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BoG's approach can't tame inflation – IEA

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By Elvis DARKO, Accra

The Institute of Economic Affairs (IEA) says the IT framework being used by the Bank of Ghana (BoG) cannot provide a lasting solution to Ghana's inflation problem.
According to the economic policy think tank, strict reliance on the IT framework alone should be avoided.

Arguing in a paper titled "How should the Bank of Ghana respond to the runaway inflation and the high cost of living in Ghana?", the IEA's Director of Research, Dr John Kwakye, stated that in principle, the IT framework may be relevant in dealing with second-round inflationary effects of initial supply or cost shocks provided the supply or cost shocks are transient in nature.

In the Ghanaian context, he stressed that the supply or cost shocks are entrenched, thereby rendering the IT framework less effective in stemming Ghana's type of inflation.

In view of these, he emphasised the need for a comprehensive approach that includes direct targeting of the supply or cost elements.

Dr Kwakye reiterated that in the Ghanaian context, a more comprehensive approach going beyond the IT framework is needed to stem inflation on a durable basis.

According to the framework, PR adjustments affect inflation by raising the cost of credit, thereby reducing aggregate demand in the economy.

Dr Kwakye explained that it is known that in the Ghanaian context, the transmission of the Policy Rate R is constrained by an under-developed and less responsive financial sector.

"But, even 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 more suited to mature economies where inflation tends to be more demand-driven," he said.

In April, Ghana recorded inflation of 23.6%, the highest in 18 years and the 11th 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.

It has to be said that Ghana is not the only country experiencing inflationary pressures in recent months.

The key driving factors have been the disruption of global supply chains by the pandemic – and, lately, the effect of the Russia-Ukraine war on prices of commodities, particularly fuel and food.

In particular, he tasked BoG to engage with government and relevant agencies to target directly the key sources of inflation pressures, particularly fuel, food, transport and the exchange rate.

He explained that the country should be prepared to mitigate oil price shocks that may occur due to geopolitical developments, which he said requires that Bulk Oil Storage and Transportation Company Limited (BOST) maintain strategic oil reserves that can be released to cushion pump prices in the midst of shocks.

In addition, he said 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.

In respect of food, the IEA's Director of Research opined that it is necessary to increase production and ensure storage and preservation of excess produce food, especially during the peak seasons so that buffer stocks may be released to cushion prices amidst shocks and during the lean seasons.

For transport, he called for public transport system to be improved and the availability of intra- and inter-city public transport increased, arguing that the public transport system should be subsidised to cushion the masses that mainly use it.

Regarding the exchange rate, Dr Kwakye said it is necessary to leverage capacities and opportunities for earning foreign exchange, including through greater processing of export commodities and increasing earnings from natural resources.

He wants the institutional and legal framework regarding remittances should be reinforced to promote inflows from the Ghanaian diaspora.

At the same time, he said the demand for foreign exchange should be curtailed through policies that promote production of import substitutes domestically.

"In addition to the supply or cost drivers of inflation, fiscally fuelled demand is also an important driver.

"It is, therefore, important to institutionalise 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," he stressed.

At its last meeting, the Committee raised the Prime Rate by as much as 250 basis points, bringing the cumulative increase during the past year to 350 basis points.

So far, the policy tightening has not been able to slow down the inflation.

The Monetary Policy Committee (MPC) of BoG faces a difficult decision at its next meeting.

In principle, the Committee bases its decisions on how it perceives the balance of risks between inflation and growth.

Taking growth first, there is evidence of a fledgling recovery from the pandemic, with 2021 growth estimated at about 5.4%, as against the mere 0.5% recorded for 2020, and a further growth of 5.8% is projected for 2022, although the outlook is clouded by the Russia-Ukraine war.

Growth should, therefore, not be an immediate concern to the Committee. On the other hand, inflation has more than tripled from 7.5% in May 2021 to 23.6% in April 2022.

Fuel and food prices have been the major drivers in addition to the exchange rate.

The role of fuel and food is evident in the fact that items like transport (33.5%), food and non-alcoholic beverages (26.6%) and housing, water, electricity and gas (25.0%), among the 13 major divisions of the CPI basket, recorded much higher inflation than the average of 23.6%.

Meanwhile, the inflation outlook is on the upside, given that the effects of the pandemic and the Russia-Ukraine war still linger on.

At 23.6%, not only is inflation substantially above the BoG target of (8+/-2) %, but it has also markedly outstripped the current PR of 17.0%.

In effect, the real Prime Rate is -6.6%, which may signify that the monetary policy stance is not sufficiently tight, especially given that just about a year ago, in May 2021, the real PR was +6.0% (the PR was 13.5% and inflation was 7.5%).

The BoG, may, however, take comfort from the easing of the budget uncertainty following the passage of the Electronic Transaction Levy (e-levy), which had cast a shadow over fiscal policy, and which, together with the escalating debt, had led to the downgrading of Ghana's sovereign debt.

The passage of the e-levy has also helped to calm the markets, at least for now, following the period of instability occasioned by the budget uncertainty as well as debt sustainability concerns.

Going by the principle underlying the IT, with current inflation and future outlook being so elevated, the immediate response by the BoG should be to tighten monetary policy by raising the PR.

The obvious question is: by how much should the BoG raise the PR? The factors that should determine the PR adjustment include:

i) The wide gap between the PR (17.0%) and inflation (23.6%). It cannot take one decision to close this gap, though given the expected impact on the economy by making credit exorbitantly costly;

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; iii) The increase in the PR by as much as 250 basis points two months ago, an increase that may not have fully exerted its impact.

Taking all of these factors together, it may be surmised that the PR should be raised by another 200 basis points to 19.0%.

This will help narrow the gap with inflation and also ease to some extent the risk of foreign currency outflows.

The adjustment will also provide some assurance to the markets that the BoG is committed to addressing the resurging inflation.

Anything less than this may be interpreted as a weak response, which may be concerning to the markets.

The BoG must buttress its decision with an effective communication strategy to make its intentions clear so that the Bank can rally the markets behind the decision.

It has to be said that the above discussion is made in the context of the IT framework that BoG signed on to since 2007.

The BoG's BWI partners and the markets expect the Bank to play by the rules of the framework.

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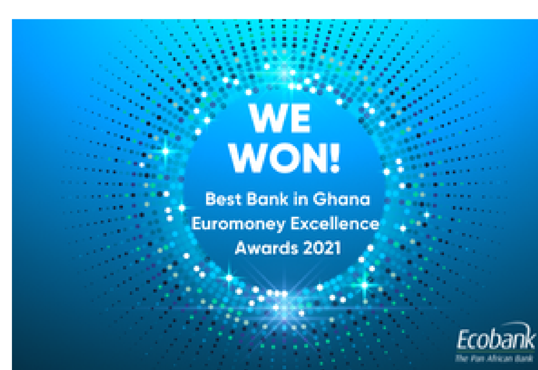

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Marble communication Group Ltd.
Kanda,
P.O.Box CT 5595,
Cantonment.

Tell: (+233) 0262843077/ 0265808610/ 0249488135/ 0246729628.
Email: news@thefinderonline.com
Website: www.thefinderonline.com

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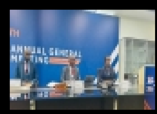
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