



BANK OF GHANA

Monetary Policy Report

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Inflation Outlook and Analysis

July 2008

1.0 Domestic Price Conditions

Developments in Headline Inflation, Q2 2008

The pace of inflation witnessed during the first quarter of 2008 was further elevated in the second quarter, pushing up prices in the economy and moving the disinflation path further from the target. The latest consumer price inflation numbers released by the Ghana Statistical Service (GSS) show that, headline CPI inflation, which stood at 13.8 percent in March 2008, increased to 18.4 percent in June 2008. Sub components which recorded significant jumps in inflation were Housing and Utilities (made up of rental charges for housing, water, electricity, gas for cooking and kerosene) which increased from 12.9 percent in June 2007, to 22.6 percent in December 2007, and was recorded at 19.1 percent in June 2008. Similarly, transport sector (which includes petrol and diesel oil) increased from 20.8 percent in June 2007, to 21.5 percent in December 2007, and further to 29.1 percent in June 2008. Food inflation increased by 4.8 percentage points to 17.7 percent while overall non-food inflation increased by 4.5 percentage points to 18.9 percent during the quarter ended June 2008.

Table 1: Sectoral inflation Rates (percent)

	Relative Importance	Inflation Rates (percent)					Absolute Change in Inflation		
		Dec-06	Jun-07	Dec-07	Mar-08	Jun-08	Mar-08 to June 2008	Dec-07 to June 2008	Jun-07 to June-08
Food & Non-Alcoholic Beverages	44.9	7.5	9.9	10.5	11.23	17.7	6.5	7.2	7.8
Alc. Beverages and Tobacco	2.2	18.0	13.8	8.4	10.09	14.4	4.3	6.0	0.6
Clothing & Footwear	11.3	7.6	0.9	5.9	6.65	12.8	6.1	6.9	11.9
Housing and Utilities	7.0	23.7	12.9	22.6	17.11	19.1	2.0	-3.5	6.2
Household Goods and Equipment	7.8	6.2	-0.5	10.1	12.91	18.2	5.3	8.1	18.7
Health	4.3	29.3	34.0	26.0	20.84	21.5	0.6	-4.6	-12.5
Transport	6.2	23.0	20.8	21.5	23.19	29.1	5.9	7.6	8.3
Communications	0.3	40.1	38.2	6.2	6.08	0.0	-6.1	-6.2	-38.2
Entertainment	3.0	15.9	20.0	9.9	11.32	11.8	0.5	1.9	-8.1
Education	1.6	6.2	2.1	13.3	14.59	19.6	5.0	6.3	17.5
Hotels, Cafes and Restaurant	8.3	14.3	19.5	14.6	15.27	22.2	6.9	7.6	2.7
Miscellaneous	3.0	17.1	16.1	10.4	11.99	11.9	-0.1	1.5	-4.3

The pace of food price increases during the second quarter was faster than that of non-food prices. The overall food inflation rose by 6.5 percentage points and items such as fish, bread and cereals, vegetables were mostly responsible for the increases. Non-food inflation however grew at a slower pace than food prices. Non-food inflation rose by 4.5 percentage points between March and June 2008. The influences on the non-food category were exerted by more by prices in the hotels, cafes and restaurants, clothing and footwear and transportation and utilities sector of the economy. The evolution of prices of the key volatile food items (which comprises around 25 percent of the entire food basket) will determine the extent to which food prices will rise in the coming months. The third quarter of the year is seasonally associated with major harvest for most staple food items. The combined effect of the potential impact of government's intervention policies and improved seasonal supply of most staples should ultimately result in attenuated price growth in the third quarter of the year.

Evidence gathered from the Bank of Ghana's urban price index for July 2008, suggests that the economy is likely to see an upward pressure on retail food prices again in July 2008. The urban price index gathered by these regional agents showed inflation going up by close to 1.2 percentage points, from 17.4 percent in June 2008 to 18.6 percent by July 2008. These agents however expect food prices to slow down with the onset of the major food harvest season and in the ensuing months

2.0 Business and Consumer Confidence

The latest survey suggests that uncertainty about developments in crude oil prices, rising inflation and surges in food prices softened business and consumer confidence. Businesses Inflation Expectations (BIE) suffered in June 2008 after rising for 3 consecutive surveys. Businesses perceptions on future costs are being affected by the persistent rise in crude oil prices. The main worry is on how these developments are likely to impinge on operations and implications on cost structures. Overall business confidence has shown signs of wane.

Overall consumer confidence went down by 4.3 points between the March and June surveys. Consumers expectations about higher energy prices as crude oil prices continue to soar and rising cost of household consumables weighed down heavily on overall consumer sentiments.

3.0 Core Measures of Inflation

Core inflation (defined to exclude energy and utility) continued to increase to reflect underlying inflationary pressures. Core inflation increased further to 12.8 percent in June 2008 from 10.2 percent in March; and 9.4 percent at the beginning of the year. The increase was exerted more by bread and cereals as well as fish prices and some volatile food items which are included in this measure of inflation.

	Dec-06	Mar-07	Jun-07	Sep-07	Dec-07	Jan-08	Feb-08	Mar-08	Apr-08	May-08	Jun-08
Inflation Measure											
CPI	10.9	10.2	10.7	10.2	12.7	12.8	13.2	13.8	15.3	16.9	18.4
CPI excl. energy and utility	9.4	9.2	8.6	8.2	9.4	9.3	9.8	10.2	11.4	11.9	12.8
CPI ex. Energy and utility and selected volatile food items	8.1	8.5	9.1	9.2	10.3	10.2	9.5	9.8	10.9	11.8	12.2
CPI ex. Energy and utility, selected volatile food items and Transportation	8.9	9.2	9.7	7.7	9.1	8.0	9.2	8.8	9.8	10.7	11.1
CPI ex. All Food items and Energy and Utility	7.3	5.8	5.6	4.3	3.1	5.1	5.3	4.1	4.6	4.8	4.6
CPI: HP Filtered	11.0	10.8	10.3	9.8	9.3	9.3	9.3	9.3	9.3	9.3	9.4

Highlights of movements in other core measures of inflation are as follows:

- i. INFXEUF, CPI inflation obtained by excluding selected volatile food items in addition to energy and utility items increased to 12.2 percent in June 2008.
- ii. INFXEUFT, CPI inflation derived by excluding Energy & Utility, selected volatile food items and transportation costs, also went up to 11.1 percent by the end of June 2008. It was estimated at 8.3 percent in April 2008.
- iii. INFSAFE (The all items CPI excluding price change effects of all food items in addition to energy & utility): This measure of inflation, although slightly down in the month of June 2008, went up within the quarter by 0.5 percentage points to 4.6 percent.

In sum, the core numbers suggest growing inflationary pressures in the economy. All the measures of core inflation have increased since the beginning of the year. Depending on

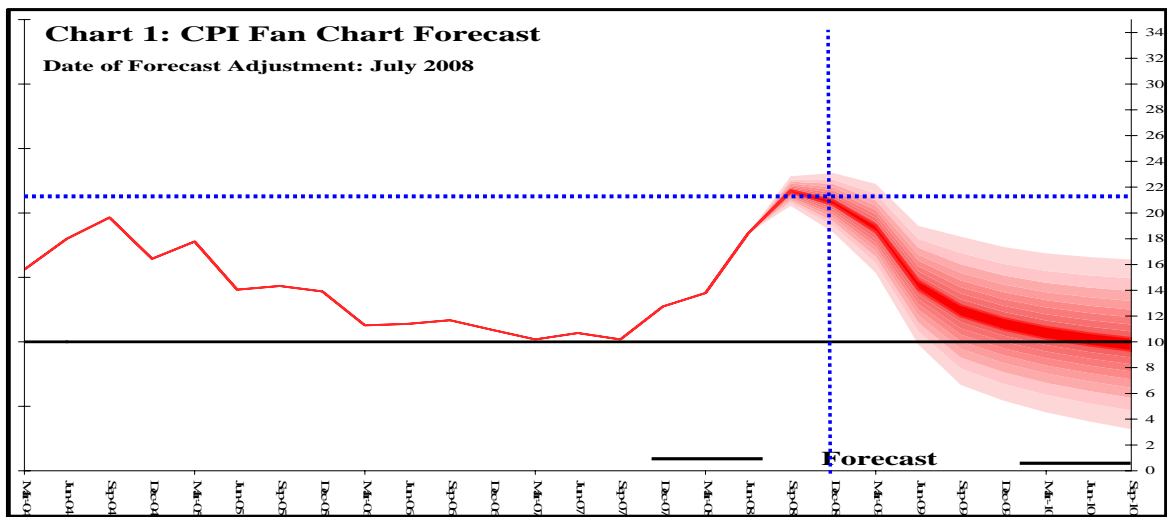
the measure of inflation being examined, these increases since the beginning of the year have ranged between 1.4 – 3.5 percentage points. This compared with developments in headline inflation which has registered an increase of 5.7 percent since the beginning of the year.

4.0 Inflation Outlook

Outlook for Inflation

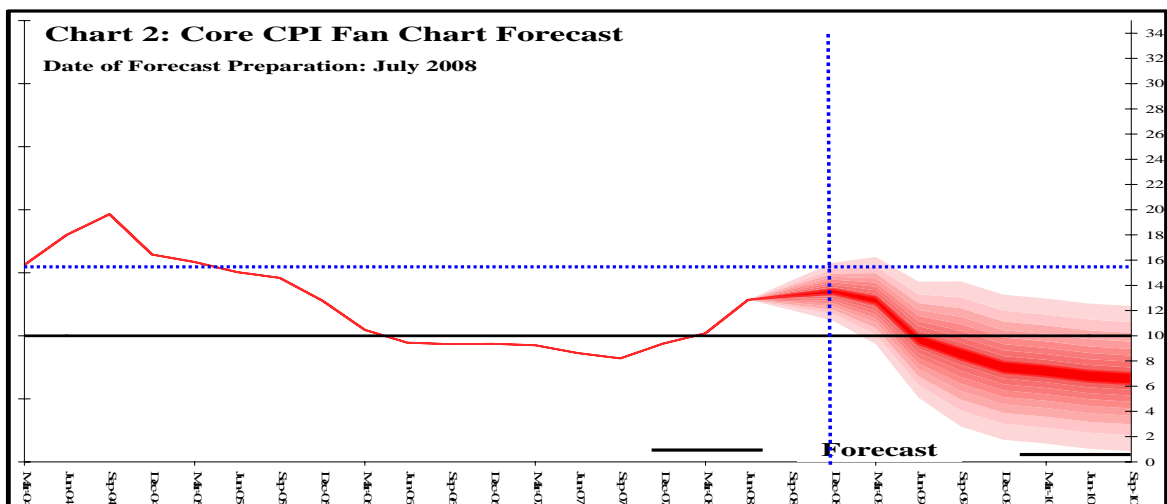
Since the last Monetary Policy Committee in May 2008, crude oil prices have increased sharply moving up by over 25 percent to around US\$145 per barrel. The increases have been driven by intense speculation amidst tight supply conditions, global demand and geo-political concerns and tight capacity. Current fears are that crude oil could reach between US\$200 – US\$ 250 per barrel within the next year. At the last projection round in May 2008, inflation seemed to pick up to 16.5 percent by the end of the second quarter, reflecting higher energy and import prices. Crude oil price was set at US\$120 and the exchange rate assumed relatively stable. These initial conditions implied a forecast of 17.5 percent for June 2008. It turned out to be 18.4 percent.

Chart 1 shows the staff's current assessment of the outlook for CPI inflation. At this forecast round, crude oil price assumption is moved to US\$150 per barrel. Real economic activity which has been sustained over the past few months driven mainly by increased credit to the private sector of the economy is expected to continue. The services, manufacturing and construction sectors have witnessed increased significant activity during the second quarter of the year and this is expected to be maintained during the third and fourth quarters of the year.



Under these and current conditions, the central path of inflation shifts upwards. The current form of the FAN CHART suggests a peak in inflation at around 21.0 percent in the third quarter reflecting the jump of 4.6 percentage points in CPI inflation in the second quarter. Inflation begins falling back through December and to within single digit, just around 10 percent, over a horizon of 18-24 months (end of the first quarter of 2010).

Under similar assumptions **core inflation** (defined as inflation derived by excluding price changes of energy and utility items from the consumer basket) rises further to 13.2 percent by the end of the fourth quarter of 2008 (see table 2 for core inflation series which is estimated at 12.8 percent for June 2008).



Core inflation then slips to 12.8 percent (Q1:2009) and then to 8.7 percent by the end of Q2: 2009. If current conditions remain as they are, 2009 could end with core rate of inflation at 7.5 percent. All these assume that there will be some monetary tightening and that the economy would not be burdened by further increases in crude oil prices.

5.0 Assessment of Risks to CPI Inflation

(1) Inflation Expectations

Inflation expectations have risen significantly over the past few surveys. The recent survey round conducted in June show further pick up in inflation expectations. Businesses expectations of inflation have moved up from 12.1 percent at the April survey to 14.4 percent during the June survey. If households' and businesses' medium-term inflation expectations are heavily influenced by their recent experience, then repeated upward surges in headline inflation may cause these agents to place weight on the assumption that inflation will be persistently high. Those expectations would be factored into higher wages and prices, which would embed inflationary pressures in the economy. Employees may demand higher wages which could affect the way businesses price their services and hence impact on inflation in the short-medium term.

(2) Import Prices

World inflation has increased sharply. Inflation in the Eurozone, the United States and Asia have all gone up. While inflation in the Eurozone and the United have more than doubled, that for China's has moved up significantly from 3 percent to 7.2 percent (end May 2008) . Given the increased influence of China in world trade, there is the likelihood that China will export its inflation to the rest of the world is high and this could compound the already high inflation rates that the world is confronted with currently. Trade between China and Ghana has also increased significantly in the past few years as most durable goods are increasingly being imported from china. This situation could also feed into inflation in Ghana in the near future.

One factor behind the rise in import prices has been Ghana Cedi's faster and steady depreciation since September 2007. Since September 2007 the cedi had depreciated against the three major currencies (dollar, pounds sterling and Euro) by 8.0 percentage points in nominal effective trade weighted terms and we could have a spill over into import prices over the next 6 months.

(3) Economic Relief Measures Announced by Government

During the second quarter, government announced certain economic policy measures designed to mitigate the inflationary impact on consumers of rising crude oil prices and

steep increases in food prices. The policy measures which were announced in May 2008, involved removing certain tax elements on basic consumable commodities.

While the tax measures are expected to provide relief to consumers at an estimated budgetary cost of GH¢92.0 million (or 0.7 percent of GDP) and they could also generate some fair amount of stimulus to the economy. The impact of these measures however may take some time (probably 2- 4 months) for its effects to be direct felt in consumer prices.

6.0 The Balance of Risks

Considering the factors discussed above, there are significant risks to inflation in both directions with considerable uncertainty about the strength of demand and output growth. Weaker demand growth would reduce risks to inflation over time through a higher margin of slack in the economy. A pronounced tightening in the supply of credit and pressures exerted by higher energy and import prices on real incomes could weigh down on inflation. Also, the mitigation package announced by government might help tone down the pace of consumer price increases though the impact of this policy measure is uncertain as to its magnitude and duration. The upside risk is that if the factors enumerated as contributing to higher inflation could materialize this would raise medium term inflation expectations. In the present circumstances, both upside and downside risks could significantly affect the outlook beyond the horizon of the fan chart.

On the whole, growth momentum in the economy has been sustained with activity proceeding above trend, and with strong demand growth driven by exports, and fiscal stimulus. The banking system remains liquid with credit expansion at high levels all pointing to prospects for continued growth at a robust pace.

The risk in the outlook for inflation is on the upside given the uncertainties associated with oil prices. The current rise in inflation has pushed up the disinflation path further from the target in the horizon, and monetary policy needs to be vigilant to avoid a build-up in inflation expectations.