Minutes of the Monetary Policy Committee

(MPC)/03/05)

The third meeting of the Monetary Policy Committee (MPC) in 2005 was held in the Conference Room of the Bank on July 6-7, 2005.

Present were:

Famara .L. Jatta	-	Governor (Chairman)
Momodou .B. Saho	-	Member
Ousman Sowe	-	Member
Basiru Njai	-	Member
Amadou Colley	-	Member
Mod Secka	-	Member
Buah Saidy	-	Secretary

In attendance were:

Momodou A. Ceesay	Adviser	Governor's Office
Oumie Savage-Samba	Director	FISD
Omar Jatta	Deputy Director	FED
Martin Brownbridge	Adviser	DoSFEA
Alieu Gaye	Deputy Director	BSD
Essa Drammeh	Deputy Director	FSD
Haddy Joof	Deputy Director	Admin
Ousainou Corr	Deputy Director	FISD
Amadou Koora	Senior Bank Examiner	FSD
Ida Fye	Senior Bank Examiner	FSD
Anetta Riley	Senior Banking Officer	BSD
Bakary Kolley	Senior Economist	ERD
Abdoulie T B Jarra	Senior Economist	ERD
Ismaila Jarju	Senior Economist	ERD
Ebrima Wadda	Senior Economist	ERD
Momodou Sabally	Senior Economist	ERD
Maimuna John Sowe	Senior Economist	ERD

Opening

The Chairman opened the meeting by welcoming members to the third session of the MPC in 2005. He expressed the hope that the Committee would exhaustively discuss the issues particularly taking into account recent economic and financial developments in order to arrive at a well-informed decision.

Before turning to its immediate policy decision and against the background of the forward looking business sentiment survey and the latest output and inflation projections, the Committee discussed balance of payments (BOP), fiscal, money market, monetary, banking sector and international developments.

(1.0) World Economic Outlook

Members observed that the world economic outlook remains positive and that evidence of a more broadly based growth in the world economy continued to accumulate.

During three consecutive meetings of the Federal Open Market Committee (FOMC), the federal funds rate, the target rate, was raised by 25 basis points, on each occasion to 3.0 per cent. The Committee observed that even after these actions, the monetary policy stance remains accommodative and, coupled with underlying growth in productivity, is providing ongoing support to economic activity in the US.

In China, a soft landing is expected and GDP is forecast to grow by 8.0 per cent in 2005, down from 9.3 per cent in 2004. But given the surge in investment approximating 35.0 per cent of GDP, growth in China may surpass initial projections.

On Sino-American economic relations, the Committee applauded the US Trade Secretary’s visit to China and expressed the hope that it would lead to a speedy resolution of the trade dispute between the two countries. The value of the Yuan which has been the main bone of contention between the two countries continued to elicit fervent debate with studies indicating that the currency was undervalued between 12-25 per cent. However, the Committee felt that the true value of the Yuan can only be known if the currency is floated, but that the Chinese authorities are not too keen to adopt a flexible exchange rate now fearing that it would negatively impact their already weak financial sector.

Given China's huge appetite for oil and non-oil commodities necessary to fuel its high growth, Chinese companies have significantly increased their investments in the African continent. The medium and long-term outlook is that these investments would be scaled-up, which bodes well for resource rich countries.

Growth in Africa is projected at 5.4 per cent in 2005, compared to 4.6 per cent in 2004 and higher-than the estimated world output of 4.3 per cent in 2005. Africa's leading reformers would continue to perform well. Africa will also benefit from the revival in Europe, Africa's major trading partner. Growth in Europe is expected to continue to gain momentum in 2005 and 2006 as earlier investments begin to bear fruit. However, many importing countries remain vulnerable to high oil prices. For instance, the increase in oil prices has not only caused a deterioration in The Gambia's terms of trade, but may significantly erode public finances unless immediate steps are taken to pass price increases to consumers.

Global inflationary expectations have risen but remain moderate despite the increase in oil prices. However, domestic measures of inflationary expectations have been higher in emerging markets, with smaller increases in industrial countries. The risks of a marked pick-up in inflation appear moderate given excess capacities, well-grounded inflationary expectations and relatively moderate labour market pressures and rising profit margins. Nonetheless, the Committee noted that policy makers would need to respond promptly if inflation edges up since the consequences of a slow reaction could be costly and diminish central banks' credibility.

(2.0) Balance of Payments

The latest estimates indicate that the overall BOP surplus would be higher-than was first thought, thanks to expected increase in foreign direct investment (FDI) and remittances. It was noted that Asian businesses are keen to make significant investments in green field projects, particularly in fishing and tourism sectors. If these investments pan out, the flow and stock of FDI would be significantly enhanced. However, to further scale-up investment, it is vital that the investment climate is continuously improved, including ensuring sustained macroeconomic stability.

(3.0) Foreign Exchange Developments

Exchange rates had been quite stable with the US dollar appreciating slightly against the Euro and the Pound Sterling. Also, reflecting increased inflows from tourism, re-exports, private remittances and cashew exports, the Dalasi was quite stable strengthening slightly against the Pound Sterling and the US dollar in the year to end-May 2005. The domestic currency however, depreciated against the CFA and the Euro. It seemed likely that the Dalasi's appreciation also reflected the prevailing high real interest rates which has made Dalasi assets relatively more attractive to investors.

Looking ahead, on balance, the Dalasi is expected to continue to strengthen against most of the major currencies in the remainder of 2005 underpinned by improving macroeconomic fundamentals. Inflationary pressures have been significantly reduced, private capital flows are projected to be much higher-than was initially estimated and there are strong indications that growth would be robust.

(4.0) Fiscal Developments

Total revenue and grants in the first 5 months of 2005 was D1.17 billion compared to D1.45 billion in the corresponding period of the previous year. Domestic revenue, comprising tax and non-tax, revenue fell by 2.5 per cent and the expectation was that it would fall below the half yearly target of D1.43 billion. While tax revenue decreased to D959.7 million, or 3.9 per cent reflecting the marked decline in taxes on international trade, non-tax revenue rose to D107.3 million, or 12.0 per cent as a result of increased accrued interest and income from property.

Total expenditure and net lending was D1.58 billion compared to D1.70 billion in the first 5 months of 2004 reflecting decreased capital expenditure. Expenditure and net lending was above the end-June 2005 target of D1.35 bilion owing to extra-budgetary expenditure totaling D116.5 million and higher-than-programmed spending on wages and salaries and interest payments.

The Committee decried the expansionary fiscal stance and urged for a return to fiscal consolidation for the sake of attaining the right mix of monetary and fiscal policy in particular, and sustaining macroeconomic stability in general. More specifically, steps should be taken to curtail extra budgetary expenditures and review the retail price of petroleum. Absenting an adjustment in the retail price of petroleum, cumulative borrowing by Government from the banking sector may increase by D100.0 million to D500.0 million in the third quarter, increasing the already unsustainable domestic debt and crowding out the private sector.

(5.0) Money Market Developments

Outstanding stock of interest bearing debt rose to D5.0 billion, or 2.0 per cent from end-March 2005. The non-bank held the bulk of the debt (48.0 per cent), deposit money banks (34.0 per cent) and Central Bank (18.0 per cent).

The Committee observed that although the debt stock is increasing, it is doing so at a decreasing rate. This should over time free funds for investment by the private sector. In actual fact, private sector credit, after episodes of contraction over the past 18 months, increased by 4.3 per cent net of provisions in the year to end-May 2005.

The marked deceleration in Treasury bills discount rate observed over the past two months was attributed primarily to the decline in the supply of bills, juxtaposed by increased demand as investors take advantage of the prevailing high real interest rates on Government paper compared to other instruments available in the market. Notwithstanding, the Committee urged for caution and prudence in policy implementation in order to avoid interest rates volatility, which could adversely affect the economy.

(6.0) Monetary Developments

Latest monetary data show a deceleration in the monetary aggregates. Growth in money supply declined to 22.0 per cent in the year to end-May, compared to 30.3 per cent a-year-earlier. Although both components of money supply increased, quasi money grew at a stronger pace.

Narrow money (M1), comprising currency outside banks and demand deposits increased by 17.3 per cent, but lower-than the 29.2 per cent a year earlier. Given that narrow money is associated with spending on the economy, the declining ratio is consistent with decreasing pressures on the economy.

Quasi-money, that is, time and savings deposits rose by 28.7 per cent relative to 31.9 per cent a-year-ago. Expectedly, the share of quasi-money to broad money rose from 40.8 per cent at end-May 2004 to 43.1 per cent in May 2005.

Regarding the factors affecting money supply, the net foreign assets (NFA) of the banking system increased to D3.4 billion, or 42.4 per cent from end-May 2004. The NFA of the Central Bank rose to D1.9 billion, or 39.4 per cent, reflecting 10.2 per cent increase in foreign reserves and 31.4 per cent decrease in foreign liabilities. Deposit money banks' NFA also increased to D1.5 billion, or 46.2 per cent from a-year-ago.

The net domestic assets (NDA) of the banking system also increased, albeit slightly to D2.4 billion, or 1.2 per cent over end-May 2004. Domestic credit fell by 0.5 per cent, reflecting in the main, decline in net claims on Government by 11.2 per cent.

Reflecting decreased Government borrowing from the banking system and the declining trend in interest rates, private sector borrowing net of provisions rose by 4.3 per cent in May 2005. The expectation is that private sector credit would continue to increase as borrowers take advantage of the declining trend in interest rates.

Reserve money, the Bank's operating target, grew by 12.1 per cent, lower-than 36.1 per cent in May 2004. Currency in circulation and deposit money banks' reserves grew by 12.3 per cent and 11.7 per cent compared to 38.2 per cent and 31.1 per cent respectively in May 2004.

The Committee observed that the monetary aggregates were consistent with the desire to sustain the disinflationary process and that the positive growth in private sector should bode well for growth.

(7.0) Financial Stability Report

The fundamentals of the banking sector remain solid. The industry average risk weighted capital adequacy ratio was 82.8 per cent at end-March 2005. All the banks observed the minimum capital requirement of 8.0 per cent.

The quality of banks' assets also improved. Non-performing loans decreased to D179.1 million, or 15.1 per cent from end-March 2005. Non-performing loans were fully provisioned.

All components of deposits declined between March and May 2005 with the exception of demand deposits. This was attributed possibly to investors shifting to higher yielding instruments, such as Treasury bills. The other view was that this phenomenon may be temporal and besides the observation period of two months is too short to give any real meaning to the numbers.

Concern was expressed of the prevailing high interest rate spreads. It was posited that default risk is a key determinant of lending rates. Therefore, to the extent that special courts are to be established to quickly settle commercial disputes and enable banks in particular to recover their loans expeditiously, this should go a long way in narrowing spreads.

(8.0) Real Sector

Available data indicate an unrevised growth in real GDP of 5.0 per cent premised on strong output of all the sectors of the economy. Agriculture in particular, the linch-pin of the economy is expected to record strong growth on the back of a projected good rainfall.

To ensure sustained agricultural output critical for poverty reduction, the Committee expressed the hope that firmer mechanisms will be put in place to purchase and export groundnuts and groundnut products as expeditiously as possible. The fact that there were no exports of groundnuts in the first six months of 2005 highlights the difficulties besetting the sector.

(9.0) Business Sentiment Survey

The business sentiment survey had been consistently positive about prospects of the Gambian economy with the majority of respondents indicating better-than-expected activity in the second quarter of 2005.

Panel firms also expressed subdued expectations of inflation, exchange rates and interest rates attributed to discernible deceleration in inflationary pressures and the strengthening of the value of the Dalasi.

Industry firms were more bullish about the economy than services and agricultural establishments despite the many constraints besetting the industrial sector, particularly the manufacturing sub-sector. The optimism was attributed to the depreciation of the real effective exchange of the Dalasi and the strong economic expansion both of which impacted positively on the sector.

(10.0) Inflation

The disinflationary process continues unabated. End-period inflation, measured by the consumer price index, declined from 15.8 per cent in April 2004 to 4.0 at end-April 2005. Average inflation rate (12-month moving average) was 10.2 per cent compared to 18.0 per cent a-year-earlier.

Food consumer price inflation declined to 4.5 per cent compared to 17.7 per cent in April 2004. Non-food inflation also fell to 2.9 per cent relative to 11.5 per cent at end-April 2004.

Core inflation 1, which excludes prices of energy (fuel, light and transportation) declined from 13.3 per cent in April 2004 to 3.7 per cent in April 2005. Core inflation 2, which strips out prices of energy and volatile food items also decelerated from 7.6 per cent in April 2004 to 2.4 per cent in April 2005.

The Committee posited that all indications point to a continuing deceleration in the general price level, but felt that efforts to improve the CPI in terms of coverage, revising the basket and rebasing the base year should be intensified.

The study on the exchange rate pass-through and correlation analysis shows a high level of interrelation between the exchange rate, inflation and interest rates. The ratio of correlation between inflation and exchange rates is 0.76, indicating strong positive correlation between the two. There is also a strong degree of interrelation between inflation and interest rates with a ratio of 0.80.

The study also found that the pass-through effect from the Euro to CPI in The Gambia is exceedingly high and fast, similar to empirical findings in other small open economies, but more fundamentally as a result of the fact that the European Union is The Gambia's foremost trading partner.

The study was deemed an important body of knowledge; however, it was suggested that the study should be expanded to look at the relationship between US dollar and the CPI as well as, say, credit expansion and general prices.

(10.1) Prospects for Inflation

Global inflationary expectations have risen but remain moderate. The combination of strong global growth and rising commodity prices would mean monetary policies will generally need to be tightened somewhat faster-than-earlier expected depending on the cyclical positions in individual countries and regions.

The Dalasi exchange rate continues to strengthen in response to tight monetary conditions, although there has been an easing of policy.

Growth in the monetary aggregates are easing. Money supply grew by 22.0 per cent at end-May 2005, lower-than 30.3 per cent a-year-earlier. It appears that the 10.0 per cent growth rate in money supply at end-December 2005 would be realized.

Action by the fiscal authorities to put a damper on extra budgetary expenditures and the positive impact of declining interest rates should improve public finances. A more supportive fiscal policy should contain inflationary pressures and lead to further easing of monetary policy.

A short-term error correction model (ECM) was used to forecast inflation. The model assumes:

(i) Year-on-year growth in money supply of 10.0 per cent (ii) Government expenditure and net lending of 26.0 per cent of GDP and zero Central Bank financing of the budget deficit and (iii) Stable exchange rate for the entire 2005.

End-June 2005 inflation is forecast at 2.4 per cent, declining to 1.6 per cent by end-December 2005. Given improved macroeconomic conditions, the balance of risk assessment declined to 1.0 in April 2005 compared to 1.14 in February 2005, indicating that there is waning risk for a reversal of the disinflationary process.

(11.0) Decision

Taking these factors into consideration including the risks to the inflation outlook, the MPC decided to reduce the rediscount rate, the policy rate, by 4.0 percentage points to 25.0 per cent. The MPC would continue to monitor the situation and if the outlook changes, the Committee would review its stance.