Bank of Ghana
Monetary Policy Report

Inflation Outlook & Analysis

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4.0 Overview of Global and Domestic Economic Conditions

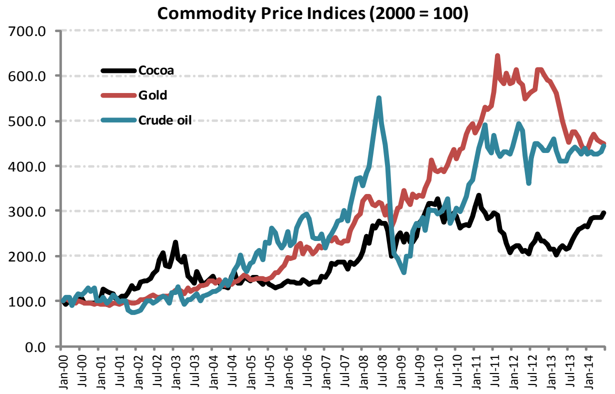
Global growth moderated in the first quarter following harsh weather conditions in the US and financial market volatilities across some emerging and developing countries. In the April *World Economic Outlook*, the IMF projects global GDP growth at 3.6 percent in 2014 from 3.0 percent in 2013 with much of the growth impetus coming from advanced economies. In particular, growth in advanced economies is projected at 2.2 percent (about 1% higher than 2013) while emerging market and developing economies are projected to growth at about 5 percent (4.7% in 2013).

On the international commodities market, price developments were mixed in the first half of the year. Gold prices were bearish hovering around US$1,300 per fine ounce while cocoa prices have improved to about US$3,000 per tonne. In the outlook, gold prices are expected to remain flat on account of liquidity needs by emerging market central banks and continued global disinflation. Cocoa prices are projected to remain bullish boosted by increased demand as the global economy picks up and an anticipated global deficit in the 2014/15 season. Crude oil price trends on the international market moved up marginally to US$112 at end June 2014 from US$111 at the end of 2013. This notwithstanding, prices of domestic petroleum products have increased significantly in the first half of 2014 mainly reflecting volatilities in the foreign exchange market. The domestic petroleum price upward adjustments have ranged between 13.9 – 29.2 percent during the first half of the year.

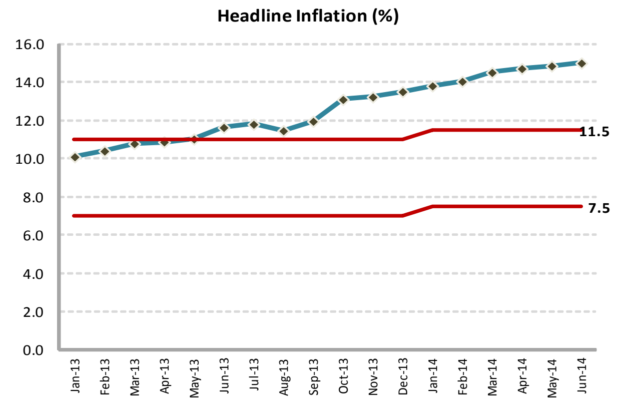
Foreign exchange market volatilities moderated somewhat in the second quarter of 2014 while the local currency depreciated at a slower pace relative to the first quarter. The local currency depreciated by 8.8 percent against the US dollar in the second quarter, compared with 17.6 percent depreciation in the first quarter. Cumulatively, the Ghana cedi has depreciated by 26.7 percent against the US dollar during the first half of 2014 against cumulative depreciation of 3.4 percent in the same period of 2013.

Fig. 1: Developments in H1 2014

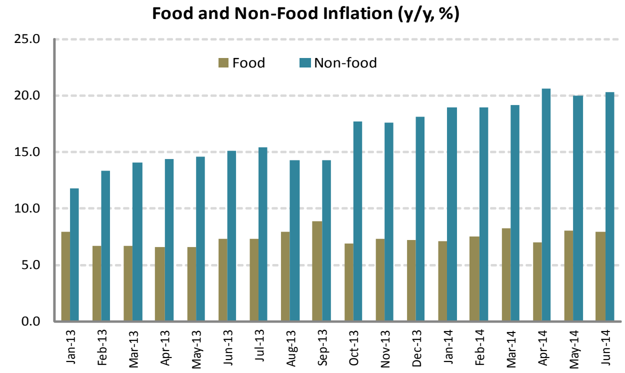
Cocoa prices rebound strongly….



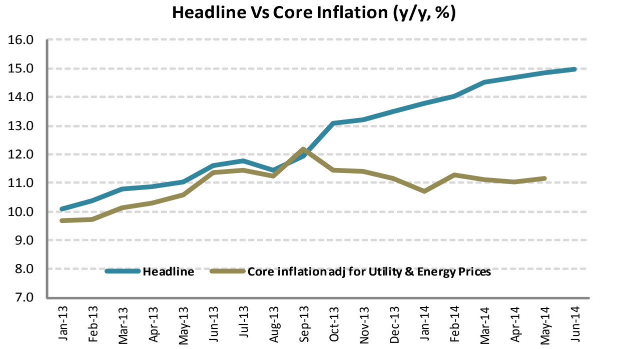
Headline inflation drifted further away from the target band



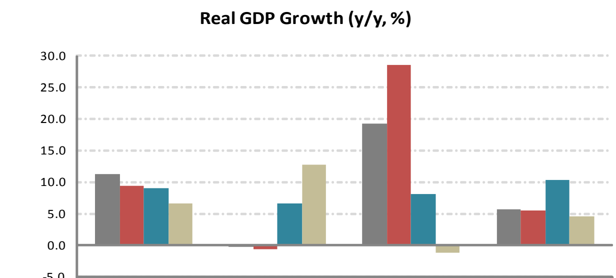
Non-food is the major driver of Inflation



Widening gap between headline and core inflation indicative of SS-side pressures

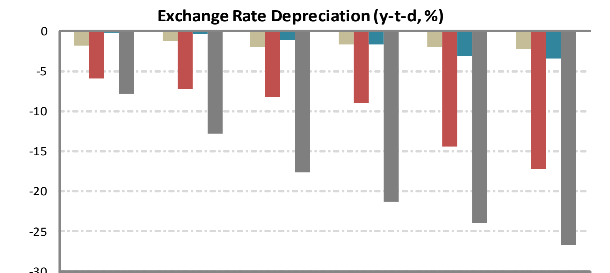


Real GDP growth moderates slightly in Q1 2014



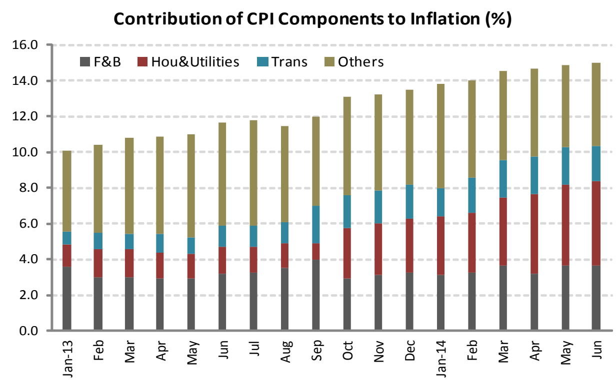
	Real GDP	Agriculture	Industry	Services
Q1-11	11.2	-0.1	19.2	5.8
Q1-12	9.4	-0.7	28.6	5.5
Q1-13	9.0	6.7	8.1	10.4
Q1-14	6.7	12.7	-1.1	4.6

Significant depreciation in the exchange rate

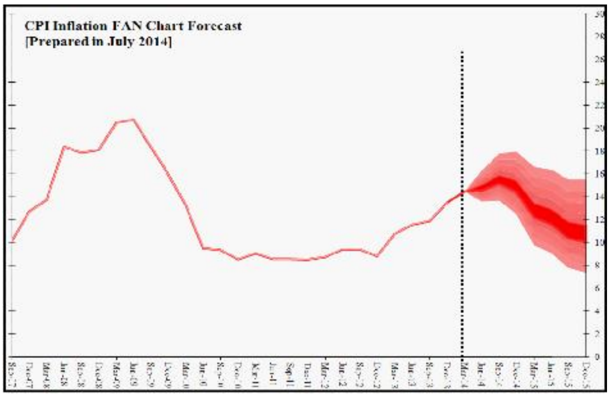


	Jan	Feb	Mar	Apr	May	Jun
2011	-1.8	-1.3	-1.9	-1.6	-1.9	-2.2
2012	-5.9	-7.3	-8.2	-9.0	-14.4	-17.2
2013	-0.2	-0.3	-1.1	-1.7	-3.1	-3.4
2014	-7.8	-12.9	-17.6	-21.3	-24.0	-26.7

Housing and Utlities contributed significantly to inflation



Fan Chart shows headline inflation will track back to target range by end 2015



In the latest release by Ghana Statistical Service (GSS), real GDP growth was provisionally estimated at 6.7 percent in the first quarter of 2014 compared with 9.0 percent growth a year earlier, indicating some moderation in the pace of economic expansion. The first quarter growth was largely driven by the Agricultural sector with a year-on-year growth of 12.7 percent followed by Services (4.6%) while Industry contracted by 1.1 percent. Alongside the slowdown in economic activity, the Bank's latest surveys conducted in March and May 2014 showed further softening of both business and consumer confidence. The survey of credit conditions at the commercial banks also showed net tightening of credit conditions for most categories of borrowers including consumer credit, SMEs and during the second quarter of 2014.

Government fiscal operations over the first five months of 2014 recorded an overall budget deficit of 3.9 percent of GDP, compared with a projected 3.8 percent of GDP as both revenues and expenditures fell short of targets. The shortfall in revenue was higher than expenditures and attributed to the delay in implementation of some revenue measures outlined in the 2014 budget.

The domestic economy continued to witness inflation pressures in the first half year. CPI Inflation went up to 15 percent in June 2014, from 14.5 percent at the end of the first quarter and 13.5 percent at the end of 2013. These price developments were largely influenced by the pass-through of the currency depreciation, upward adjustments in the petroleum prices, and utility tariffs as well as demand pressures from the fiscal overruns. The analysis of contributions by CPI sub-components to overall inflation during the review period showed that utilities & housing, food and to a lesser extent transport costs were the major drivers of inflation. The contribution of other sub-components to inflation remained high, despite a marginal decline in the period reflecting the pressures from the demand side of the economy.

All the measures of core inflation continued to rise but at a slower pace than headline inflation particularly during the second quarter. Core inflation excluding energy and utility, rose from 10.7 percent at the beginning of the year to 11.1 percent at end March to 11.2 percent in June 2014. Further widening of the gap between the headline and the core inflation is indicative of continued pressures from supply-side factors.

4.1 Inflation Projection and Outlook

At the July 2014 meeting, the Monetary Policy Committee (MPC) decided to increase the Monetary Policy Rate from 18 percent to 19 percent to contain the elevated risks to inflation. This policy decision was underpinned by the following considerations:

- The unwinding of external sector imbalances appeared on track with relatively improved trade deficit during the first half of 2014. This was as a result of the significant slowdown in imports, particularly consumable imports and marginal improvement in exports. However, concerns on the external sector outlook included the softening of gold prices and declining production volumes, slower remittances and tightening global financial conditions. The continuity of these trends in the second half of 2014 would present significant risks to the external and fiscal outlook.

- On the domestic front, inflation continued to rise in the second quarter although at a slower pace than the first quarter but remained well above the target of 9.5 ± 2 percent. The widening inflation gap was due to a combination of factors including the pass through effects of the faster exchange rate depreciation and aggregate demand effects from the large twin deficits in 2012/2013 fiscal years. Also, the latest round of survey show heightened inflation expectations by firms and consumers driven mainly by faster depreciation of the cedi, rising inflation and energy challenges.

- While the pace of fiscal consolidation remains modest, certain pressure points have emerged such as delays in implementation of some revenue measures outlined in the budget; the postponement of switching from specific to *ad valorem* tax petroleum taxes and VAT on financial services; irregular adjustments of petroleum and utility prices; lower import volumes and lower tax revenues from the mining sector due to declining gold prices. All these intensify risks to the fiscal outlook, thus fiscal consolidation would have to be more aggressive in the second half year to achieve the fiscal targets for the year.

- Real GDP growth has moderated slightly on the back of macroeconomic instability and energy sector challenges. Prospects for growth in the second half year however remain positive and are expected to be supported by improved cocoa production in 2013/14 crop season and the addition of gas to the economy. On the downside, softened business and consumer sentiments, energy sector challenges, rising input costs, and sharp decline in imports may slow growth somewhat and partially offset the widening output gap in support of the disinflation process.

- The Inflation Fan Chart forecasts show the central projection, which is underpinned by the Bank's average forecast and underlying assumptions on the exchange rate, energy prices, monetary conditions and fiscal policy stance has further shifted. The outlook shows that inflation will slow down marginally during the third quarter but remain at somewhat elevated levels through 2014, with the central path subject to a high degree of uncertainty over the medium term. The central projection shows that inflation is likely to end the year around 15 percent and track back within the target range in the later part of 2015. This profile is expected to be driven largely by faster depreciation of the cedi and persisting fiscal pressures.

4.2 Assessment of Risks to CPI Inflation

There are uncertainties surrounding these 2014 inflation projections and key among them are the behaviour of the fiscal and exchange rate challenges and how these would filter through to the price movements in the economy. We itemise the major risks to the inflation outlook below.

- ***Fiscal vulnerabilities have increased***

The risks associated with government fiscal operations remain heightened heading into the second half of 2014 with lingering and emerging fiscal pressures. The fiscal situation is precarious, particularly with shortfalls in domestic revenues, deferment of some payments and increasing difficulty in raising financing from traditional sources.

In the outlook for the short-term, the major fiscal risks include non-implementation of the changeover of petroleum taxes to *ad valorem* from specific; postponement in the implementation of VAT on financial services; increased burden on the budget from higher subsidies due to delayed adjustments of utility tariffs and petroleum prices; non-disbursement of programme grants; and further worsening of the macroeconomic situation, partcularly currency depreciation and interest rate hikes.

- ***Heightened Exchange Rate Pressures***

The volatility in the exchange rate market moderated slightly during the second quarter of the year, but still significant to feed into expectations. Further depreciation of the currency in the second half year will pose significant risks to restoring macroeconomic stability and lessen the potential for inflation to track back within targets in the near term. However, expected proceeds from the cocoa syndicated loans and Eurobond in the third quarter is likely to provide some buffer to the foreign exchange market and boost reserve levels.

- ***Energy sector challenges***

The energy supply constraints in the early part of 2014 has eased somewhat but a recurrence could result in cost-push pressures as businesses seek alternative sources of energy and pass on the additional costs to consumers.

- ***Impact of Petroleum and Utility Prices Adjustments***

Prices of petroleum products were adjusted upwards within the range of 13.9-29.2 percent reflecting mainly the depreciation of the currency during the first half of the year. The pass through effects of the upward adjustments to the CPI basket has already taken effect, but underlying the current petroleum prices are subsidies which the government seeks to gradually eliminate. Again, a rebound in international crude oil prices as global growth gains momentum, together with further cedi depreciation, could instigate further upward adjustments with implications for inflation.

In addition to petroleum price adjustments, utility tariffs have also seen some upward adjustments. The recent increases of 12.1 percent for Electricity and 6.1 percent for Water will take effect from the beginning of the third quarter of 2014. These notwithstanding, there are outstanding tariff adjustments for Electricity (19.5%) and Water (3.4%) which was withheld due to the social implications of large tariff increases in the move towards full cost recovery. If these tariffs are implemented in the last quarter, it will add to the cost structure of businesses.

- ***Inflation Expectations***

The Bank's surveys conducted between March and May 2014 showed heightened inflation expectations of consumers, businesses and financial sector. This was prompted by the fast pace of currency depreciation and rising inflation and looking ahead, a concerted effort is required to dampen such high inflation expectations before it transmits to pricing of goods.

4.3 Conclusion

The overall risks to the inflation outlook are judged to be on the upside and inflation is expected to broadly remain elevated till the end 2014. The Monetary Policy Committee would continue to monitor these risks and the threats they pose to achieving price stability in the near term. Similarly, fiscal policy must keep within the budget targets to complement monetary policy to achieve inflation objective in the medium term.