have all converged across countries. Many production processes, ostensibly, taking place in the US have in actual fact been dismembered or have been outsourced to firms across countries including Ghana where pay checks or parking tickets to people in the US are issued. The more active a country is in the global village, the more severe is the effect of the crisis on that country. As we see later, although Ghana is undoubtedly part of the global village, its weak interdependency links have so far shielded it from the frontline effects of the crisis. To appreciate the full implications of the crisis for a developing country such as Ghana, it is important to understand the "true" causes of the current global financial and economic crisis so as to be able to fashion workable solutions to addressing the probable impacts of the crisis on the economy.

3 Origins of the Crisis

The origins of the crisis lie in complex interaction of a number of forces scattered across policy setting and mistakes, market failure and regulatory failure in the developed market economies.

3.1 Policy Setting and Mistakes

In the case of policy setting and mistakes, the five years leading up to the first visible signs of the crisis in July 2007 were characterised by low real short term policy interest rates following successful reduction in inflation and "disinflation scares" in the US and EU. Both short and long term interest rates virtually converged and market participants were able to use both long term and short term credit interchangeably without regard to when repayment was due. The market became careless as several participants tended to use short term instruments for long term purposes in the misguided belief that the short term rates were going to be prolonged. Furthermore, as the system was awash with all types of credits, and even households that were previously not creditworthy by acceptable standards (sub-prime borrowers) were now given the opportunity to borrow heavily. At the same time, global financial savings exceeded perceived investment opportunities, which helped to depress long-term rates across the world. Global conditions remained accommodating even when short term rates were increased, thus still keeping real and nominal rates generally low. Developing economies were able to build up larger reserves to reduce external vulnerability and maintain stable value of their currencies against the dollar. Indeed, Ghana was also able to improve its gross international reserves with massive foreign inflows and nominal appreciation of the cedi between 2003 and 2006 paving the ground for the redenomination which envisaged a one-to-one parity with the US dollar on a sustained basis. In June 2004 the US monetary authorities began to slowly increase its policy rates, which peaked at 5.25% in June 2006. Long term interest rates began to fall with bursting of the housing bubble and a wild gyration of commodity prices as money flowed out of assets like housing or stocks.

3.2 Market failure: Rapid financial innovation

In the US rapid financial innovation and engineering were promoted, making risk easier to trade and distribute with securitisation (the process of aggregating similar financial instruments, such as loans or mortgages, into a security that can be sold or transferred or delivered to another party). Financial assets of all sorts from credit-card to companies' debt repayments were turned into securities and priced. As a result of heavy subprime borrowing, homeownership rate increased exacerbating house price increases and consumer spending. Indications are that between 1997 and 2006, home prices increased by about 124%. Unfortunately however, with increasing loan default, housing prices started falling with a domino effect, hence the crisis.

3.3 Market failure: Poor Underwriting Standards

The financial system was characterised by lowering of underwriting standards and proliferation of credit risk transfer instruments, which were driven in part by assumption of frictionless and uninterrupted liquidity. Credit rating agencies out-competed one another for market shares by issuing ratings that did not reflect the risk characteristics of the borrowers. Exploitative risk-shifting took place at every stage of the financial engineering process. Lenders collected upfront fees for originating and selling poorly underwritten, and sometimes fraudulently documented, loans and passed the risks along to investors without accepting responsibility for subsequent defaults. Consequently when the crisis was triggered by increasing interest rates, the subprime borrowers were first to declare their inability to honour their mortgage obligations.

3.4 Market failure: Risk models' failure

There was widespread miscalculation by banks and investors of the level of risk inherent in making loans to subprime borrowers due to the fact that the lenders used statistical models that were not able to differentiate different risks, especially the risk profile of subprime mortgages. Not surprisingly, bad risks were given triple A ratings while in actual fact they should not have been entertained at all. When house prices began to decline between 2006 and 2007, mortgage delinquencies soared, and securities backed with subprime mortgages, widely held by financial firms, lost most of their value. These massive losses have considerably impacted the balance sheets of banks across the globe, leaving them with very little capital to continue operations.

3.5 Regulatory failure

Regulatory failure was manifested in too much faith in the discipline of the market with high tolerance of weakening underwriting standards. Mortgage lending standards by financial institutions became lax, especially as each link in the mortgage chain collected profits while believing it was passing on risk. As each player made its money, the regulatory authorities pretended as if the market was allocating resources efficiently; credit rating agencies were themselves unregulated in the pursuit of competition. Not surprisingly, the policy makers and regulators were not able to quickly bring themselves to the realization that what they religiously believed in, the power of the invisible hand, was actually strangulating the global economy.

4 Policy Responses to the Crisis by the Industrialised Countries and G20

Interventionists and Protectionists Policies: To manage the liquidity concerns and slowdown in the global economy in general and their respective economies in particular, the authorities in the US and many European governments have taken unprecedented steps of providing extensive liquidity, giving assurances to bank depositors and creditors that include blanket guarantees, structuring bail-out programs that include taking large ownership stakes in financial institutions, in addition to establishing programs for direct provision of credit to non-financial institutions. Some countries are in the proceeds of re-introducing capital controls as a policy of last resort in the event of extensive bank runs and capital outflows. Monetary policy is being redefined to move away from narrowly focusing on goods prices to taking into account asset price inflation, and prudential regulation that recognise systemic vulnerabilities. In the United States, bastion of capitalism, the Federal Reserve announced its readiness to pump an extra $1 trillion into the financial system by purchasing Treasury bonds and mortgage securities to bolster the economy. The U.S monetary authorities (FED) have already reduced key policy interest rate nearly to zero, making the FED a buyer of long-term government bonds rather than the short-term debt that it typically buys and sells to help control the money supply. Owing to the strong interventionist and protectionist policies being used to address the crisis, many analysts have declared capitalism and the mainstream policy views associated with the Washington Consensus, dead.
Globally, Leaders of the Group of Twenty (G20) affirmed at their London Summit April 2009 that the only sure foundation for sustainable globalisation and rising prosperity for all is an open world economy based on market principles; effective, prudential regulation, and strong global institutions.

The G20 pledged to do whatever is necessary to restore confidence, growth, and jobs; repair the financial system with improved capital adequacy guides to restore lending; strengthen financial regulation to rebuild trust; fund and reform international financial institutions to overcome this crisis and prevent future ones; promote global trade and investment and reject protectionism to underpin prosperity; and build an inclusive, green, and sustainable recovery. For the developing countries such as Ghana, the G20 agreed to triple International Monetary Fund (IMF) resources to $750 billion; support a new Special Drawing Rights (SDR) allocation of $250 billion; support at least $100 billion of additional lending by the Multilateral Development Banks (MDBs); ensure $250 billion of support for trade finance; and to use the additional resources from agreed IMF gold sales for concessional finance for the poorest countries. All of this together will constitute an additional $1.1 trillion programme of support to restore credit, growth and jobs in the world economy. Since the financial system precipitated the global crisis, emphasis was placed on its restructuring. Accordingly, the G20 resolved to establish a new Financial Stability Board (FSB) with a strengthened mandate, as a successor to the Financial Stability Forum (FSF), including all G20 countries, FSF members, Spain, and the European Commission. The FSB would collaborate with the IMF to provide early warning of macroeconomic and financial risks and the actions needed to address them.
Countries are also to reshape their regulatory systems so that the authorities are able to identify and take account of macro-prudential risks. Similarly, measures are to be taken to extend regulation and oversight to all systemically important financial institutions, instruments and markets including, for the first time, systemically important hedge funds. Other major recommendations are to:endorse and implement the FSF's tough new principles on pay and compensation and to support sustainable compensation schemes and the corporate social responsibility of all firms;take action, once recovery is assured, to improve the quality, quantity, and international consistency of capital in the banking system. In future, regulation must prevent excessive leverage and require buffers of resources to be built up in good times; take action against non-cooperative jurisdictions, including tax havens.

We stand ready to deploy sanctions to protect our public finances and financial systems. The era of banking secrecy is over. We note that the Organisation of Economic Co-operation and Development (OECD) has recently published a list of countries assessed by the Global Forum against the international standard for exchange of tax information;
call on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards; extend regulatory oversight and registration to Credit Rating Agencies to ensure they meet the international code of good practice, particularly to prevent unacceptable conflicts of interest.

5 Implications of Global Crisis for Ghana

So far, the turbulence has been an industrial country phenomenon; LDCs have not been at the centre, at least for now. The impact on LDCs such as Ghana would be through lower global growth with domino effect on developing countries' economic performance (real GDP growth), declining external demand for Ghana' exports, falling commodity prices, drop in remittances and higher-priced financial flows from the international capital markets.

5.1 Implications For Real GDP Growth

Although the global economy and the industrialised economies have been experiencing GDP growth rates with increasing unemployment, performance of the economy of Ghana is still robust, and the growth trajectory that emerged some five or so years ago still continues. For 2007 and 2008, real GDP growth rates were estimated at 6.3% and 6.2%. For 2006, the growth rate was 6.2%. Hence, Ghana's economic growth appears not to be impacted adversely by the crisis to the point of derailing the growth trajectory, so far.

5.2 Commodity Prices and Export Performance

The prices of Ghana's major exports are still holding out in the face of weakening global economic growth and falling prices in manufactured products. Total export earnings for 2008 were estimated at US$5,275.33 million, up by 26.4% from the 2007 level. Cocoa exports rose from US$975.7 million in 2007 to US$1,239.65 million in 2008, which is some 67% increase. This was mainly on account of increases in both volumes exported and realised export prices. For gold, export earnings increased by 29.6% from US$1,733.78 million in 2007 to US$2,246.25 million in 2008. The growth in value was due to the combined effects of price and volume as average realised prices went up by 25.8% and the volume of exports increased by 4.06%. The value of exports of timber products also improved considerably to about US$309.0 million, from the US$249.0 million recorded in 2007. While average prices increased by 17.64% to US$554.09 million per cubic metre, the volume went up to 557,663 cubic metres, which is an increase of 5.5%. These good performances of export earnings suggest a lagged effect of the global crisis on Ghana's exports or that the market is taking a flight into commodities. Whichever of these options holds, Ghana must start looking inwards to "domesticate" cocoa and gold as linkages to the industrial sector

5.3 Exposure of Financial Sector and Implications for Ghana Stock Exchange

Fortunately for Ghana, its financial exposure to the global economy is limited. On the part of the private sector, especially the banking system, the possible direct links to the global financial crisis by Ghanaian banks continue to be exposure to counterparties in the form of correspondent balances and placements with overseas banks. Deposit Money Banks (DMBs) correspondent balances at the end of December 2008 were 55.46% of networth of banks, which exceeds the 48.12% in 2007. These exposures are within the internationally acceptable prudential limits. As regards the Ghana Stock exchange, the crisis can only also adversely affect it when foreign investors decide to liquidate their shares. However, this appears not to be the case yet as the Ghana Stock Exchange (GSE) has continued to perform creditably. Indeed, the Bank of Ghana and GSE regulatory framework is strong enough to pre-empt unprecedented attacks on the GSE to disrupt it.

5.4 Effects on Remittances

As massive job cuts occur in the industrialised countries, Ghana will not remain unaffected by declining remittances. Remittances flows to Ghana have been increasing over the years, from US$0.717billion in 2001 to US $1.83 billion in 2007 and US$8.7 billion in 2008. The significance of remittances in Ghana's macro-economy and micro-economy cannot be overemphasised. Remittances are used to shore up external reserves and manage exchange rate stability. They are also micro aids to dependants, whose poverty profiles would have been worse without them. NGOs and charities, which are beneficiaries of remittances have already scaled down their activities and shed labour. Many of the real estate and constructional activities taking place are from remittances. Consequently, any significant reductions in remittances will have adverse effects at both the macro and micro levels of the economy.

5.5 Lower Budgetary Support through Official Development Assistance

Official Development Assistance to Ghana is a critical source of closing Ghana's resource gap. Within the Multi-Donor Budgetary Support (MDBS) framework, the development partners provide about 20% of Ghana's annual budget. Indeed, virtually all major capital/development projects in Ghana are undertaken with donor assistance. Any reduction in donor inflows would therefore adversely affect Ghana's development agenda. It is therefore heart-warming to note that the G20 has pledged some US$1.1 trillion for the IMF to be used in financing low income countries faced with the adverse effects of the crisis. However, it has yet to be seen if this money is actually going to be disbursed; this is the critical challenge for Ghana and other such developing countries.

5.6 Implications for Ghana's Chances to Borrow from the International Capital Market

In 2007, Ghana issued sovereign bonds to raise US$750million dollars from the international capital market. This facilitated closing of the financing 2008 fiscal gap. With the global crisis, access to international financing of fiscal gap has become extremely difficult and on unaffordable terms. Government's attempt to raise US$300 million loan from the international capital market to cover debt absorbed from the 70% stake in Ghana Telecom sale to Vodafone for $900 million was aborted because of stringent market conditions including some 27% cost of credit. Clearly, the resort to the international capital market to finance fiscal deficits is no longer a viable option under the prevailing global crisis condition.

6 Ghana: What To Do and Not To Do

Ghana has been able to weather the storm so far because of the limited integration of the economy in the world market. This cannot continue especially as government's development agenda envisages export-led growth strategies, which necessarily calls for macroeconomic stability.

Government would have to get more serious with macroeconomic management if investors, both foreign and local, are to be attracted into the country. Risk adverse investors will increasingly discriminate against weak policies. Macroeconomic stability for growth entails judicious fiscal management. The fiscal slippage of 15% of GDP in 2008 was what engendered the acceleration of inflation and exchange rate instability, which are both bad for investor confidence. Monetary policy should be disinflationary and should not accommodate expansionary fiscal excesses.

Government should develop plans for adjustment to potential shortfalls in external financing, especially by exacting value for money on the expenditure side, and curtailing revenue leakages through administrative efficiency. If Ghana must go to the IMF/World Bank, it must be prepared with well-thought out programs underpinned by strong economic arguments, just as the East-Asian tigers did in their negotiation strategies.

The use of cheap money policy is not a viable option for now. The industrialised countries are fighting consumption deficiency while in Ghana the problem is low savings with investment deficiency. The securitisation problem that precipitated the crisis is not part of Ghana's financial superstructure. Financial stimulus or fiscal stimulus that instigates further consumption is not desirable and would rather send wrong signals to investors.

The regulatory authorities should learn from the policy mistakes of the industrialised world; the market with invisible hand will always work but may do so at times by strangulation. Consequently, the regulatory and legal environment must be strengthened to ensure that market failures are promptly dealt with.

Bank of Ghana should enhance the capacity of the deposit money banks to develop financial products that would enhance intermediation of remittances and other inflows.

Furthermore, the regulatory authorities and policy makers must, expeditiously, work on the removal of costs of doing business to the private sector to enhance private sector competitiveness.

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