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PRESS RELEASE

Bank of Ghana's Response to Inflation Crisis Largely in Synch with IEA's Expectations

The Monetary Policy Committee (MPC) of the Bank of Ghana (BoG) held its 106th meeting during May 18-20 to respond to Ghana's inflation crisis. Inflation has been sweeping the globe as a result of the disruption of supply chains by the pandemic and the effect of the Russia-Ukraine war on prices of fuel and food. And Ghana has had its share of the crisis as inflation rose sharply in April to 23.6%, the highest in eighteen years and the eleventh consecutive monthly increase. The cost of living has risen sharply across the country, with the prices of almost all goods and services experiencing marked increases.

Ahead of the MPC meeting, the IEA published an article stating its expectations. The IEA noted that at the MPC's last meeting in March, the Committee raised its benchmark Policy Rate (PR) by 250 basis points, bringing the cumulative increase during the past year to 350 basis points. However, the policy tightening had so far not been able to slow down the inflation. Noting that the MPC bases its PR decision on how it perceives the balance of risks between inflation and growth, the IEA argued that, in light of a fledgling recovery from the pandemic, growth should not be an immediate concern to the MPC, and that inflation posed the greater risk. **The IEA is pleased to note that the MPC came to the same conclusion when it declared that: "...with the strong rebound in growth......, the balance of risks is clearly on inflation."** As to by how much the PR was to be raised, the IEA posited that consideration should be given to: i) The wide gap between the PR (17.0%) and inflation (23.6%); ii) The policy tightening by major central banks, which increases the risk of foreign currency outflows from developing and emerging market economies and which could put renewed pressure on the *cedi*; and iii) The increase in the PR by as much as 250 basis points at the last MPC meeting, an increase that might not have exerted its full impact. Taking all of these factors into consideration, the IEA suggested that the MPC should increase the PR by another 200 basis points to 19.0%. **Here also, the IEA takes comfort in the fact that the MPC agreed with it on the quantum of the increase and raised the PR by 200 basis points.**

The IEA noted, however, that the Inflation Targeting (IT) framework that the BoG has used since 2007, had limitations in a developing country like Ghana that needed to be recognized. First, the transmission of the PR is constrained by an under-developed and less-responsive financial sector. Second, and perhaps more important, is the fact that Ghana has a long history of inflation with strong supply or cost undercurrents, in particular, food, fuel and the exchange rate. Therefore, as an essentially demand-management tool, the IT framework is less suited to Ghana's type of inflation. It is rather suited to mature economies where inflation tends to be more demand-driven. The IEA buttressed its argument about the influence of fuel, food, and the exchange rate by pointing to the fact that Transport inflation (33.5%), Food and Non-alcoholic Beverages inflation (26.6%), and Housing, Water, Electricity and Gas inflation (25.0%) were much higher in April than the average inflation of 23.6%.

The IEA observed that a principle underlying the IT framework is that it mitigates the second-round inflationary effects of initial supply or cost shocks in addition to anchoring inflation expectations. However, to be effective, these supply or cost shocks must be transient in nature. In the Ghanaian context, however, the supply or cost shocks are entrenched, thereby rendering the IT framework less effective. Strict reliance on the IT framework alone should, therefore, be avoided, as it will not be the solution to Ghana's inflation persistence. In view of the limitations of IT in the Ghanaian context, the IEA called for a more comprehensive approach in stemming inflation on a durable basis. In particular, the IEA urged the BoG to engage with Government and relevant agencies to target directly the key sources of inflation pressures, in particular, fuel, food, transport and the exchange rate.

For fuel, the IEA suggested that the country should be prepared to mitigate price shocks that may occur due to geopolitical developments. This will require BOST to maintain strategic reserves that could be released to cushion pump prices in the midst of shocks. Government should also be ready to use some of its windfall earnings from higher oil prices to cushion domestic prices and also suspend or reduce some of the numerous fuel taxes and levies amidst oil shocks. The BoG did not directly address this call.

Regarding food, the IEA stressed the need to increase production and ensure storage and preservation of excess produce especially during the peak seasons so that buffer stocks may be released to cushion prices amidst shocks and during the lean seasons. In the Q&A Session of the MPC press briefing on 23rd May, the Governor indicated BoG's recognition of the supply-side influencers of inflation and the Bank's readiness to support, in particular, agriculture and food production to cushion prices. To this end, the Governor said the Bank previously provided seed money to the Ghana Buffer Stock Company to support food storage efforts. It is obvious, however, that such intervention needs to be sustained to achieve durable outcomes. It is worthy of note, here, that the IMF recently called on countries to provide food subsidies to cushion high food prices for their citizens. The IMF, as we all know, is not a fan of consumer subsidies. Therefore, for it to call for food subsidies at this time highlights the need for a visible state hand to intervene to deal with what is obviously a non-conventional global development.

For transport, the IEA suggested that the public transport system should be improved and the availability of intra- and inter-city public transport increased. The public transport system should be subsidised to cushion the masses that mainly use it. The BoG did not directly address this call.

For the exchange rate, the IEA stressed the importance of leveraging capacities and opportunities for earning foreign exchange, including through greater processing of export commodities and increasing earnings from natural resources. The institutional and legal framework regarding remittances should also be reinforced to promote inflows from the Ghanaian diaspora. At the same time, demand for foreign exchange should be curtailed through policies that promote production of import substitutes domestically. Notably, the BoG reported that Gross International Reserves (GIR) had dropped to US$8.34 billion (or 3.7 months of imports) as of end-April from US$9.70 billion (or 4.3 months of imports) as of end-December 2021. This should be concerning and, apparently, reflects the heightened intervention by the Bank in the market to mitigate the pressure on the *cedi*, as well as, as the Governor admitted during the Q&A Session, the fact that Ghana was finding it difficult to access the international capital markets due to its recent sovereign downgrade. Meanwhile, responding to a question regarding the Government's recently-announced intention to seek US$2 billion international funding to support the *cedi,* the Governor said this was still pending. The Governor did not also provide any definitive position on Cocobod's syndicated loan that also traditionally provides support to the *cedi.* The IEA wishes to state, however, that it does not believe that borrowing periodically to prop up the *cedi* is a viable option, given the potential future reverse foreign exchange outflows as the loans are repaid.

The IEA indicated in its statement that in addition to the supply or cost drivers of inflation, fiscally-fuelled demand was also an important driver. The IEA, therefore, stressed the importance of institutionalising fiscal discipline, including through adherence to the Fiscal Responsibility Act that limits the deficit to 5% of GDP, so that the demand side of inflation can also be restrained. The BoG reported a deficit of 2.6% for the first quarter, compared with the target of 2.3%. The 2.6% deficit, however, excluded energy and financial sector costs. The public debt was also reported to be GHc391.9 billion (or 78.1% of GDP) at the end of March compared with GHc351.8 billion (or 76.6% of GDP) at the end of December 2021. It is not clear, however, whether the debt figures included the energy and financial sector costs. The IEA has maintained that these costs must be fully reflected in both the fiscal deficit and debt figures so that the true levels are known and that we have consistent figures across all relevant institutions. The IMF is also believed to hold a similar view. The Governor mentioned in the Q&A Session that both fiscal and monetary policies were working in concert to control inflation. The IEA has repeatedly called for collaboration between the fiscal and monetary authorities in that pursuit. It cannot be stressed enough that amidst a loose fiscal policy, monetary policy will be pushed to the wall and will not only be ineffective in controlling inflation but may also be damaging to the economy's long-term growth prospects as the cost of credit escalates.

The IEA wishes it to be known that, contrary to some of the reports circulating around, **the IEA never called for the IT framework to be abandoned.** The IEA only said that the framework is less effective in the Ghanaian context where transmission of the PR impulses is slow and inflation has strong supply and cost undercurrents. It is in view of these limitations that the IEA called for a more comprehensive approach, whereby the IT framework would be complemented with interventions directly targeting the entrenched supply and cost factors. At the Q&A Session, the Governor said IT has served the country well in contributing to bringing inflation down from the high levels during the pre-IT period. This, according to the Governor, had prompted the BoG to consider lowering its inflation target of (8+/-2)% at some point. While the IEA recognises that inflation has been brought down progressively under IT, it has to be noted that, along with inflation, almost all key macroeconomic indicators have improved during the period in question, in line with the generally improved macroeconomic management of the economy. Regarding the inflation target, it is the case that the (8+/-2)% has been in place almost forever, which, in a way, seems to suggest a lack of sufficient ambition on the part of the MPC to lower inflation further to levels comparable to those of Ghana's peers or trading partners.

Finally, the IEA wishes to make it clear that, while we are talking here about inflation as an immediate problem, the other persistent macroeconomic problems—such as high fiscal deficits, high public debt, exchange rate instability, high rate of employment, large external imbalances, etc.—are all manifestations of a bigger problem. And that problem is the underlying weak structure of the economy, characterised by reliance on low-value added primary export products and high import dependency. The only way to find a durable solution to these recurrent problems is to address the economy's weak structural fundamentals. This should be done through transformation of the colonial-type economy to a vibrant industrialised economy. This cannot, however, be achieved by relying on our narrow tax base and borrowing but rather by leveraging our vast natural resource wealth by taking ownership of it.

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