

**CEPA LAUNCH STATEMENT**

**THE STABILIZATION PROGRAMME**

**OF THE**

**GOVERNMENT OF GHANA**

**STATEMENT DELIVERED**

**BY THE**

**EXECUTIVE DIRECTOR**

**CENTRE FOR POLICY ANALYSIS**

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## TABLE OF CONTENTS

<b>1 INTRODUCTION AND BACKGROUND .....</b>	<b>3</b>
<b>2 RISKS TO THE STABILIZATION PROGRAMME.....</b>	<b>4</b>
<b>3 MONITORING PERFORMANCE UNDER THE PRGF ARRANGEMENT.....</b>	<b>5</b>
I: PERFORMANCE CRITERIA.....	6
II: INDICATIVE TARGETS.....	6
III: CONSULTATION MECHANISM ON INFLATION.....	7
<b>4 STABILIZATION EFFECT OF THE PRGF ARRANGEMENT AND CHANNELS OF TRANSMISSION.....</b>	<b>7</b>
FOREIGN EXCHANGE MARKETS AND THE NOMINAL EFFECTIVE EXCHANGE RATE (NEER) .....	8
TERMS OF TRADE SHOCKS .....	10
MERCHANDISE TRADE.....	11
PRIVATE INWARD TRANSFERS.....	11
CREDIT CONDITIONS .....	12
INTEREST RATES AND SPREADS .....	14
AGGREGATE DEMAND SLOWDOWN.....	17
<b>5 ASSESSMENT OF THE STABILIZATION EFFECTS .....</b>	<b>18</b>
DECELERATION IN REAL GROWTH .....	18
INFLATION RECORD AND FORECASTS .....	19
<b>6 RECOMMENDATIONS .....</b>	<b>20</b>
NARROWING THE SPREADS BETWEEN LENDING AND DEPOSIT RATES .....	20
SUGGESTED PATH OF THE PRIME RATE.....	21
IMPORTS-FINANCED AID.....	21

## ***1 Introduction and Background***

The first half of 2009 witnessed considerable uncertainty following from the large macroeconomic imbalances of election year 2008, coming on top of the weakening fundamentals of two years of fiscal indiscipline and monetary accommodation. These were manifested in exchange rate expectations, inflation and inflationary expectations and general macroeconomic uncertainty in spite of the promise of a more stringent fiscal stance contained in the 2009 budget. It may be worth noting, that having lost any credibility as inflation fighter over the course of the preceding three years, the monetary targets in the Budget Statement carried no weight. As a result, the first quarter performance could be characterized as following a “business as usual” policy, namely a continuation of trends of the last three years.

Following discussions with the World Bank and subsequently the International Monetary Fund (IMF), a comprehensive policy framework was agreed which maintained some key parameters of fiscal policy in the 2009 budget but had a more coherent and tougher monetary policy stance. Moreover, the programme was supported by resources of both the World Bank and the IMF. This marked the return of the IMF to support the policy framework since the troubled Poverty Reduction and Growth Facility (PRGF) 2003-2005 Arrangement — the successor to the failed PRGF (1999-2002) Arrangement — which, after several waivers, was completed eight months later than scheduled in October 2006.

The Press Release of the Monetary Policy Committee (MPC) of the Bank of Ghana of July 21, 2009 reported in paragraph 9 as follows:

*“The June survey shows further softening of business and consumer sentiments along with mixed signals of inflation and exchange rate expectations.....businesses and consumers are less optimistic about the prospects of the economy, suggesting that both businesses and consumers have already factored in the slowdown in economic activity in forming expectations.”*

The Bank of Ghana’s Composite Index of Economic Activity (CIEA) grew “*well below the trend growth rate*” in the first half of the year, and in real terms “*the index declined by 2.2 percent compared with growth rates of 25.6 percent and 17.5 percent respectively, for 2008 and 2007.*”

The MPC report identified the major sectors driving the slowdown as:

- cement sales — an indicator of developments in construction — which decreased by about 28.5 percent in year-on-year terms;
- tourist arrivals — an indicator of the impact of the global recession;
- domestic VAT — an indication of low consumption levels; and

- industrial consumption of electricity — an indicator of scale of industrial production — which recorded a decline, albeit marginal, during the period.

## **2 Risks to the Stabilization Programme**

Significant risks to the stabilization program have been identified. The key ones are (paragraph 140 of the EGPRC document of the World Bank):

- potential downside risks from the global recession, with implications for GDP growth, macroeconomic stability and financing prospects (from public and private creditors) for Ghana.
- political feasibility risks to the fiscal adjustment.

The 2008 elections were contested generally on “*an electoral platform emphasizing the need to improve and broaden public services, at a time of fiscal stabilization requirements*” (ibid; paragraph 67, emphasis added). Consequently, many high spending-related promises were made ***by all the political parties*** at a time when reality and objectivity rather called for policy packages geared more towards economic restraint.

And as the World Bank put it, “*The lack of transparency and accountability prevented large deviations from planned expenditures being brought to the public eye, and even to the notice of political parties.*”

- Considerable budget execution risks.  
“*In 2009, the reduction of investment expenditures, the containment of the public sector wage bill and other recurrent expenditures (energy-related subsidies), additional grants and low oil prices will largely contribute to reduce the deficit.*” Should any one of these risks materialize and not be mitigated as envisaged, additional fiscal adjustment would be needed, most likely through greater compression of domestically-financed investment.
- Energy-related risks of various types, including the hydro-thermal mix, higher oil prices on world markets than budgeted, and low levels of rainfall than expected, inducing resort to higher subsidies to the energy sector to cover thermal generation costs.

### 3 Monitoring Performance under the PRGF Arrangement

Quantitative performance criteria have been set for monitoring the programme targets under the new PRGF Arrangement. Given the need for close monitoring in the context of an uncertain global environment, the programme includes quarterly reviews for 2009 followed by semi-annual reviews starting in 2010.

The first review of the programme for this year, 2009, is expected to be completed by end-December 2009, with end-September 2009 as the test date for the quantitative criteria.<sup>1</sup> Detailed reporting requirements for all quantitative performance criteria for 2009 are contained in Table 1.

**Table 1: Ghana Quantitative Program Targets**  
(Cumulative from the beginning of the calendar year; unless otherwise stated)

	2008	2009						CEPA Projection
	Dec. Act.	Mar. Act.	Jun. Proj.	Jun. Act.	Sep. Prog.	Sep. Act.	Dec. Prog.	
<b>I Quantitative Performance Criteria</b>								
Overall fiscal deficit of the government (ceiling; GH¢ million)	2,558	344	788	616	1,470	1,377	2,034	2,274
Net international reserves of the Bank of Ghana (floor, US\$ million)	1,301	-404	-637	-626	-728	-720	-404	-404
<b>II Inflation Consultation Mechanism</b>								
Twelve-month consumer price inflation (%)								
Outer band (upper limit)	...	...	...		19.5	19.5	17.5	17.5
Inner band (upper limit)	...	...	...		18.5	18.5	16.5	16.5
<b>Central target rate of inflation</b>	<b>18.1</b>	<b>20.5</b>	<b>19.7</b>	<b>20.7</b>	<b>16.5</b>	<b>18.4</b>	<b>14.6</b>	<b>14.2</b>
Inner band (lower limit)	...	...	...		14.5	14.5	12.5	12.5
Outer band (lower limit)	...	...	...		13.5	13.5	11.5	11.5
<b>III Indicative Target</b>								
Net domestic financing of the government (ceiling; GH¢ million)	479	243	591	634	828	826	1,033	1,268
Net domestic assets of the Bank of Ghana (ceiling; GH¢ million)	299	41	382	301	662	650	146	146

Essential components of the quantitative indicators under the PRGF Arrangement have been broadly grouped and categorized as (i) performance criteria; (ii) indicative targets; and (iii) inflation consultation mechanism.

<sup>1</sup> The second and third reviews under the programme are expected to be completed by end-April and end-October 2010, with end-December 2009 and end-June 2010 as test dates

*I: Performance Criteria*

Two performance criteria have been set under the arrangement: the first is a ceiling in respect of the overall fiscal deficit (including grants) of government; and the second is a floor on the net international reserves of the Bank of Ghana.

Published data from official sources suggest that both targets were satisfactorily met at end-June 2009. Estimates for September 2009 — the test date for reviewing the programme — also indicate that the ceiling on the overall fiscal deficit has fallen within target and that performance has been on track. CEPA projects, however, that by end-December 2009 the target on the overall fiscal deficit would be overshoot by some GH¢240 million. On the other hand, the floor on the net international reserves position of the Bank of Ghana is most likely to remain within the set target by end-year.

*II: Indicative Targets*

Two indicative ceilings are also established under the new PRGF Arrangement:

- a) net domestic financing of the government fiscal deficit; and
- b) net domestic assets (NDA) of the Bank of Ghana.

In the case of the first, the programme requires that the ceiling be adjusted upward by 50 percent for any shortfall in programme loans and grants, up to a maximum adjustment of GH¢75 million. When disbursements of programme loans and grants exceed the programmed amounts, the ceiling will be adjusted downward by the full amount.

The available data for the first half of the year indicate that the ceiling on the net domestic financing of the government of GH¢591 million for June was overshoot by GH¢43 million; in the subsequent period up to September 2009, however, net domestic financing of the government deficit amounted GH¢826 million — just within the ceiling of GH¢828 million targeted for the first nine months of 2009. CEPA projections suggest that by end-2009, the programmed target of GH¢1,033 million would be overshoot by some GH¢235 million.

In the second case of the NDA of the Bank of Ghana, indications are that performance has been within the set ceiling in both June and September and, therefore, most likely to be met by year end.

*III: Consultation Mechanism on Inflation*

The new PRGF Arrangement also includes a consultation mechanism on inflation. A target is set for the twelve-month rate of consumer price inflation, which triggers discussions (or consultations) with the IMF staff (Executive Board) if inflation moves outside specified inner (or outer) bands.

Inner and outer bands have been constructed around a central inflation target for the end of each quarter —  $\pm$  two percentage points for the inner band and  $\pm$  three percentage points for the outer band — starting from September 2009. In situations where the year-on-year inflation rate moves outside of the outer band, the Government of Ghana (GoG) is obliged to complete consultation with the Executive Board of the IMF on the proposed policy response (which will also be announced to the public) before requesting further disbursements under the stabilization programme. The GoG is also obliged to conduct discussions with the IMF staff when the observed year-on-year inflation rate falls outside the inner band specified for the end of the quarter under review. (IMF: Attachment II, MEFP, paragraph 13).

Published data by the Ghana Statistical Service (GSS) indicate a slowdown in the year-on-year inflation rate from 20.7 percent in June 2009 to 18.4 percent in September 2009. Given that this rate of inflation is a little lower than the inner band upper limit rate of 18.5 percent, there is no formal obligation on the part of the Government to enter into and complete discussions with the IMF staff.

While CEPA forecasts show that the declining trend in the year-on-year inflation rate will persist into next year, it projects a year-on-year inflation rate of 14.2 percent for 2009 — marginally lower than the central target of 14.6 percent for the year.

***4 Stabilization Effect of the PRGF Arrangement and Channels of Transmission***

The stabilization effect of the new PRGF Arrangement with the IMF has been most discernible particularly in the third quarter of 2009. It has worked through the following channels:

- deceleration in the rate of depreciation of the nominal effective exchange rate;
- rising real interest rates, as average nominal lending rates rose; in addition, non-price measures were also applied;
- tight credit conditions on account of ceilings on credit expansion—specifically, on the net domestic assets of the Bank of Ghana; and
- sharp reduction in aggregate demand, including on account of reduced growth in remittances and the shares to individuals, as well as net hiring freeze in public sector employment.

*Foreign Exchange Markets and the Nominal Effective Exchange Rate (NEER)*

The exchange and payments system is a liberal one, described as “*free of restrictions on payments and transfers for current international transactions.*” Ghana has accepted the obligations under Article VIII of Agreement of the International Monetary Fund. The interbank exchange rate for the cedi is freely determined on the exchange markets. The rate coexists with daily quotations for bank notes in an atomistic retail market of foreign exchange bureaux operators. The total of recorded transactions on the forex bureaux market has been estimated at about 10 percent of the overall total daily volume of trade. These transactions are “*based on firm, but somewhat more volatile exchange rate expectations which tend to feed into general market expectations.*”

The freedom of payments transactions makes domestic prices of traded goods and exchange rate highly responsive to market forces and demand pressures. Consequently, all other things remaining unchanged, the high aggregate demand pressures of election year 2008 can be expected to place strong depreciating pressure on the cedi in domestic currency markets.

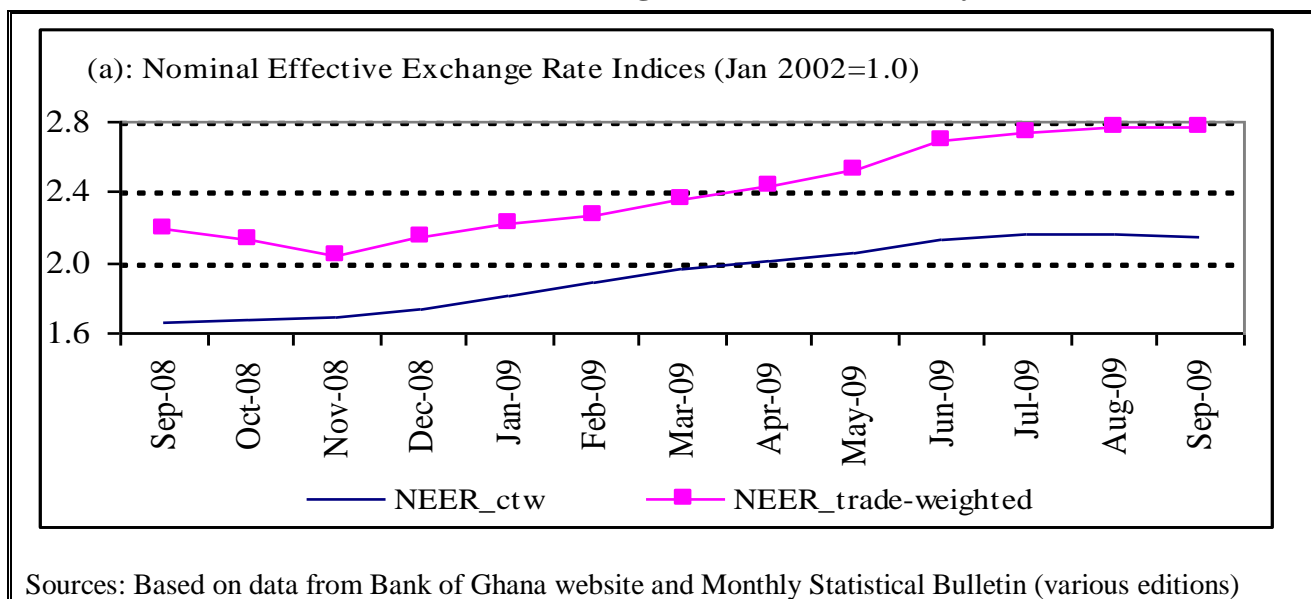
Total purchases and sales in the foreign exchange market by banks and forex bureaux during the first half of the year was some 14.5 percent lower than recorded in the same period last year. The cedi also recorded a slowdown in the rate of depreciation against the three core currencies in the second quarter. The nominal effective exchange rate (NEER) — calculated on a currency of transactions basis — depreciated by 12.7 percent in the first quarter compared to 8.5 percent in the second quarter.

Chart 1 present two versions of the *nominal effective exchange rate (NEER)* of the Ghana cedi with respect to the three topmost currencies — the US dollar, the pound sterling, and the euro — traded on the domestic foreign exchange market. Both have been constructed as weighted summary indices of the bilateral nominal exchange rates between the cedi and the three topmost currencies.

The first measure — the currency of transactions index (NEER\_ctw) — which is typically the preferred choice of most central banks interested in assessing currency flows (inflows plus outflows) into an economy, employs as weights the value of payments by currency of transactions for imports and receipts from exports.

The second measure — the trade-weighted index (NEER\_trade-weighted) — uses the shares in the volume of total trade (imports plus exports) of the respective trading-partner countries as the appropriate weighting scheme.

**Chart 1: Nominal and Real Effective Exchange Rate Indices (January 2002 = 1.0)**



As measured, a rising trend in any of the indices signals a nominal depreciation of the exchange rate, while a declining trend in the indices implies a nominal appreciation.

Chart 1 shows that both NEER indices have generally trended upwards, with the trade-weighted index rising faster compared with the currency-weighted index. Both indices show, however, that the rate of nominal depreciation of the cedi appeared to have moderated somewhat in the third quarter of 2009, with the currency-weighted index, NEER\_ctw, signalling the possibility of the cedi appreciating in nominal terms.

There are also indications suggesting that the country may be regaining some price competitiveness for her products on both domestic and foreign markets. The evidence is that the yearly changes in the real effective exchange rate indices — the nominal effective exchange rate adjusted for inflation differentials between Ghana and major trading-partner countries — turned positive in the third quarter of 2009. These generally signal an incipient real depreciation of the cedi against major currencies — a trend that has persisted since the second half of 2009 compared to real exchange rate appreciations in preceding periods.

Terms of Trade Shocks

The available evidence and historical experience show that the Ghanaian economy is vulnerable to shocks emanating from international commodity markets. As former Bank of Ghana Governor Paul Acquah noted: An analysis of the data confirms the close relationship between movements in terms of trade (ToT), interest rates, exchange rate depreciation and inflation. For the period from 1992 ending 2001, it can be observed that terms of trade deterioration has generally been accompanied by higher inflation and exchange rate depreciation even as interest rates rose — an obvious indication of some attempt at tightening monetary policy.

Developments in the realised terms of trade (ToT) based on the three principal commodities — cocoa, gold, and oil — in the second quarter of 2009 were adverse, mainly on the strength of a rebound in crude oil prices. The average price of cocoa beans exports rose 10.4 percent higher over that realised in the first quarter. Gold prices, on average, also rose by 3.6 percent. In contrast to these relatively modest price increases on the export side, the average realised weekly price per barrel of the benchmark Brent crude oil increased by a massive 37.4 percent between March and June 2009.

**Chart 2: Core Terms of Trade Index (December 2006=100)**

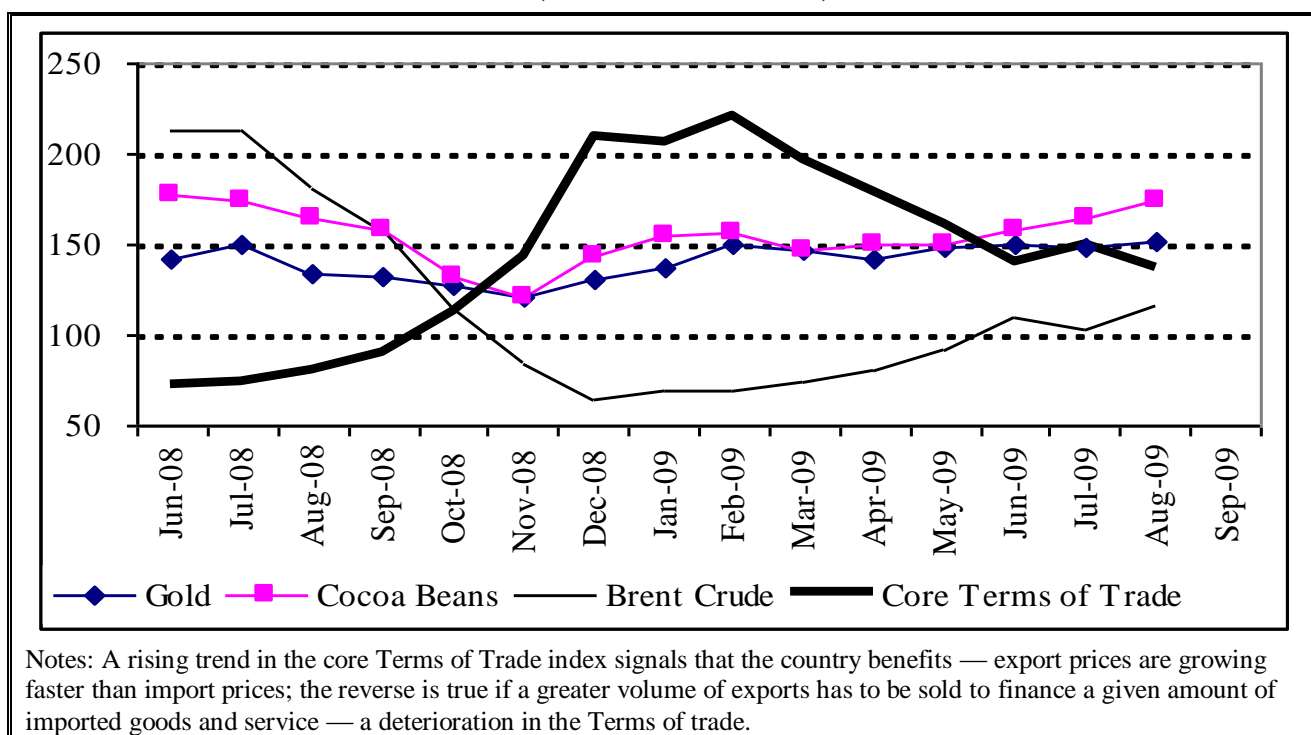


Chart 2 shows that after a relatively benign first quarter, the core Terms of Trade deteriorated sharply in the second quarter before finally returning to positive in the third quarter. The expected

consequence of this in the foreign exchange markets would be relatively mild in the first quarter, negative in the second quarter, and positive in the third quarter of 2009.

The combination of terms of trade and exchange rate developments, together with the global financial crisis, invariably impacted generally on the economy in the form of reductions in imports and a slowdown in private remittances.

### *Merchandise Trade*

Non-oil imports slowed down significantly in the first half of the year — registering a decline of 6.8 percent. This stood in stark contrast to the growth of 39.8 percent recorded over the same period of 2008:

- Capital goods declined 11.0 percent;
- Consumption goods declined by 5.5 percent; and
- Intermediate goods declined by 3.6 percent.

Overall the proportion of capital and intermediate goods in total non-oil imports, however, remained virtually unchanged at 68 percent over the period.

The oil import bill showed a significant annual decline of 66.1 percent. This decline was attributed to the impact of a change in the hydro/thermal mix in the generation of electricity in favour of hydro, demand contraction, as well as lower prices on the international market.

As a result of these developments, the merchandise trade deficit for the first half year of 2009 narrowed sharply to just about 40 percent of that of the first half of the previous year.

### *Private Inward Transfers*

Private inward transfers — received by non-governmental organizations (NGOs), embassies, service providers, individuals etc. — through the banks during the first half of 2009 declined by 1.3 percent on a year-on-year basis. Of the total private inward transfers received over the period, about 17.2 percent accrued to individuals. This was a fall of 2 percentage points from what was achieved in the first half of 2008. The overall decline and the reduced share of accruals to individuals point to the adverse impact of the global recession on the Ghanaian economy. In particular, it would contribute to a lowering of private consumption expenditure and, therefore, in aggregate demand.

*Credit Conditions*

The Bank of Ghana survey of credit conditions continued to show a general tightening of credit to both businesses and households in the second quarter of 2009 along with further declines in net demand for credit. Non-price terms and conditions were also used in tightening the credit stance, such as:

- shortening of the maturity of loans and credit lines; and
- the requirement of additional loan covenants and collaterals

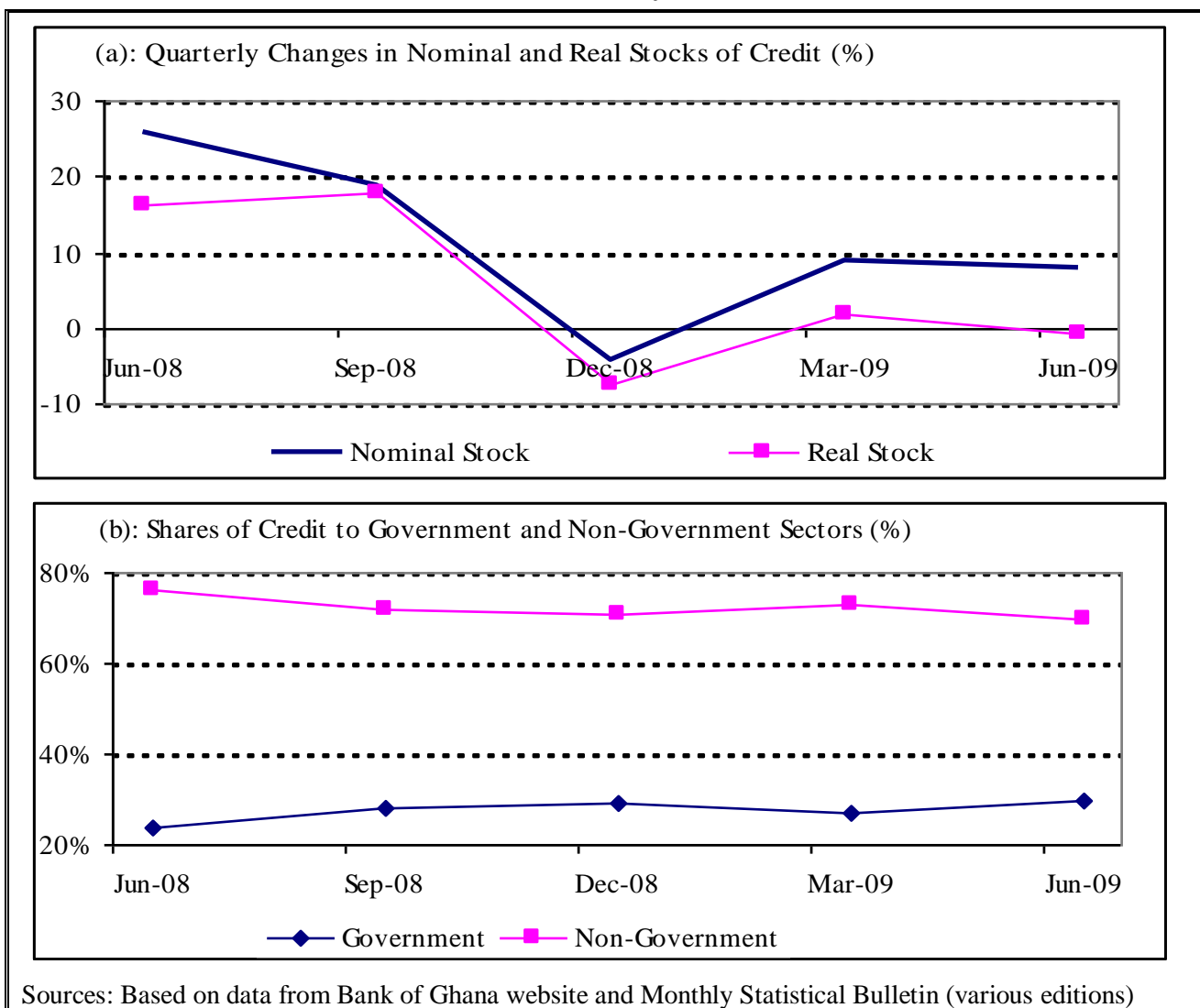
Experience shows that in such situations credit is allocated not according to expected productivity of the investment project. Instead, it is allocated according to transactions cost and perceived risks of default. Apart from quality of collateral listed above, experience shows that political pressures, “name recognition,” loan size, and covert benefits to loans officers have also been known to influence allocation in such circumstances.

According to the July 21, 2009 Press Release of the MPC, the net tightening of credit has been more pronounced for long-term facilities than for the short-term. In particular, the mortgage sub-sector as well as transport and storage sector “*witnessed significant reduction in credit allocation during the second quarter.*”

The stock of credit to the economy from the banking system rose by 8.7 percent in the first quarter of this year. It rose further by 7.9 percent in the second quarter of 2009. Thus over the course of the first half year, the nominal stock of credit increased by 19.3 percent. This is less than half the growth in the stock of 39.1 percent realised in the corresponding period of last year (see Panel (a) of Chart 3).

Adjusted for inflation, the stock of real credit has remained basically stable. It increased by 1.7 percent in the first quarter but declined albeit marginally by 0.7 percent in the following quarter bringing the change over the course of the first half year to a rise of less than 1.0 percent — providing supportive evidence noted elsewhere of a further lowering of the real GDP growth rate estimate by CEPA at about 3.8 percent. It is worth recalling that the real GDP of 5.9 percent in the 2009 budget was revised downward to 4.5 percent in the stabilization programme and subsequently placed in the 4.0 to 4.5 range by the IMF staff. By way of comparison, in the course of the corresponding period of the preceding year, the stock of real credit rose by 23.0 percent with real GDP growth of 7.3 percent in 2008.

**Chart 3: Total Real Stock of Credit to the Economy**



Credit to the private sector (including the state-owned enterprises) grew at about 11.7 percent in the first quarter and at 4.5 percent in the second quarter, bringing the increase over the course of the first half year to 16.7 percent — a little lower than the growth in total credit. This implies that the private sector share in total credit fell slightly in the first half year of 2009.

Adjusted for inflation the stock of real credit to the private sector has remained unchanged — marginally rising by 0.9 percent in the first half of the current year. Again, to drive home the point the strength of the levers of stabilization, the comparative growth over the corresponding period last year was 19.1 percent.

It is discernible from the analysis above that the share of credit to government has increased somewhat in the first half of this year. In nominal terms growth is estimated at 18.6 percent in the year to June 2009. In real terms, the growth was a much more modest 2.3 percent. By way of

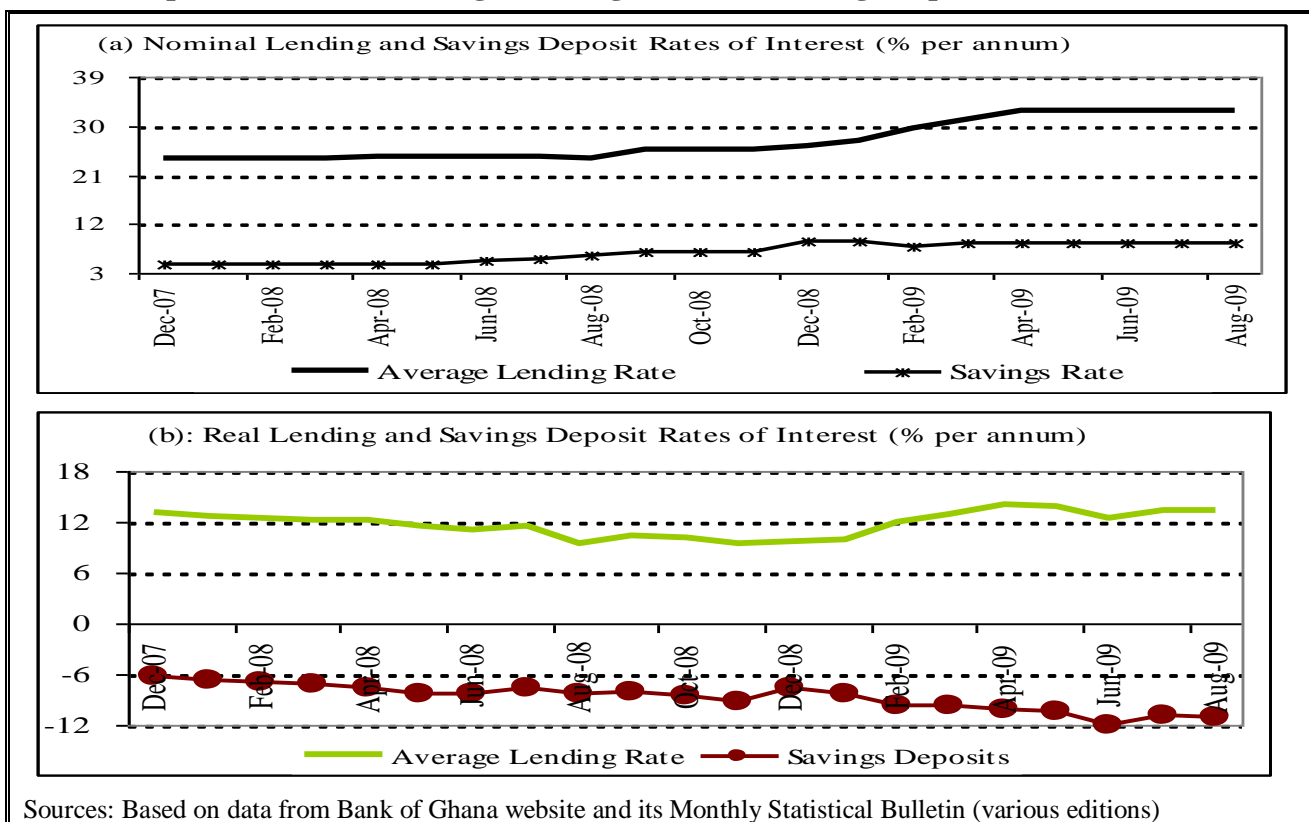
comparison, the stock of real credit to government last year grew by 37.5 percent in the first half of 2008.

A disturbing feature of credit to government from the banking system noticeable from the middle of 2008 is the sharp increase in dependence on the Bank of Ghana. This reversed previous trends so that by the close of 2008, sourcing from the Bank of Ghana represented about 60 percent of the total. This has continued into 2009 and as a result the share of credit to government from the Bank of Ghana rose to 70 percent at the end of June. The worrying fact is that, as happened last year, the central bank (BoG) impliedly would be breaching the statutory limit in the Bank of Ghana Act (2002) of lending to government no more than 10 percent of government domestic revenue.

*Interest Rates and Spreads*

There has been a general firming up of interest rates charged by deposit money banks (DMBs) in the money market during the first half of 2009. In the first quarter of the year, both the DMBs’ savings deposit and lending rates gained 0.5 and 1.5 percentage points to reach 8.5 percent and 32.75 percent respectively, following the upward adjustment of the prime rate in February 2009 to 18.5 percent. The consequence has, however, been a widening of the spread between the average lending and savings deposit rates — both in nominal and real terms (see Chart 4).

**Chart 4: Spreads Between Average Lending Rates and Savings Deposit Rates**



By all accounts, this has been particularly onerous on small-scale borrowers, as the average lending rate adjusted for inflation rose by 2.6 percentage points over the period compared with 3.9 percentage point increase in the average rate of inflation. Small-scale savers and potential customers hoping to reap some returns on their deposits at banks could be equally discouraged and frustrated, as the savings deposit rates have tended to be negative in real terms.

A primary cause of high loan repayment arrears is often traced to the rapid expansion in response to government pressures to achieve mandated credit disbursement targets. Some of the causes of high arrears include the following:

- failure to tie lending to productive investments;
- neglect of marketing and linking credit recovery to the sale of the product;
- defective loan policies — delayed loan disbursement, too much or too little credit, and unrealistic repayment schedules;
- misapplication of loans;
- ineffective supervision;
- apathy and indifference of bank management with respect to recovering loans; and
- lack of responsibility and discipline on the part of borrowers.

Delinquency rates are high in developing countries for a variety of reasons. Cultural factors undoubtedly play an important role. The concept of loan repayment is unfamiliar in some countries. Government-supervised credit programmes have suffered serious arrears problems, in part because collateral was not required. Low subsidized interest rates, negative in real terms themselves provide a strong incentive to postpone loan repayments.

The critical problem of arrears lies in the fact that, if financial institutions are to remain solvent, higher default costs must reduce net returns to savers or raise gross costs to successful investors. They create a wedge, just as administrative costs do, between loan and deposit rates of interest. Arrears also reduce banks' flexibility in that credit cannot be redirected towards alternative activities if it is not repaid. Excessive arrears and default rates indicate inefficiency of one kind or another. The financial institution has either financed investments or failed to press for loan repayment. In either case, financial intermediation is impaired.

There was a reported deterioration in the quality of the loan books of the banking industry in the first quarter of 2009. Data from the various Press Releases of the MPC for the year 2009 show that on a year-on-year basis, the non-performing loans (NPL) ratio increased by 9.6 percent in March 2009 compared with 8.7 percent for the same period in 2008. The rate of increase of the ratio

accelerated in the second quarter to 12.5 percent. In the third quarter preliminary data suggest a massive increase of 44.3 percent.

When financial intermediaries perform efficiently, domestic resource mobilization through the financial sector is enhanced. Other things being equal, unit resource costs of intermediation between savers and investors would be associated negatively with efficiency, provided the total costs of transferring funds from original savers to final investors is calculated here. In practice, financial intermediaries' total operating costs — wages, depreciation, intermediate input costs such as computer expenses, and advertising — as a percentage of total earning assets may serve as a reasonable proxy. *Ceteris paribus*, the lower this percentage, the smaller the spreads between net returns to savers and gross costs to investors.

Costs of financial intermediation refer to the spread between the gross costs of borrowing and the net returns on lending. They can be broken down into borrower, lender, and intermediary costs. If borrower and lender resource costs of such things as information, travel, and time have relatively low variance or vary in a way unrelated to intermediary costs, the spread or wedge between gross borrowing costs and net lending returns will vary with transaction costs of the financial intermediaries. These transaction costs consist of administration costs and default costs. Both of these costs can and do vary widely. Intermediation costs are higher, the smaller and more risky the loan.

International empirical evidence is that developing country banking systems are less competitive, are more heavily taxed, and suffer higher loss rates than the OECD banks. Hence spreads tend to be substantially wider. Oligopolistic structures of banking systems in developing countries also cause high spreads. High bank operating costs have been found in developing countries with high inflation and little or no competition. The international experience also shows that “*bank operating costs and the concomitant spread between deposit and loan rates are inordinately high in most developing countries suffering from inflation in excess of about 20 percent. Inflation is the basic problem, and bringing it down is the only sensible cure.*” (Fry *op cit* page 273).

Higher reserve requirements also raise bank operating costs and impose a tax on financial intermediation.

In varying degrees all these characteristics are evident in contemporary Ghana and are no doubt contributory factors to the observed high spread, which has widened from 17.3 percentage points in December 2008 to about 24.3 percentage points in August 2009.

### *Aggregate Demand Slowdown*

Aggregate expenditure is defined to comprise:

- real private consumption;
- real investment (private and government) — also referred to as gross domestic capital formation; and
- real government consumption.

Anecdotal evidence and some qualitative indicators from surveys carried out in the course of this year point to non-buoyant business confidence, contributing to the slowdown of aggregate demand in the economy, particularly in the first two quarters, with some recovery in the third.

The MPC Press Release of July 21 observed in paragraph 6 that *“initial data for the first half of the year point to ... some softening in general demand pressures and declining volatility in prices and exchange rates”*. Furthermore, indications from the Bank of Ghana’s Composite Index of Economic Activity (CIEA) *“suggest that real GDP growth could be slowing down but at a moderate pace. At the same time, latest surveys conducted in June show further drops in business and consumer confidence and a net tightening of credit conditions for all categories of borrowers in the second quarter”*.

The MPC Press Release of November 20, 2009 further reaffirms the economic slowdown. It observed that *“information derived from the Bank of Ghana’s CIEA showed that the first three quarters of the year recorded significant slowdowns in economic activity. In the first three quarters of the year, the index recorded declines of 4.32 percent, 0.91 percent and 0.94 percent respectively. In year-on-year terms, the index as at September 2009 had declined by 6.2 percent compared with a growth of 14.7 percent for the corresponding period of 2008”*.

Construction, port and harbours activities, credit to the private sector, and tourist arrivals were reported to have contributed to the slowdown relative to the pace observed a year ago. Other indicators of economic activity that are monitored by the central bank such as new vehicle registration, benchmark retail sales, advertised job vacancies, and domestic VAT collections have all recorded slowdowns consistent with the direction of the composite index.

## 5 Assessment of the Stabilization Effects

Aggregate demand is the money value of aggregate expenditure. If the **assumption of a perfectly elastic aggregate supply is dropped** increases in aggregate demand will have the effect of generating **simultaneous increases in both** prices and output (Greenaway and Shaw p.226).

John Maynard Keynes recognized that prices would in fact increase before full employment was reached. The increase in effective demand will, generally speaking, spend itself partly in increasing the quantity of employment and partly in raising the level of prices. Thus, we have in fact a condition of prices rising gradually as employment increases.

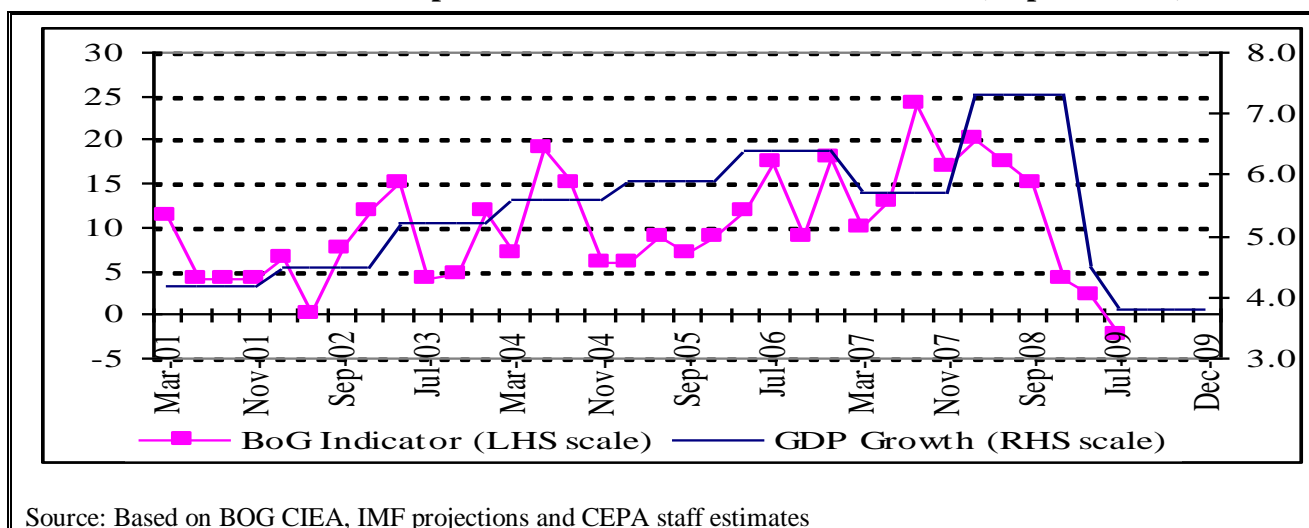
As output increases, a series of ‘bottlenecks’ will be successively reached, where the supply of particular commodities ceases to be elastic and their prices have to rise to whatever level is necessary to divert demand into other directions. (ibid)

The working hypothesis is that the reverse also applies with reductions in aggregate demand — the decrease in effective demand will show partly in decreasing the quantity of output or employment and partly in lowering the level of prices.

### *Deceleration in Real Growth*

The Ghana Statistical Service has reportedly projected a 4.7 percent real GDP growth for 2009 while the IMF in a Press Statement lowered its growth projection for 2009 to fall in a 4.0 to 4.5 percent range. Using the same sources of information as the IMF — namely, the CIEA of the Bank of Ghana — CEPA projects a lower annual growth rate of 3.8 percent for the year (see Chart 5).

**Chart 5: Bank of Ghana Composite Indicator and Real GDP Growth (% per annum)**



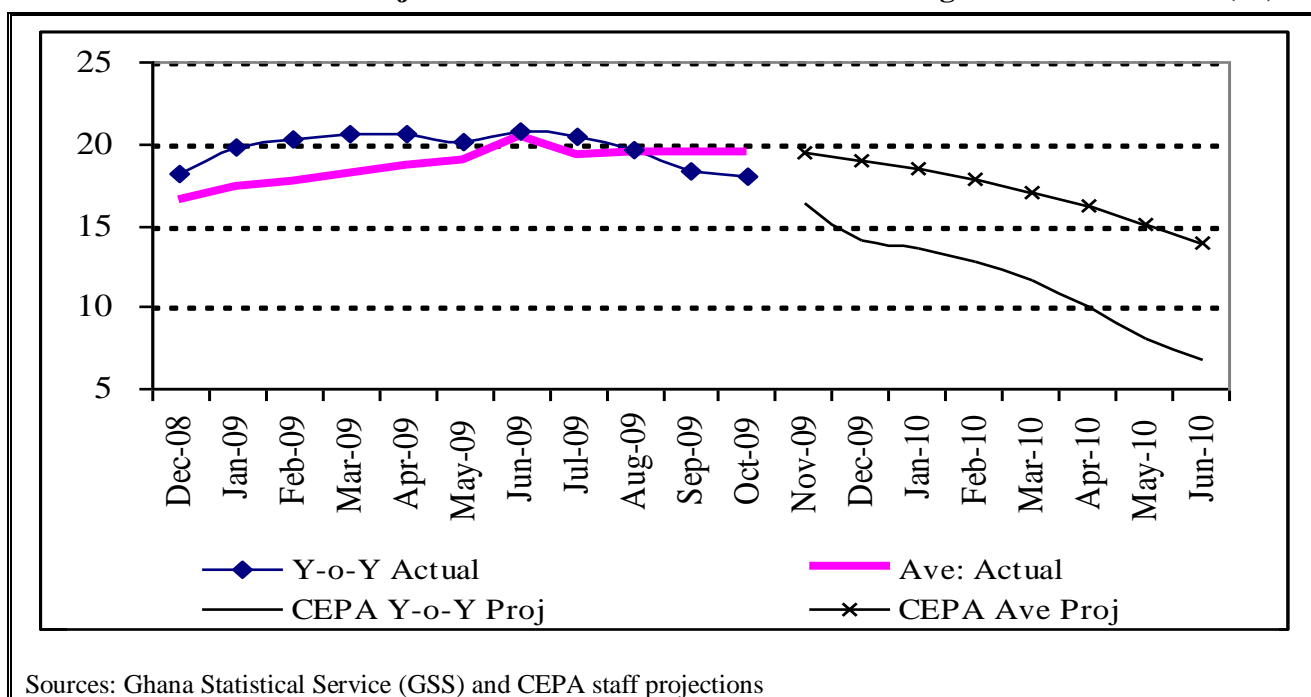
Source: Based on BOG CIEA, IMF projections and CEPA staff estimates

*Inflation Record and Forecasts*

The rate of inflation, as measured by changes in the consumer price index (CPI) compiled and published by the GSS, has generally trended upwards and has been higher in the first half of 2009 compared with the same period of 2008. This trend is applicable to the two measures of inflation — the year-on-year and the average rates of inflation — officially published by the GSS.

Chart 6 shows that except for a momentary dip in May 2009, the year-on-year rate of inflation increased from 18.1 percent on December 2008 to peak at 20.7 percent in June 2009; it had since been on a declining path reaching 18.04 percent in October 2009. The average rate of inflation, meanwhile, followed a more stable and less volatile path, lagging behind the year-on-year (the lead indicator) until about July 2009 when it started declining to equalize the year-on-year at about 19.5 percent in August 2009. It has virtually remained at that level in both September and October 2009.

**Chart 6: Estimates and Projections of the Year-on-Year and Average Rates of Inflation (%)**



Sources: Ghana Statistical Service (GSS) and CEPA staff projections

CEPA forecasts show that the declining trend in the year-on-year inflation rate will persist into next year, reaching single digits in the second quarter of 2010. The average rate of inflation — the lag indicator — will consequently follow suit, as is to be expected, and trend downwards to reach about 14 percent by mid-2010.

Given the more stable path of the average rate of inflation, CEPA strongly suggests that it should be the more appropriate variable to focus on in the BoG’s inflation targeting framework.

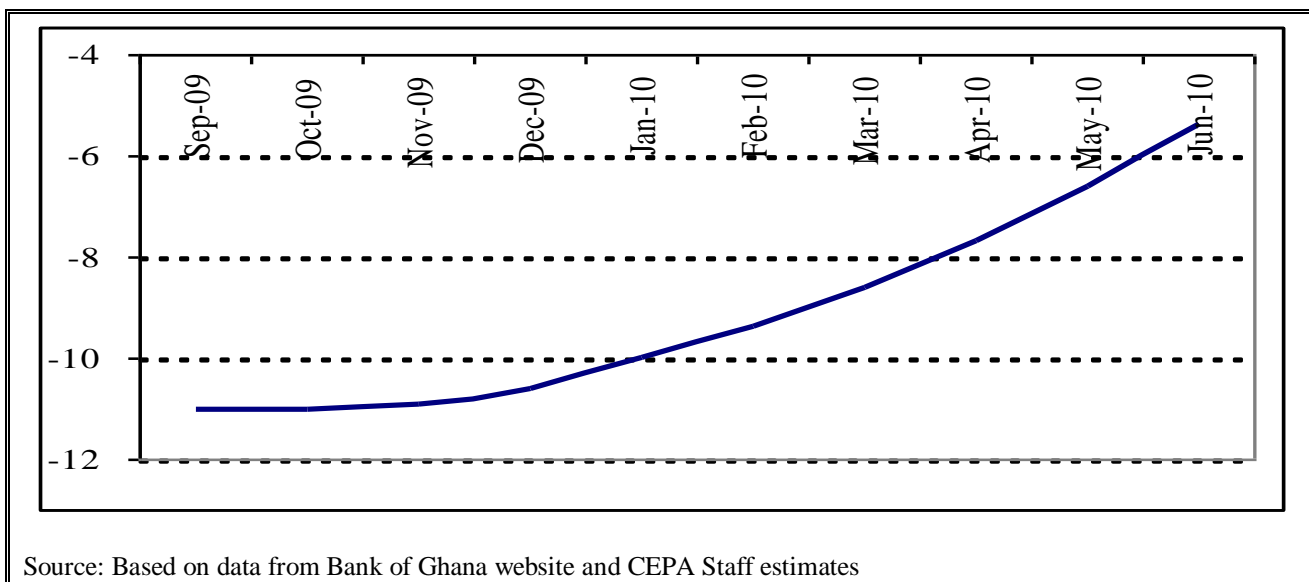
## 6 Recommendations

### *Narrowing the Spreads between Lending and Deposit Rates*

CEPA's key recommendation is to provide added price incentives for increased deposit mobilization to ease the credit squeeze. This incentive is by way of bringing lending rates down with deposit rates unchanged. It would call for a narrowing of the wide spread between the average lending rate and savings deposit rate. This recommendation is being made with the proviso that fiscal discipline on the part of government continues to be maintained under the stabilization programme. Price stability and policy credibility are also important in all of these.

As discussed earlier, there are signalling pointers of stability in prices on the domestic goods and foreign exchange markets. Consumer price inflation has been on a declining path since June this year. CEPA projects further declines in the rate of inflation from the 18.04 percent registered for October 2009 towards 14.2 percent by year-end — marginally lower than the target of 14.6 percent a year.

**Chart 7: CEPA Projection Path of Real Deposit Rate (% per annum)**



Consistent with its projections of inflation, CEPA is of the view that without adjusting the nominal deposit rate — at least leaving it unchanged at the current rate — while gradually nudging the lending rate downwards will be an added incentive to savers hoping to reap some returns on their savings deposits. Leaving the deposit rates at their current levels does not provide a strong enough signal to savers, considering that they still will be negative in real terms. At the same time, since this also requires a narrowing of spreads that should be underway over the next two quarters, it is not a recommendation to be taken for granted (see Chart 7).

CEPA's position is that, if at all possible, raising the deposit rates while simultaneously lowering the lending rate will be the ideal way not only to enhance deposit mobilization as the basis of easing the credit squeeze, but also a means of relieving businesses and enterprises of the high and burdensome borrowing costs.

In urging the Bank of Ghana to lead the way in narrowing the high and widening spread, CEPA has no illusions of the fact that this may be easy. Consequently, CEPA will hope that fiscal discipline will be in place — albeit in ways that the public sector borrowing requirements does not become over-bearing, leading to a crowding out of the private sector. In order to operationalise our recommendations, CEPA suggests that at the minimum the nominal deposit rate, if it cannot be raised, must also not be lowered.

#### *Suggested Path of the Prime Rate*

The reduction in the prime rate — the policy rate — of the Bank of Ghana to 18.0 percent by the MPC at its November meeting also retained that rate for the rest of 2009. At the next meeting in January 2010, CEPA recommends a further reduction by another 50 basis points to 17.5 percent.

**Table 2: CEPA Projections: Average Inflation & Suggested Path of the Prime Rate (% per annum)**

	Nov-09	Dec-09	Jan-10	Feb-10	Mar-10	Apr-10	May-10	Jun-10
Average Rate of Inflation	19.4	19.0	18.5	17.8	17.1	16.2	15.1	13.9
Suggested Path of Prime Rate	18.5	18.1	17.5	17.0	16.0	15.0	14.0	13.0

Source: CEPA staff estimates

As macroeconomic policy credibility takes root — in particular by maintaining fiscal discipline under the stabilization programme — the MPC may consider meeting monthly to review the situation instead of every two months.

CEPA recommends a further drop in the policy interest rate by 50 basis points in February (not otherwise a meeting month of the MPC). From March onwards, CEPA recommends a full percentage point (100 basis points) reduction till mid-year 2010 (see Table 2).

#### *Imports-Financed Aid*

With the continued maintenance of price competitiveness, a policy measure that appears capable of sustaining or even increasing the rate of economic growth while monetary deceleration is reducing the inflation rate would be an increase in imports-financed aid from say the BRICs — Brazil, Russia, India and China — until our exports pick up. As Anne Krueger put it:

*Another way to view the importance of foreign credits during the stabilization period is to recall that increased flows of imports simultaneously liberalize the regime faster than would otherwise be possible (except with recession) and are deflationary in that they absorb excess aggregate demand. Trade liberalization as part of a stabilization policy that includes appropriate monetary deceleration has been effective in the few countries that have tried it, and not only in curbing inflation. (cited in Fry ibid)*