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Press Release

107TH Meeting of the Monetary Policy Committee:

"TO HIKE OR NOT TO HIKE THE POLICY RATE?"

The Monetary Policy Committee (MPC) of Bank of Ghana (BoG) will hold its 107th meeting to decide on the Policy Rate (PR) on July 20-22. Once again, the Committee faces a challenging decision as inflation shot up further to 29.6% in June, the highest in eighteen years. In the past year, the MPC has acted aggressively to stem the soaring inflation by raising the PR cumulatively by as much as 550 basis point to 19.0%, the last increase being 200 basis points in May. The strong policy tightening, however, has not succeeded in bringing the situation under control. With the gap between the inflation rates widening to 10.6 percentage points, the question is: how will the Committee respond?

What Should Inform the MPC Decision?

We have repeatedly drawn attention to the fact that the current inflation—as well as past inflations in Ghana—has strong supply or cost undercurrents. A careful analysis of the disaggregated CPI shows that food, fuel, and transport are major drivers of the recent inflation. Further, imported inflation has become elevated, reflecting the effect of the steep exchange rate depreciation in the past year or so. Unfortunately, these supply or cost factors are factors that the PR, in and of itself, can hardly influence. Indeed, relying on the PR alone to fight inflation could even be counterproductive. This is because it could inflict significant harm on the real sector of the economy as the high cost of credit it generates could dampen investment and general economic activity. Even in the advanced economies, such as the US and the UK, ongoing monetary policy tightening is seen to be a potential source of "inflationary recession" or "stagflation"—a situation where both inflation and economic stagnation or recession coexists. Ghana faces a similar risk if the PR is used exclusively and the supply or cost drivers are ignored.

To deal effectively with the current inflation—and to limit the harm that exclusive use of the PR could cause—we have called for the Bank of Ghana and Government to work together to target directly the key inflation drivers, viz. food, fuel, transport and the exchange rate. We have provided detailed suggestions to address these factors in a July 12 Roundtable paper titled: *Rethinking Inflation Management in the Wake of Covi-19 and Russia-Ukraine War*. In major countries such as the US and UK, the governments have made inflation control a top policy priority and are taking measures to complement their central banks' actions. The same approach is needed in Ghana. Even the IMF that is known not to be a fan of subsidies, has called on member governments to provide food subsidies to their citizens to cushion the cost of living crisis. This call should tell us that new interventions are required in dealing with what is clearly an unconventional-type of inflation that is currently sweeping the globe.

We have to repeat that we are not calling for the abandonment of the current inflation-targeting framework being used by the MPC. We are only calling for new interventions to complement it to make it more effective. The MPC must, therefore, proceed with its decision on how to position the PR. It has to be admitted that aggregate demand pressures cannot be ruled out completely from the current inflation in view of the large injection of liquidity into the economy to mitigate the effect of the pandemic on lives and livelihoods. The PR approach would, therefore, be relevant in mitigating the demand pressures. Further, the PR, in principle, can help to mitigate the second-round inflationary effects that the supply/cost factors may cause. Also, the PR adjustment, conveying a strong message of the MPC determination to fight inflation, could help dampen inflation expectations and, ultimately, inflation itself.

The MPC's decisions are, in principle, based on what the Committee perceives to be the balance of risks between inflation and growth. Taking growth first, the Ghana Statistical Service (GSS) reported a year-on-year growth rate of 3.3% for Q-1**,** a sign that the economy is recovering, *albeit* slowly, from the pandemic. For 2022 as a whole, growth has been projected by the IMF to be about 5.2% *(Ref: IMF WEO, April 2022).* This compares favourably with the growth of 3.6% and 3.8% it has projected for the world and Sub-Saharan Africa respectively. The Ghanaian economy has the potential to grow at higher rates, if only the right policies backed by adequate resources, especially what can be mobilised from domestic sources, would be implemented. That said, relatively, growth is not an immediate serious risk factor. On the other hand, inflation is of a major concern and poses a greater risk, especially as the outlook of Covid-19 and the Russia-Ukraine war, key drivers of current global inflation, remains uncertain, while economic hardship has also heightened.

As to how to position the PR, a number of factors have to be taken into consideration. First, the last time in the past year that the PR (then at 14.5%) was higher than the inflation rate (then at 13.9%) was in January 2022. Since then, inflation has overtaken the PR, with the gap widening to 10.6 percentage points as of June. While, in principle, it is not unusual for the inflation rate to exceed the PR, in the case of Ghana where inflation has been unusually high, and where the PR transmission is severely constrained, the PR has mostly exceeded the rate of inflation in the past. In other words, the real PR has been mostly positive. Currently, however, the real PR is grossly negative (-10.6%). What that suggests is that monetary policy may not even be tight enough, implying that further tightening may be needed. We have picked a signal from the IMF mission that visited Ghana recently to discuss a financial programme with Ghana to the effect that they would assist Bank of Ghana "to further strengthen the monetary policy regime" in response to the raging inflation. Per the IMF's traditions, it would appear to us that they imply encouraging further tightening of monetary policy.

Second, the strong policy tightening carried out by the MPC recently may not have exerted its full effect yet, given the impact-lag involved. Here, an important factor that is not readily available to us is the exact relationship between PR adjustments and inflation. In other words, when the PR is increased by one percentage point, by how much does inflation decrease? Also what is the lag between the change in the PR and the effect on inflation? Third, it would appear that though inflation has risen consistently in the past year, the rate of increase in recent months, being 4.2, 4.0 and 2.0 percentage points respectively in April, May and June, shows a decelerating trend. Fourth, continued policy tightening by the major economies, particularly the US, continues to put pressure on developing and emerging-market countries' currencies, including that of Ghana.

Fifth, the MPC has the benefit of the forecast of the inflation outlook, informed by more comprehensive data that may not be available to us. The forecast of the inflation outlook will be an important factor in the PR decision.

Taking all the foregoing factors—both known and unknown—into consideration, we are minded to suggest that the MPC should increase the PR by a further 100-150 basis points, taking it to 20.0-20.5%. This adjustment will narrow the inflation-PR gap, although the real PR will still remain negative. Further, the adjustment will signal the MPC's unwavering commitment to fighting the inflation and bring it under control. The adjustment will also send the right signal to, and help calm, the markets. The next meeting of the MPC in September, when the Committee would have had the benefit of two more inflation readings in July and August, would give it a clearer sense of the trend for it to reposition the PR accordingly.

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