



BANK OF GHANA

Monetary Policy Report

VOLUME 2 NO.1.

Inflation Outlook and Analysis

February 2010

Overview of World and Domestic Economic Developments

The global economy is recovering faster than previously anticipated with world growth bouncing back from negative territories in 2009 to a forecast of 3.9 percent in 2010 . On the domestic scene most of the key macroeconomic indicators improved in 2009 with inflation settling within target range in the year. On growth prospects the sluggishness that characterised economic activity during the first three quarters of 2009 gave way to a rebound in the last quarter.

There are signs that the world economy is recovering and coming out of recession. Though off to a stronger start than anticipated, the recovery is proceeding at different speeds in the various regions. In most advanced economies, the recovery is expected to remain sluggish by past standards, whereas in many emerging market economies, activity is expected to be relatively vigorous, largely driven by buoyant domestic demand. In the United States for example, the economy expanded at a 5.9 percent annual rate in the fourth quarter, reflecting stronger business investment and a greater contribution from inventories. The Eurozone economies grew on the average by 0.1 percent in the last quarter with growth in the United Kingdom registering 0.3 percent in Q4 2009.

While there is general consensus that the worst may be over in terms of the decline in the real economies, the outlook is still unclear. The recovery has been tagged as a 'jobless recovery' and a lot of nervousness exists in the major economies. Credit markets are beginning to function well, as the extraordinary stimulus measures and interventions in the financial system begin to take effect. Most of the economies are winding down on their quantitative easing and the focus is now on exit strategies.

On the international market, crude oil prices continue to exhibit volatility. After dropping to around US\$50 per barrel in the first half of 2009, prices rose steadily to around US\$76.0 per barrel by October 2009 and stabilised at that level till December 2009. In January 2010, prices declined to around US\$71.0 per barrel but has since edged up slightly supported on the

strength of global demand, especially from emerging market economies. However, this upward pressure is expected to be modest with analysts predicting an average price of US\$85.0 per barrel by the end of 2010.

On the domestic economy:

- [1] The Composite Index of Economic Activity (CIEA), which gauges the pulse of economic activity, declined by 2.1 per cent and 0.3 per cent in the first and second quarters of 2009. During the third quarter of 2009, the CIEA increased by 2.3 percent and by a further by 9.9 percent, during the fourth quarter of 2009, a remarkable recovery,. In year-on-year terms, the index, as at December 2009 had recorded a growth of 9.9 percent.
- [2] Surveys of businesses and consumers showed improved conditions. The index of business and consumer confidence has improved relative to conditions that existed during the survey conducted in October 2009 (which provided the background for discussions in November). The results of the most recent surveys conducted last month show that the overall assessment of economic prospects by businesses and consumers are strongly positive.
- [3] Provisional data through November 2009 indicate that Government budgetary revenues fell short of expenditures resulting in a cash deficit (on a broad coverage basis, including foreign financed capital expenditures) of GH¢2.1 billion (9.6 percent of GDP) compared with GH¢2.5 billion (14.0 percent of GDP) for the corresponding period in 2008.
- [4] The improvement of the fiscal situation has resulted in a reduction in the Public Sector Borrowing Requirement (PSBR) which has contributed to the reduction in Treasury bill rates. Between October 2009 and mid-February 2010, the benchmark 91-day Treasury bill rate went down by 8.4 percent to 17.4 percent. The 182-day Treasury bill rate declined by 10.0 per cent to 18.7 per cent.
- [5] Available information point to steady diminishing inflationary pressures. The rate of inflation which stood at 18 percent in October 2009 declined to 16.9 percent in November and then to 15.9 percent in December 2009. In January 2010, the Ghana Statistical Service

reported a further decline in the inflation rate to 14.8 percent. Of the 3.5 percent decline in inflation recorded since October 2009, 18 percent is attributed to food price changes while the remaining 82 percent is due to changes in non-food prices.

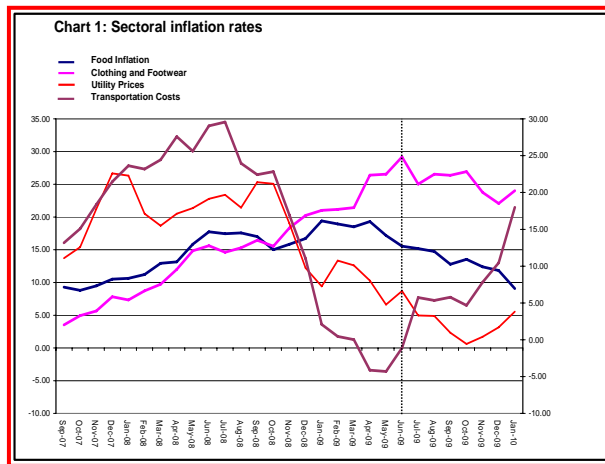
- [6] The merchandise trade deficit for 2009 significantly narrowed to US\$ 2.2 billion from the US\$ 5.0 billion deficit recorded in 2008. The developments in the trade account resulted in a lower deficit of US\$ 1.2 billion in the current account compared to the deficit of US\$3.5 billion recorded in 2008. With a surplus of US\$2.8 billion registered in the Capital and Financial Account an overall Balance of Payments surplus of \$1.2 billion was recorded in 2009 compared with a deficit of \$904.8 million in 2008.
- [7] As a result of the improvements in the external sector, the Gross International Reserves of the Bank of Ghana grew from US\$ 2 billion at the end of 2008 to \$3.2 billion. The reserve level of US\$3.2 billion at the end of 2009 represents approximately three months of current import cover compared to 2.1 months of import cover achieved at the end of 2008.
- [8] The favourable external environment continues to support the stability in the foreign exchange market that started in the third quarter of 2009. In year-on-year terms, the Ghana Cedi as at December 2009 had recorded depreciations of 14.8 percent, 22.4 percent and 16.2 percent against the US dollar, the pound sterling and the euro respectively. By the end of January 2010, the rate of depreciation (also in year-on-year terms) had slowed down to 10.2 percent, 20.7 percent and 15.6 percent against the US dollar, the pound sterling and the euro respectively.

Outlook for Inflation

During the last quarter of 2009 CPI inflation declined by 2 percentage points and continued in January 2010. The outlook is for the disinflation process to continue till the end of the second quarter of 2010. Given the state of the macroeconomic fundamentals and the risks in the outlook, inflation is likely to be within 7-11 percent by the end of the year. Looking ahead, the slowdown in the fall of the Ghana cedi, the continued fiscal consolidation process, the slowdown in aggregate demand pressures and the harvest season for major food staples during the third quarter of the year should improve prospects for reduced inflation.

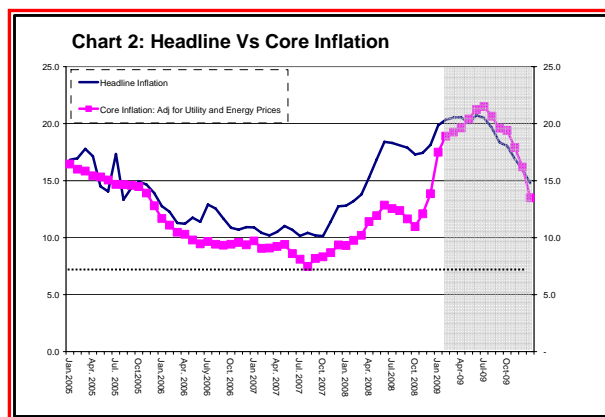
In line with expectations, CPI Inflation which started easing in the third quarter of 2009, continued through in the fourth quarter and into January 2010. CPI inflation by the end of January 2010 was 14.8 percent. At the end of the third quarter inflation was estimated at 18.7 percent. The decline in inflation has, in general, been broad based with the utility and

transportation subsectors being sources of inflationary pressures in the economy. As observed from chart 1, since October 2009, the utility sub-sector of the economy, , has witnessed subtle price increases. Inflation in that sector which was at -0.6 percent in October 2009 had risen to 3.8 percent by the end of January 2010. The factors driving prices, in that sector, are charges for rented accommodation, charges for household routine maintenance works and cost of liquefied petroleum gas.



The transportation sector has also witnessed price surges for some time now. Transportation costs alone went up from 10.5 percent at the end of December 2009 to 17.9 percent by the end of January 2010. Several factors have accounted for this; first, there have been petroleum prices increases in the past six months that have fuelled transport prices. Second, in January 2010, the Government increased road tolls which may have had some impact on transportation costs.

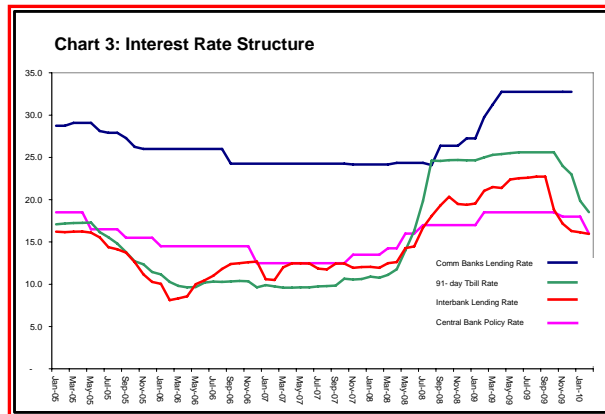
Along the declining path of headline inflation, the core measure of inflation, which excludes energy and utility price changes, also continues to ease but at a much faster pace. Between the end of the third quarter and January 2010, core inflation had declined by 6.1 percentage points,



moving from 19.6 percent at the end of September 2009 to 13.5 percent by the end of January 2010. Headline inflation over the same period declined by 3.6 percentage points moving from 18.4 percent to 14.8 percent. The current trends in core inflation suggests that underlying inflationary pressures may be easing at a faster pace (see chart2).

At the November 2009 meeting, the Monetary Policy Committee reduced the policy rate by 50 basis points and indicated that if inflation did continue on the downward path it would respond by reducing its key policy rate further. Since that meeting the economy has witnessed a rapid fall

in short term interest rates, especially the 91 day treasury bill rate. This rate which stood at around 24.0 percent in November 2009 has declined steadily to 18.5 percent by the end of



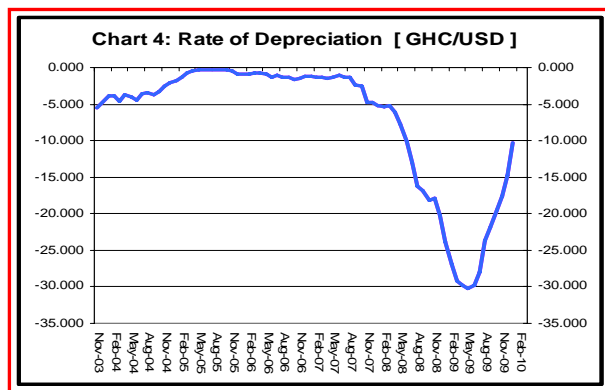
February 2009 and was driven by inflation expectations and a decline in Public Sector Borrowing Requirement (PSBR) of government. The inverted yield curve that pertained in 2008 is near correction now. With falling inflation expectations, investors are gradually moving towards the longer end of the bond market and the interest of non-

resident investors in the local bond market has re-emerged. With diminishing inflation and lower PSBR the markets may further to see further declines in this rate.

After assessing the risks in the outlook, especially factoring in a continuation of the disinflation process, improved economic fundamentals, exchange rate stability, a pick-up in economic activity and an improvement in business and consumer confidence, the Monetary Policy Committee reduced its Policy Rate by 200 basis points to 16 percent.

The challenge for monetary policy will be the extent to which these policy changes will be transmitted to the other sectors of the economy. It is the broad expectation that banks will respond by reducing their lending rates (see Chart 3, which stands, on the average, at around 33 percent) and allow for a restoration of credit growth in the economy and ensure a steady growth in output.

The combination of the sound macroeconomic environment and the favourable external



environment continues to support the stability on the foreign exchange market that started in the third quarter of 2009 with the exchange rate recording four consecutive months of appreciations against the US dollar. In year-on-year terms, the Ghana Cedi, as at December 2009, had depreciated by 14.8 percent, 22.4 percent and 16.2 percent against

the US dollar, the pound sterling and the euro respectively. By the end of January 2010, the rate

of depreciation (also in year-on-year terms) had slowed down to 10.2 percent, 20.7 percent and 15.6 percent against the US dollar, the pound sterling and the euro respectively. The continued stabilisation of the exchange rate during the past 6-months provide some stability as far as imported costs are concerned. If businesses choose to pass on these appreciations in the form of lower pricing then we should witness some rapid falls in non-food prices. If, on the other hand, they choose to stick to their old pricing mode, the prices are likely to remain sticky and the economy might not get the full benefit of the appreciation in the GHS/USD price movement.

The inflation outturn for December 2009 was within the target range of 12.5 – 16.5 percent. At 15.9 percent, the December 2009 inflation was in the upper band of the target range. The Central Path of the FAN CHART expected inflation shows a fall by 2.4 percentage points to bring the end 2010 inflation within the 7.2-11.2 percent target band. At 14.8 percent inflation is currently 3.3 percentage points above the end 2010 upper band of the target. With continued disinflation, inflation should be well within target by June 2010. The framework shows a small rise in inflation thereafter but overall inflation is likely to stay within the target range for the year. Policies would have to be reinforced to keep inflation within target.

Assessment of Risks to CPI Inflation

The risks to inflation are tilted on the downside as all the macroeconomic indicators seem to be pointing in the right direction for now and the expectations are that this will continue. However, upside risks could come from how economic agents would factor in past appreciations of the Ghana Cedi and how future increases in crude oil prices would affect inflation expectations. Possible utility tariff adjustment could also be an added risk in the outlook.

First, developments in key macroeconomic indicators show some stability. The imbalances that characterised the economy in the first half of 2009 have reversed and should help in the disinflation process. Inflation has stabilised, exchange rate volatility has reduced sharply, short-term interest rates are trending down and consolidation in the fiscal balances is still on-going, all supportive of a disinflation process.

Second, monetary and fiscal policies have worked to constrain aggregate demand pressures in the economy. Indicators like credit to the private sector, household consumption (measured through VAT collections) and the earlier sharp depreciations of the currency have all played out to constrain aggregate demand and should help exert downward pressures on prices.

However, there are uncertainties in the outlook which have a potential to affect the disinflation process and impact on inflation on the upside:

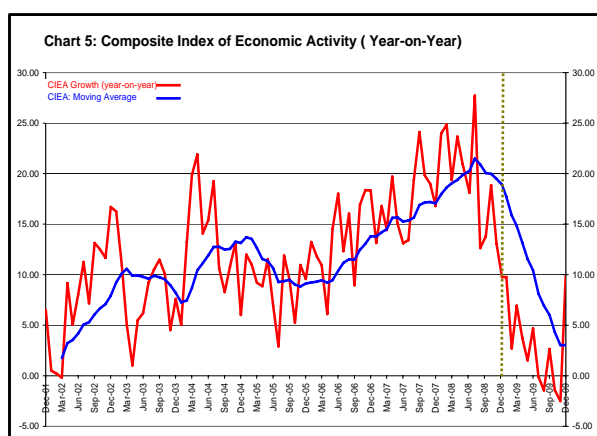
- The proposed electricity tariff increases and its impact on consumer prices. It is not yet clear, at this stage, what the magnitude of the increases would be. However, reports indicate that the increases could be anywhere around 100-110 percent. The issue at this stage is how these increases, when they come through, will affect the pricing behaviour of economic agents. If a greater proportion of the proposed increases is passed on as costs to consumers, inflation is likely to pick up.
- There are also uncertainties associated with crude oil price movements. Some market analysts have suggested that crude oil prices could top US\$85 per barrel in 2010. This will obviously have consequences on domestic petroleum prices which then will spiral to other commodity prices.
- In January 2010, the Government announced road toll increases in a bid to increase the revenue base of the budget. This toll increases which affects mainly transportation costs has been increased quite significantly. The move by government was an attempt to rationalize these toll rates which had remained unchanged for a very long period of time. It is not yet clear how this policy will feed into prices but already there is evidence that it has had some impact on transportation charges. The next three months should give a clear indication of its impact on food prices
- The resurgence of fiscal pressures over the long term as arrears are settled. There are outstanding Government payments (including statutory obligations) in addition to outstanding obligations of some public sector enterprises. These represent additional challenges that would need to be managed in a manner consistent with the macroeconomic framework. The economy will need a close alignment of public spending with budgetary resources in reinforcing macroeconomic stability.

The Monetary Policy Committee judges that the strength of the upside threats may not be enough to counter the downside factors and therefore conclude that the overall risks to inflation is tilted to the downside.

The Outlook for GDP Growth

The risks to growth are on the downside even though output has rebounded judging from information derived from the Composite Index of Economic Activity (CIEA). Current data suggests that economic activity recovered somewhat in the last quarter of 2009 as most of the indicators rebounded.

Data on the CIEA for the last quarter of 2009 show a significant rebound in economic activity. The Composite Index of Economic Activity (CIEA), which is used in gauging the trend of economic activity, declined by 2.1 per cent and 0.3 per cent in the first and second quarters of 2009. During the third quarter of 2009, the CIEA recorded a growth of 2.3 percent and by a further by 9.9 percent during the fourth quarter of 2009. In year-on-year terms, the index rose



by 9.9 percent (chart 5). Some of the sectors which contributed to the rebound of the index are in construction, port harbour activity, industrial consumption of electricity, imports and tourist arrivals

Indicators like sales of key industrial concerns and credit to the private sector weighed down on the index during the last quarter of the year.

Surveys on businesses and consumer sentiments show improved sentiments. The index of business and consumer confidence has improved relative to conditions that existed at the survey conducted in October 2009. The results of the most recent surveys conducted last month show that the overall assessment of economic prospects by businesses and consumers are strongly positive.

Based on the trends derived from the CIEA and other real sector indicators, real economic growth is expected to continue to slowdown. It is expected that although real GDP could potentially have slowed down significantly from what was observed in 2008, real GDP growth in 2009 is being estimated at between 5.0-5.3 percent. All the factors enumerated above point to a softening and unwinding in real sector conditions.

Conclusions

The overall risk in the short-term outlook for inflation is on the downside given the state of the economy and the direction of the macro indicators in general. Developments through the last quarter of 2009 and early 2010 suggest improved economic fundamentals driven by diminishing inflationary pressures, exchange rate stability, a pick-up in economic activity and an improvement in business and consumer confidence. The economy is responding to the policy initiatives of Government which have engendered improved business confidence and will help to anchor inflationary expectations. The outlook is for steady disinflation towards the target range of 7.2 -11.2 percent for 2010.