

is that rather than using aid for current consumption it is vital for it to be used in infrastructure development or invested in other ways so as to lay the foundation for higher growth in the economy. This is particularly important since the global trend in aid disbursements is downward. In order that the economy not be overtaken by events, it is appropriate to adopt strategies for reducing aid intensity and hence dependence by continuously improving the institutional mechanisms of aid delivery.

The study reinforces the importance of a conducive policy environment. This shows up in the relationship between aid and the positive growth in macroeconomic variables such as exports. The parallel market premium was also shown to have an appreciating effect on the real exchange rate, indicating the need for continuing policies that minimize the over-valuation of the exchange rate and ensuring that markets are well-aligned. The government should endeavour to maintain a sound policy environment so as to elicit good macroeconomic performance. Policy management thus needs to focus on ensuring the prevalence of sound macroeconomic fundamentals, among others. This will help to create the appropriate incentive structure and conducive environment necessary for the enhanced performance of industry, which should be a major engine of economic growth. With a good policy environment, external aid could be an effective investment in the Ghanaian economy and could spur the realization of the country's vision of becoming a middle-income country.

EXTERNAL AID INFLOWS AND THE REAL EXCHANGE RATE IN GHANA

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EXECUTIVE SUMMARY

Context

Since the early 1980s when Ghana began measures to halt the downturn of the economy and move on a path of sustained growth and development, the country has attracted tremendous donor assistance. From about 4% of GDP in 1980, official development assistance rose to 10% in 1990 and has generally remained at that level ever since. This overwhelming dependence on external aid inflows has made the Ghanaian economy vulnerable to policy conditionalities that accompany such assistance.

What is the problem?

Depending on whether aid inflows are temporary or permanent, and whether they are spent on imports or domestically produced goods and services, they have various repercussions. The real exchange rate, by virtue of its impact on the international competitiveness of an economy, assumes an overriding importance among policy variables in Ghana. Surges in external aid inflows are believed to cause "Dutch disease" problems for Ghana's macroeconomic management. This study seeks to understand how Ghana's export performance interfaces with the policy environment. It attempts to see whether external aid, serving as a proxy for the policy environment, elicits positive macroeconomic performance from such variables as exports. The study uses an econometric model to analyse the real exchange rate in Ghana, and links

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this analysis with export performance in order to identify policy implications and management issues.

Ghana's aid history

Ghana embarked on a major economic recovery programme in 1983, and except for a few slippages, economic performance has generally been encouraging. Real GDP growth has been round 5% on an annual basis and real structural transformation appears to be taking hold. In relative terms, for example, the agricultural sector, which has been the leading sector contributing no less than 45% of GDP has declined, while an increase in service sector activity is pervading the production structure of the economy. However, the service sector is dominated by the wholesale and retailing subsector and is to a large measure a non-tradeable sector. The industrial sector still appears to be struggling to make an imprint on the economy.

Historically, external aid has been an important feature of the Ghanaian economy, and even more so since the advent of structural adjustment. Ghana's major bilateral donor partners are Japan, UK, USA, Canada, Germany and the Netherlands. The International Development Association is the primary multilateral donor. The aid is multi-purpose. During the 1980s commitments to the production sectors of the economy (defined specifically in this context as agriculture, industry, mining, construction, trade, tourism and banking) benefited most, receiving an average of 29% of overall aid flows. Programme assistance generally amounted to 21%. Development of economic infrastructure took 25% and contributions to social infrastructure and services accounted for only 8.8%.

During the 1990s the support for social infrastructure and services jumped to 28% and economic infrastructure and services to 34.5%. The contribution to the production sectors declined to 14.5% and programme assistance to 15.7%. The relatively large commitments of aid to economic and social infrastructure in the 1990s conform to the general global consensus and World Bank position that infrastructure development is a prerequisite to socioeconomic development.

Actual disbursements of aid have in the past been known to be very slow, often being less than initial expectations. Between 1983 and 1988, the actual disbursement ratio of programme aid was 43%, while that for project aid was 35%. Reasons for these disparities include structure of commitments, delays in commitment translation, and implementation problems of both donors and recipient. And as the structure of aid commitment gets skewed towards project aid as opposed to quick disbursing programme support, as well as food and commodity assistance, the tempo of disbursement is reduced.

The cumbersome nature of procedures, especially for procurement, also tends to contribute to slow disbursement of multilateral aid. In recent times, however, there has been an increase in disbursement ratios for both programme and project aid. Actual disbursement of IDA programme aid to Ghana was 91% while that for project aid was 58% of pledged commitments.

Exchange rate movements and aid dependence

Two dimensions of the exchange rate are important here. The real exchange rate measures the relative price of domestic goods in terms of foreign goods. The real effective exchange rate measures the degree of competitiveness of the country relative to a group of its trading partners. For Ghana, it compares movement in the cedi with the currencies of a selection of trading partners.

In general for Ghana, both the real exchange rate and the real effective exchange rate have tended to move in the same direction. The real exchange rate changed over time depending on whether inflation was more or less rapid in Ghana than in the USA (or other major trading partners). Failure to adjust the official exchange rate in line with deteriorating prices strongly appreciated the real exchange rate and led to the emergence of a flourishing black market. The appreciation of the real exchange rate also shifted relative incentives away from exports into import trade with adverse effect for Ghana's current account balance. Inflation remains a problem, and so is exchange rate misalignment. Since the mid 1980s, however, there has been a trend towards exchange rate depreciation.

The concept of aid dependence has both quantitative and qualitative aspects. On the one hand, it refers to large inflows of external assistance, and on the other it suggests that the country itself is not contributing significantly toward self-sustaining development in spite of the continuous aid. In short, aid dependence can be perceived as a situation in which the country becomes overly dependent on aid inflows for its survival. As can be concluded from the high aid intensity indicators in the 1990s (notably aid/GDP ratio of 11%; aid/imports ratio of 43%; and aid/investment ratio of 61%), Ghana can be called rather heavily aid dependent.

The study concludes that terms of trade, aid inflows, government consumption, commercial policy stance and technological progress are the salient variables in Ghana's long-run equilibrium real exchange rate model. In the short run, however, the key variables are nominal exchange rate together with all the real fundamentals with the exception of terms of trade. The results show that external aid inflows have a significant impact on the real exchange rate. However, unlike the situation in some other countries, in Ghana aid inflows lead to depreciations of the real exchange rate rather than appreciations. Generally, depreciation in the real exchange rate positively affects export performance. This suggests that improvements in the policy environment would elicit a favourable response from non traditional exports (defined as non-cocoa, non-gold exports).

Implications for policy makers

In Ghana's search for economic renewal, accelerated growth and poverty reduction, the real exchange rate and its interplay with external aid inflows are crucial to strategic economic decision making and efficient policy management. With the current high aid flows into Ghana, it is obvious that any curtailment of these inflows could have adverse effects on the economy. One implication for macroeconomic management