

Kwesi Bekoe Amissah-Arthur: Conduct of monetary policy in a challenging economic environment

Address by Mr Kwesi Bekoe Amissah-Arthur, Governor of the Bank of Ghana, at the swearing in ceremony of new executives of the Association of Ghana Industries (AGI), Accra, 14 January 2010.

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Mr. Chairman
Hon. Minister of Trade and Industry
Out-going and In-coming Presidents of the AGI
Togbe Afede and Nii La
Members of Council
Members of the AGI
Distinguished Guests

Ladies and Gentlemen

1. It is a pleasure for me to join this important event of the Ghanaian industrial sector; to swear in new executives of the Association of Ghana Industries (AGI). The membership of this association is said to be truly national and representative; spreading across small, medium and large scale enterprises operating in all sectors of the economy across the entire country.
2. Let me commend members of the Association for their contribution to Ghana's economic progress over the years. I hope that your hard work will continue in the coming years.
3. Mr. Chairman, my address today will focus on the "**conduct of monetary policy in a challenging economic environment**". Ghana faces two key economic challenges; the long-term accelerated growth and development agenda which can only be pursued aggressively after the challenge of macroeconomic instability has been tackled. Restoring macroeconomic stability is important given that the global (and indeed our own domestic) economy is gradually recovering from severe economic imbalances that characterized the past two years.
4. I will begin by explaining to you the peculiar challenges that confronted monetary policy, the conduct and role of monetary policy in addressing these, and conclude with an outlook for 2010.
5. Mr. Chairman, in first half of 2009 major economic challenges confronted businesses, investors, individuals and policymakers. The rate of inflation which began rising in the last quarter of 2008 increased consistently in the first six months peaking at 20.7 percent in June, the highest level in over four years. Between January and June, the cedi depreciated by 17.5 percent against our main reserve currency, the US dollar. Gross international reserves declined to about 1.9 months of imports cover by June 2009. The deterioration in these indices were the results of both global and domestic developments. Dramatic increases in energy prices, combined with high prices of imported foods, contributed to increases in inflation. On the domestic front, Government's reaction was to accommodate the shocks by providing subsidies on oil products, leading to large budget deficits partially financed by the Central Bank. Clearly these developments signaled an economy in distress, underlying the urgency of implementing policies to reverse the trend and restore stability.
6. Of the economic challenges, the continuing high inflation was particularly worrisome due to its impact on fixed income earners, savers, investors and the poor. Rising inflation creates uncertainty in long-term decision-making, delaying investment decisions and

distorting business plans. Therefore inflation has fundamental implications for long-term employment and growth.

7. Given the adverse economic conditions just described, the Government had to take decisions to improve the business environment. As I just stated with respect to inflation, business decisions are taken with a higher degree of confidence and certainty under stable economic conditions. Consequently, monetary policy had to be decisive in reducing uncertainty and turning the economy around towards stability.

8. Mr. Chairman, the primary mandate of the Bank of Ghana is to maintain price stability. To achieve price stability the Bank has to manage the supply of money. In classical theory, the control of the money supply is the basis of monetary policy; the process through which the monetary authority controls the cost of money or interest rates and supply of credit, thereby influencing inflation, exchange rates and employment levels.

9. Interest rate adjustments influence inflation. Rising interest rates reduces consumption and Investment thereby dampening aggregate demand. A low interest rate environment results in the opposite effect, raising consumption and investment; therefore aggregate demand.

10. Now let me turn my attention to the role of fiscal policy on the effectiveness of monetary policy. To a large extent, the achievement of a stable interest rate and credit environment depends on the size of Government borrowing (the Public Sector Borrowing Requirements or PSBR) and how it is financed. The sources for financing Government borrowing within the domestic economy are the public and the banking system (whether or not including the Central Bank). When financed such Government borrowing “crowds out” the private sector from accessing capital. It is often said that for “every cedi government borrows, the private sector has one cedi less”. But more importantly, the effect of excessive borrowing is to raise the cost of money.

11. Mr. Chairman, The interest rate policy setting process at the Bank of Ghana is very extensive. The objective is to gain a comprehensive understanding of the state of the economy.

12. To do this, we assess developments in the external sector, the state of Government operations, the banking and financial sectors, the real sector through monitoring business and consumer confidence, and price conditions in the economy. It includes the analysis of liquidity, credit, balance of payments, employment levels, and a broad range of other economic data which helps us to create an index of economic activity.

13. The desire to take account of real sector issues in the monetary policy process results in the construction of a Composite Index of Economic Activity which estimates the upswings or downswings in economic activity. This Index incorporates indicators such as construction, exports, imports, consumption, industrial production, formal employment generation, and credit to the private sector among others.

14. I need to state that contrary to popular perception the Bank of Ghana does not focus exclusively on price stability. Some of your members may be aware that we conduct bi-monthly business surveys on some 45 companies in all sectors of the economy, through which we collate diverse information from the market.

15. Admittedly, the sample size is small and may not capture the broad concerns of industry but it provides the Bank with relevant information on industrial performance. I would therefore use this platform to appeal to the Association to open up its membership database to the Bank of Ghana for policy purposes. This will provide us with useful information such as employment trends, rising or falling profitability levels. so we can broaden the critical factors that inform our decision making.

16. Mr. Chairman, the conduct of monetary policy during the economic challenges of the first part of 2009 focused on restoring macroeconomic stability. The decision to raise the

prime rate in the first quarter of 2009 was essential. I know that the private sector was not enthused by the decision but by the second half of the year, there was clear evidence that the policy initiatives were beginning to take effect.

17. Government's fiscal prudence in 2009 paved the way for significant reduction in the fiscal deficit. The second half of 2009 was characterized by consistent declines in inflation from 20.7 percent to 16.9 percent by end November and there are strong indications that inflation will fall further. The currency stabilized in the foreign exchange markets and even appreciated against some major currencies. Given these encouraging economic developments, the Bank of Ghana responded by lowering the prime rate in November, signaling to the market that the economy was entering into a cycle of declining interest rates.

18. Looking ahead, Mr. Chairman, the Central Bank anticipates a much stronger rebound in economic activities in 2010. The objective of monetary policy is to foster growth by encouraging further declines in interest rates as inflation declines and inflation expectations diminish. This will set the stage for the private sector to access credit at relatively cheaper costs to pursue productive ventures while the Central Bank works to preserve macro-economic and financial stability requisite for economic growth.

19. As we move towards an era of low and stable inflationary environment, access to credit for productive activities will improve and businesses must begin to map out strategies to improve efficiency and reduce operating costs in order to stay competitive. I will encourage the incoming executives of the AGI to promote strategies that will ensure that our local industries stay competitive especially as the Ghanaian economy continues to integrate into the global economy.

20. To conclude, let me state that the primary objective of the Central Bank is to pursue sound monetary and financial policies aimed at price stability and the creation of an enabling economic environment for sustainable economic growth. Together with members of this Association and the private sector at large, we must collaborate to achieve the common objective of sustained economic growth.

21. I wish the new AGI executives good luck as they embark on their period in office.

Thank you.