Millison K Narh: Monetary policy and outlook for economic growth

Speech by Mr Millison K Narh, Second Deputy Governor of the Bank of Ghana, at the Databank Investor Forum, Accra, 26 April 2010.

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1. Introduction

[1] Distinguished Ladies and Gentlemen, I would like to thank Databank for inviting me to this Forum which has brought together institutional investors to apprise themselves of policy initiatives and assess investment opportunities in the country.

[2] I understand that Databank is celebrating twenty years of entrepreneurship this year. Let me take this opportunity to congratulate you on your significant achievements and contributions towards Ghana's financial sector over the past two decades and hope that you will expand your activities further in the coming years.

[3] My address today will focus on "Monetary Policy and Outlook for Economic Growth". I will seek to address this topic by focusing on three key issues. That is, the Bank of Ghana's monetary policy stance, the stabilization role of monetary policy in the Ghanaian economy and lastly, the outlook for economic growth in 2010 and beyond.

2. The monetary policy stance of the Bank of Ghana

[4] The primary objective of the Bank of Ghana is to maintain price stability. The objective of price stability is not an end in itself; rather it is in the interest of promoting balanced and sustainable growth in the long-term. Indeed, the clear focus on price stability as stipulated in the Bank of Ghana Act 612 reflects a consensus from various policy dialogues that "inflation is a major obstacle to the growth process and price stability can contribute to accelerating growth by promoting an enabling environment for efficient investment and savings decision-making". Various country experiences, including Ghana, show that sustained periods of strong growth have always gone hand in hand with low inflation whereas low growth episodes occur under highly inflationary environments.

[5] As you may be aware, the Ghanaian economy witnessed consistent growth periods in the recent past with real GDP growth increasing steadily from 3.7 percent to 7.3 percent within a spate of nine years. To a large extent this growth phase of the Ghanaian economy was largely supported by a policy environment aimed at macroeconomic stability which anchored inflation expectations. This was combined with structural reforms, particularly in the financial sector, needed to increase financial intermediation and promote economic growth.

[6] Although growth was achieved, the reemergence of macro instability underpinned by both external and domestic factors such as considerable credit expansion to both government and the private sector dislodged inflationary expectations and increased inflationary pressures in the economy. The combined effect of expansionary fiscal and monetary policies resulted in severe macroeconomic imbalances characterized by rising inflation, exchange rate depreciation and loss of international reserves. To bring back stability in the economy, the policy framework had to refocus on restrictive monetary policy and fiscal prudence, leading to tight credit conditions, a general slowdown in the economy, and low economic growth in 2009.

[7] It is therefore prudent that in seeking to promote economic growth, the Bank of Ghana remains committed to its mission of price stability as well as improving the regulatory and supervisory frameworks to secure a strong financial sector for efficient intermediation. In delivering this mandate, the Bank of Ghana's operational framework for monetary policy involves adjusting interest rates to achieve the target inflation in the policy horizon. By this

process, the stance of monetary policy is to continuously assess risks to growth and inflation and properly position the key policy rate to restore balance between inflation and growth.

[8] The mandate and strategy of the Bank of Ghana is consistent with theoretical arguments in the economic literature regarding the role of monetary policy in attaining price stability. We also believe that monetary policy should be mindful of the country's growth objectives. Therefore, by committing to the long-term objective of price stability, the Bank's monetary policy strategy adopts a gradualist policy response approach to addressing shocks in the economy so as to minimize the output loss associated with pursuing our inflation objective and help anchor inflation expectations.

3. The stabilizing role of monetary policy

[9] It is useful for us to understand how monetary policy has over the past year and half contributed to stabilize the Ghanaian economy, and how it is currently being fashioned to foster growth in the economy.

[10] The Ghanaian economy was severely challenged in the first half of 2009 with rising inflation, a depreciating currency, loss of international reserves and weakening business and consumer confidence. The rate of inflation increased steadily and peaked at 20.7 percent in June, the highest on record in over four years. There were excessive upward surges in the exchange rate with the local currency depreciating by 17.5 percent against the US dollar between January and June. Gross international reserve position fell to about 1.9 months of imports cover by June 2009. Clearly, these signaled an economy in stress, underlying the urgency to implement prudent policies to restore economic stability.

[11] The immediate policy response was to institute a stringent policy framework of restrictive monetary policy complemented by prudent fiscal policies to restore stability. These measures were also supported by multilateral and bilateral assistance. Monetary policy tightening was deemed necessary in support of stringent fiscal policies aimed at steering the economy back to stability. Hence, the Bank of Ghana responded to the economic challenges by adjusting the policy rate upwards by 150 basis points.

[12] Let me state that the macroeconomic outcome of the stringent policy framework has been positive. The policies have contributed immensely to the return of stability and are gradually restoring business and consumer confidence in the economy. With tighter monetary policies, stability in the local currency has been restored and the disinflation process is ongoing. Year on year inflation has declined steadily from its peak in July 2009 to 13.3 percent in March 2010. Similarly, the core measure of inflation (excluding energy and utility) is declining indicating downward inflationary pressures within the economy.

[13] The latest assessment of the economy by the Bank of Ghana point to improved economic fundamentals driven by diminishing inflationary pressures, exchange rate stability, a gradual pick-up in economic activity and improvements in investor and consumer confidence. The external position has strengthened with significant increases in the reserve level, as well as improvements in the trade and current account balance in spite of the challenges of the spillover from the world economic downturn. Overall, the economy has responded well to the tight policy responses.

[14] These notwithstanding, economic activities in 2009 remained subdued in line with the policy tightening stance although some indicators of economic activities and confidence indices show signs of recovery. Real GDP slowed from 7.3 percent in 2008, reflecting expansionary policies and strong credit expansion to a provisional forecast of 4.7 percent in 2009 as credit conditions tightened.

[15] With cognizance to the successful role played by monetary policy in shifting the economy back to the disinflation path and price stability, the Bank of Ghana also realizes the need to complement the process by stimulating economic growth in the medium-term.

Consequently, the policy rate has been cut by a cumulative 350 basis points between November 2009 and March 2010. With the reduction, it is anticipated that credit conditions will gradually ease and credit growth will be restored to ensure a steady growth in output.

4. Outlook for economic growth

[16] The outlook for economic growth remains positive. Although growth was constrained in 2009 on the basis of tighter policies, improved economic conditions have paved the way for monetary policy easing to stimulate growth in 2010 and beyond. There are indications of a rebound in business and consumer confidence, as well as increasing investor confidence in the economy. Hence, as economic stability gains a firm hold, the private sector must reposition itself to drive the growth agenda.

[17] As noted in the 2010 budget and economic policy statement, the government will continue with the fiscal consolidation process which started in 2009 with a view to stabilizing inflation and reducing exchange rate volatilities. External sector policies will also focus on building up reserves (which is currently at 3 months imports cover), and reducing the current account deficit, while pursuing strategies to increase economic growth in 2010. The budget is optimistic about growth prospects in 2010 with a revised real GDP growth of 6.5 percent compared to an initial program target of 5.0 percent.

[18] Starting from 2011, Ghana will benefit from oil production which is expected to attract additional investments into the country, and boost economic growth. Initial production is projected to contribute about 17 percent towards Ghana's GDP. Accordingly, real GDP growth has been estimated to increase above 20 percent in 2011.

[19] There is a general consensus that the contribution of monetary policy is to stabilize the economy and create an enabling environment for sustainable growth in the long-run. Looking forward therefore, the Bank of Ghana's monetary policy stance will remain focused on steering the economy towards price stability whilst deepening financial intermediation processes to ensure that credit flows to the productive sectors of the economy.

[20] Despite the role of monetary policy in creating an enabling environment, promoting long-term growth is a complex process and requires the support of structural reforms that seek to remove "binding constraints" on the business environment to ensure sustainable growth. Clearly, monetary policy is limited beyond the scope of resolving structural bottlenecks that often constrain growth in the Ghanaian economy. The commitment of the Bank of Ghana to ensure macroeconomic stability and ease credit constraints must therefore be supported by policy reforms to strengthen the investment climate, increase productivity and innovation, as well as close infrastructural gaps especially in the energy and road sectors.

[21] It is anticipated that the increased government revenues from the oil production will create the much needed fiscal space to close the country's infrastructural gaps and ease some of these growth constraints. Additionally, the implementation of credible fiscal consolidation policies underscored by growth-enhancing measures should provide the needed boost for the private sector and accelerate economic growth.

5. Conclusion

[22] Ghana's economy has rebounded strongly from the instability that characterized the first half of 2009. Recent trends indicate that macroeconomic stability has gained ground with declining inflation, exchange rate stability, growing reserves as well as increasing investor and business confidence. These conditions have paved the way for monetary policy easing to increase investments and spur economic growth.

[23] Most importantly, the Central Bank remains committed to delivering a low inflation environment that would support the overall broad development agenda of growth and poverty reduction. Consistent with this, the monetary policy regime will sustain price stability and economic growth.

[24] I would like to conclude by stressing that monetary policy can effectively maintain price stability but it must be accompanied by structural reforms that will create the enabling environment for accelerated growth in the long-run. Therefore, notwithstanding Bank of Ghana's monetary policy stance to preserve price stability and create an enabling environment to foster growth, structural reforms to ease binding constraints in the economy must be implemented to make Ghana competitive and an important investment destination within the sub-region.