CONFIDENTIAL

MINUTES OF THE MONETARY POLICY COMMITTEE MEETING 01/04

The maiden meeting of the Monetary Policy Committee of the CBG, established in the first half of this year, took place in the Conference Room of the Bank on July 26-27, 2004. Present at the meeting were:

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

Observers: -

- Oumie Savage-Samba - Ag. Director, Finance and Infor. Systems Dept.
- Momodou Mboge - Special Assistant to the Governor
- Omar Jatta - Ag. Deputy Director, FED
- Pa Alieu Sillah - Deputy Director
- Philip Akibogum - Principal Officer, FED
- Mbye Jammeh - Principal Banking Officer, BSD
- Lasana Fati - Principal Auditor, IAD
- Essa Drammeh - Principal Officer, FSD
- Miss Rohey Khan - Senior Economist, ERD
- Momodou Sabally - Economist/Statistician, ERD
- Ismaila Jarju - Economist, ERD
- Amadou Koora - Banking Officer, FSD

- Karamo Jawara - Banking Officer, BSD
- Bakary Jammeh - Econometrician, ERD
- Buba Touray - Economist/Statistician, ERD
- Maimuna John-Sowe - Economist, ERD

In his opening remarks, the Chairman pointed out that a lot of valuable time and effort have been devoted in the preparation for this august meeting. He further indicated that the presentations and the attendant deliberations covering the entire spectrum of the economy should guide the Committee in setting the policy rate. He finally urged the Committee to discuss the issues with disarming frankness. After these remarks, the meeting proceeded with the presentation on the Global Economic Outlook.

1. Global Economic Outlook

During the discussions that ensued, it was observed that The Gambia's competitiveness has improved going by the depreciation the real effective exchange rate of the Dalasi. It was also mentioned that despite the rapid increase in oil prices, the inflation outlook remains promising provided the Authorities continue to pursue contractionary monetary and fiscal policies. Global interest rates were also deemed too low and that they may rise in the near future but the speed and timing may vary from country to country. An observation was made that data on countries from the sub-region be separated from the rest of the world for easy comparison especially between The Gambia and other WAMZ countries in terms of the agreed convergence criteria. However, one of the members reminded the meeting that issues relating to WAMZ, though important, are outside the purview of the MPC.

2. External Sector Developments

After the presentation on the external sector, it was highlighted that foreign direct investment (FDI) flows in 2004 are expected to increase significantly. As a result, the overall balance of payments (BOP) is projected to improve considerably to a surplus of D878.9 million against a deficit of D323.4 million in 2003. Tourism is projected to account for the bulk of the FDI. The construction of a state-of-the art five star hotel, valued at $40 million best illustrates increasing flows from the tourism sector. About $8 million of this amount is expected to be released in 2004. Other FDI flows include equity from a new commercial bank and an airline incorporated in The Gambia. The meeting was also informed that plans are underway to improve the tax incentives to attract more foreign investments, albeit without eroding the tax base.

Deliberating on the foreign exchange market, the Committee observed that although the market share of CFA franc has diminished, the demand for Senegalese goods, particularly building materials, has increased over the years. It was further noted that not all foreign currency inflows are captured by the inter-bank market given the fairly large size of the informal market. The Committee welcomed the apparent surge in re-exports despite the myriad bottlenecks but stressed that more robust modalities should be set up to better estimate the volume and value of re-exports. It was suggested that foreign currency collection items should be one among many data that can be used to better determine re-export receipts.

3. Government Fiscal Operations

The Committee observed that the amount of float was disturbingly high and urge for a tripartite (Accountant General's Office, DoSFEA and the Central Bank) reconciliation of Government accounts. It was suggested that the float may have been caused by the delay in fully accounting embassy remittances. On the issue of the on-going land sales that is expected to raise D103.0 million in Government revenue, members were informed that demarcations have been completed and that a number of applications have been received. The Committee, however, expressed concern that the seeming delay in land sales may make it difficult for Government to meet the revenue targets agreed with the Fund under the Staff Monitored Programme (SMP). The Committee also lamented the mounting debt service payments attributed principally to the surge in the domestic debt. It was agreed that the domestic debt issue should be left to the Committee on Domestic Debt, which is charged with the responsibility of coming up with recommendations on how to restructure the debt, with a view to reducing the suffocating burden on Government finances.

The pace of privatization was considered very slow and the Authorities were urged to speed-up the process to sustain the robust economic growth and pay down the domestic debt. The Committee hailed the establishment of the Revenue Authority (RA) which is awaiting ratification in the National Assembly. The RA should enhance revenue and presumably reduce the recourse to borrowing.

4. Money Market Developments

The Committee observed that the stock of domestic debt excluded the foreign exchange loan that was advanced to Government by the Central Bank. Members also noted that the maturity profile of the outstanding bills can give an indication of inflationary expectations. To the extent that investment has been gradually shifting to longer dated bonds connotes lower inflationary expectations.

The Committee was informed that the domestic debt issue will be discussed during the upcoming Government of The Gambia/UNDP round-table in November 2004. The Cape Verde’s successful domestic debt strategy was hailed as a possible model for The Gambia to emulate. Members noted that because of high interest rates, investors are converting their foreign currency holdings into Dalasi–denominated assets as demonstrated by the increased demand for Treasury bills.

5. **Financial Stability Report**

The Committee expressed satisfaction that the banking system as a whole has consistently out performed the benchmark 8.0 percent capital adequacy ratio but felt that the simple average method used to calculate the ratio may not be reflective of the real situation. The weighted average method was recommended. The idea of increasing the ratio over and above the 8 per cent marker was floated. It was opined that once all the banks meet the newly introduced paid-up capital of D60 million this matter would be looked into. The Committee was also of the view that banks should be strongly encouraged to diversify into term lending through moral suasion. Increased lending to the productive sector is a necessary and important step to boosting and sustaining output growth.

It was also not lost to the Committee the flouting of the provisioning for bad and doubtful loans regulation and recommended that appropriate punitive actions be taken for non-compliance. Banks were also derided for the opaque manner some foreign exchange transactions are conducted. The Committee urged that banks should transparently share with their customers the true transaction rates.

6. **Real Sector Developments**

The Committee took note of the fact that the 6 percent growth forecast is premised on the continuing rebound in agriculture, re-exports and sustained boom in building and construction and related mining and quarrying. This growth rate should translate into a reduction in poverty and improvement in living standards. Concerning the effect of high interest rates on the growth forecast, it was emphasized that the agricultural sector, the main driver of growth borrows little. Besides, long-term growth is driven largely by supply side factors such as investment in human capital, infrastructure and institutions and not interest rates.

7. **Private Sector Business Sentiment Survey**

The overall assessment of the results from the survey indicated pessimism regarding general economic and business activity over the next seven months of 2004. It was also observed that the services sector was less pessimistic than industry and agriculture. The point was also made that this may augur well for the economy considering that the services sector is the dominant sector of the economy.

One worrying development that emerged from the survey was that investors expect inflation to rise and given the fact that inflation could be a self-fulfilling prophecy, this may likely have negative consequences on the economy. Members felt that inflationary expectations can best be dampened by stabilizing the Dalasi and concomitantly putting a lid on inflationary pressures.

8. **Consumer Price Index**

Two measures of consumer price inflation were presented: headline and underlying inflation. Headline inflation was estimated at 15.8 percent at end-May 2004 compared to 17.7 percent during the same period in the previous year. Two measures of underlying inflation were also used: core1 and core 2. Core1 strips out volatile food items from the consumer price basket. The standard deviation of all the monthly price changes for each item in the food basket was calculated. The items with high standard deviation relative to the mean were deemed volatile.

The Committee noted that while core 1 is trending downwards, core 2 was edging upwards. In other words, by removing all the noise in headline inflation *a* *la core 2,* it became apparent that demand-pull as opposed to cost-push inflation was at play. The Committee further opined that monetary policy should be effective against demand-pull inflation.

The rolling standard deviation of GDP and the exchange rate were also examined. This shows whether business cycles exist (using growth rates of GDP). It is also used to determine the level of volatility in the foreign exchange market. When it rises, it connotes volatility or that the level of risk in the economy is rising and vice versa.

Members also took note of the exchange market pressure (EMP). EMP represents the difference between domestic money supply and demand, reflected in both exchange rate and reserve movements. Where money supply is more than demand, there will be pressure in the markets in the form of higher prices and currency depreciation. Should the Bank intervene by raising interest rates, the differential between domestic and world (US) interest rates increases in favour of The Gambia. Capital inflows will, in turn, increase reducing pressure on the exchange rate. It was self evident that the EMP was driven largely by the stance of monetary policy. And to the extent that policy has been tightened, the EMP was close to zero, implying stability in the exchange rate.

A short-run error correction model (ECM) and calibration technique were used to forecast inflation for 2004. The ECM assumes: (I) growth in money supply of 20.0 percent (II) Government expenditure and net lending of 25.5 percent of GDP and (III) stable exchange rate for the entire 2004. Inflation was forecast at 13.8 percent and 12.3 percent for end-September and end-December 2004 respectively using this model.

In the calibration method three scenarios were used: (i) Maintaining the same inflation path as was in 2003 (ii) Assuming average trend in 2002 and2003 and

(III) petroleum price adjustment by 20.0 percent and sales tax on building materials of 15.0 percent.

Scenario 1 projects end-September and end-December 2004 inflation of 17.6 percent and 17.7 percent. Scenario 2 forecast inflation of 15.1 percent and 15.2 percent for end-September and end-December 2004 respectively. Scenario 3 estimates 19.1 percent inflation for end-September and 19.7 for end-December.

9.0 **Decision**

The general consensus after the deliberations was to maintain the prevailing policy rate in view of the challenges facing the economy and to consolidate the gains made through the Bank's current monetary policy stance. More specifically, the policy decision was arrived at in view of the following premises:

Surveys and broad indicators of economic activity showed that the economic outlook is favourable in 2004. Economic activity is expected to remain robust following the 9.4 per cent output growth in 2003 premised on increased exports, particularly exports of groundnut oil and cake, the discernible boom in construction activity and the associated mining and quarrying and the continuing rebound in re-exports. The projected increase in FDI reflecting the favourable investment environment, sustained implementation of prudent fiscal and monetary policies and far-reaching structural measures should boost output growth in the medium to long-term.

As to the outlook for inflation, the forward-looking private sector business sentiment survey indicates high inflationary expectations for the remainder of 2004. Other downside risks to the inflation outlook include sustained increase in oil and non-fuel commodity prices and expansionary fiscal stance.

Taking the above-mentioned factors into consideration, in particular the risks to the inflation outlook, the Monetary Policy Committee (MPC) decided to maintain the Rediscount Rate, the policy rate at 34.0 per cent. The MPC would continue to monitor the situation and if the outlook changes, the Committee would review its stance.

A N N E X: Summary of Data Presented

(1.0) World Economic Outlook and External Sector Developments

Since the beginning of the last quarter in 2003, global economic recovery has strengthened and broadened. Industrial production has picked up sharply, accompanied by a stronger rebound in global trade. Business confidence remains high and investment growth -essential to sustain the recovery- has turned solidly positive in almost all regions.

In the second half of 2003, global GDP averaged 6.0 percent, the highest since late 1999. Global GDP growth in 2004 and 2005 are now projected at 4.5 and 5.0 percent respectively. With global trade rising, financial markets buoyant, and the US economy rebounding, the balance of risks has significantly improved (IMF WEO, April 2004). Actual growth may be higher than projected, although geopolitical risks, including terrorists' attacks and oil price hikes are a cause for concern.

Recovery in individual countries and regions vary considerably, reflecting differing degrees of policy stimulus; exchange rate developments; openness and the ability to benefit from rising global trade, especially in information technology (IT).

- The United States is projected to have the strongest recovery among industrial countries. The growth rate is estimated at 4.6 percent in 2004, accompanied by continued strong productivity growth, which should put inflation at bay.

- In Japan, GDP growth has continued to exceed expectations, owing to strong external demand notably from China accompanied by rising investment and latterly a pickup in consumption. Looking forward, GDP growth is projected at 3.4 percent in 2004, the highest since 1996, mirroring the buoyant growth in China (rapid increases in exports and investment) and the recovery in the IT sector.

- In the Middle East, growth is expected to increase from the relatively high levels of 2003, mainly owing to higher oil prices. However, a slow-down in economic output is projected in the medium term especially given difficult fiscal situations in a number of countries.

- Among the poorest countries, GDP growth in Sub-Saharan Africa (excluding South Africa) jumped to 4.4 percent in 2003, aided by surging oil production in Nigeria. GDP growth in the region is expected to strengthen further in 2004, reflecting a combination of improving macroeconomic fundamentals; higher commodity prices; better weather conditions and rising oil and gas production in several countries.

- In the Euro area, where external demand has been the main driving force, recovery has been subdued. Growth is projected to increase to 1.8 percent in 2004 and 2.2 percent in 2005, but with recent economic indicators failing to improve, the robustness of the recovery is uncertain. Across countries in the euro area, growth divergence mainly reflects differences in domestic demand-weakest in Germany and strongest in Greece, Ireland and Spain.

- In contrast to the euro area, macroeconomic performance in the UK remains strong and the main risk to the outlook is the possibility of an abrupt correction in the housing market. Strong performance is due not only to an appropriately counter cyclical monetary policy and an expansionary fiscal stance, but also to structural flexibility, reflecting the deep reforms of labour, product and financial markets over the past twenty years.

- Growth in Latin America has also picked up, partly thanks to stronger demand for primary commodities. Looking ahead, growth is expected to strengthen during 2004, although the outlook remains vulnerable to deterioration in the global financial market environment or domestic policy slippages that undermine investor confidence.

(1.1) Global Fiscal and Monetary Policies

(1.1.1) Fiscal Policy

The weakening of fiscal positions has in recent years become a near global trend, in many cases reversing progress made during much of the 1990s. The US government budget, which was in surplus to the equivalent of 1.5 percent of GDP in 2000, is this year likely to register a deficit of 5.0 percent of GDP, a deterioration of the US fiscal position without precedent since the World War II. Deficits in some large economies in the Euro area are still above the ceiling set in the Stability and Growth Pact.

In the emerging economies, despite action to limit fiscal deficits, the level of public sector debt as a whole has still tended to rise, and now exceeds 50.0 percent of GDP.

It is of some concern that fiscal deficits and debt levels have risen in spite of circumstances that would normally facilitate fiscal consolidation. Interest rates have been falling. And some commodity-exporting countries have had windfall gains in government revenue as the prices of raw materials have boomed.

(1.1.2) Monetary Policy

There is no immediate prospect of generalized inflation that would require a substantial tightening of policies. Comparatively high unemployment is limiting nominal wage increases and spare capacity in manufacturing worldwide reinforces the competitive pressure on prices. Perhaps most important, clear policy commitments across the globe to contain inflation have been made credible by more than a decade of declining inflation rates. But there are signs that inflation is edging higher. Japan is slowly emerging from deflation. The pace of consumer price inflation in China has increased sharply in recent months, and there is evidence that prices are beginning to rise faster in some other Asian economies.

The rapid rise in commodity prices has created perhaps the most visible threat to global price stability. Oil has been trading in recent weeks at around 35 to 40 dollars a barrel, and futures markets indicate that prices are expected to remain high for some time. Non-oil commodity prices are also much higher – indeed, the price of virtually every major commodity has risen appreciably over the past two years. It is therefore essential to monitor commodity price developments very carefully.

(1.2) Economic Developments in Neighbouring Countries

(1.2.1) Senegal

Growth in real GDP averaged a little under 5 percent per annum over 2000/03. In 2002, GDP grew by only 1.1 percent as a result of decreased value-added of the agriculture sector, consequent of poor rainfall. Excluding 2002, real GDP growth averaged 5.8 per cent.

Inflation remained low, averaging less than 2.0 percent over 2000/03. The external current account deficit, excluding official grants declined from 6.3 per cent of GDP in 2000 to 5.0 percent and 5.7 percent in 2001 and 2002 respectively, reflecting good export performance and a surge in private transfers. The fiscal deficit, which rose to 6.6 percent in 2003, is projected at 5.1 percent in 2004.

(1.2.2) Mali

Mali's economic situation improved considerably in 2003 due to favourable weather conditions and adherence to prudent macroeconomic policies, which helped to offset the negative impact of the crisis in Cote- D'ivoire. Agricultural production was estimated to have risen by 32 percent resulting in real GDP growth of 6 percent in 2003, following growth of 4.3 percent in 2002. The combined effects of an increase in the supply of cereal products and a reduction in telecommunication, water and energy prices led to a decline in the consumer index to an average of 1.3 percent during 2003.

In 2004, real GDP is projected at 4.7 percent, inflation to average 2.5 percent, and the external current account deficit, excluding official transfers, to remain below 7 percent of GDP. The overall budget deficit, on commitment basis and excluding grants is expected to be contained at 7.5 percent of GDP in 2004, or an increase of about 2.4 percent of GDP compared with 2003, premised on a higher execution rate of the public investment program.

In 2004, growth in real GDP is projected at 3.0 percent and 4.6 percent whilst inflation is forecast to average 3.0 percent and 8.8 percent in Guinea Bissau and Guinea respectively. As a result of the civil unrest in Cote D'Ivoire, GDP is estimated to grow by a mere 1.8 percent in 2004 and to rebound to 4.4 percent in 2005.

(1.2) Commodity Prices

The global recovery, higher-than-expected economic activity in the U.S and continuing robust economic output in China, instability in Iraq, depreciation of the US Dollar, and speculative activities combined to cause oil prices to rise sharply. Spot prices rose from $26.50 a barrel in September 2003 to $41.0 a barrel at end-June 2004.

Non-fuel commodity prices have also rallied, increasing by about 10 percent in SDR terms since mid – 2003, with metals (traditionally the most cyclical commodity) and food and agricultural raw materials experiencing the largest gains. However, non-fuel prices are expected to moderate in the latter part of 2004 as agricultural supply shocks unwind.

(1.3) Consumer Prices

Concerns about inflation have heightened reflecting robust economic growth, rising commodity prices, particularly oil prices and the accommodative stance of monetary policy in the US and to some extent Britain.

In the emerging economies of Asia, while inflation is still low, it is edging upward. And, in China, concerns about falling prices have given way to worries about overheating and the risk of inflationary pressures. In Africa, inflationary pressures are expected to abate somewhat, thanks to the implementation of prudent macroeconomic policies.

(1.4) Interest Rates

Global interest rates though low, a consensus is beginning to emerge that they will eventually have to rise substantially. In a low interest rate environment, there is a danger that asset prices, which have already rebounded substantially, may defy the fundamentals and continue to spiral upwards. However, future interest rates rise especially if abrupt or unexpected could lead to financial market volatility and possibly adversely affect the recovery. This is a particular concern for countries with buoyant property markets including the US, UK, Australia and New Zealand.

(2.0) Balance of Payments (BOP)

Government's external sector policy in the medium to long-term is aimed at ensuring a sustainable Balance of Payments (BOP) as well as to build reserves adequate to cushion the economy against external and internal shocks. Foreign currency reserves were programmed to cover at least five months of imports in 2003 and 2004.

External sector developments are projected to be more favourable in 2004 compared to 2003. The overall BOP is estimated at a surplus of D814.1 million compared to a deficit of D323.8 million in 2003.

The deficit in the trade balance is expected to widen to D2.1 billion, or 23.3 per cent over the previous year. Although merchandise exports are projected to increase by 35.5 per cent underpinned by the robust export growth of groundnuts and groundnut products and re-exports, imports are expected to grow by 30.8 per cent.

The current account deficit, excluding official transfers is estimated at D1.8 billion compared to D1.5 billion in 2003. Including official transfers, the current account is projected at D757.7 million relative to D516.9 million in 2003.

The capital account is projected to increase markedly to D1.6 billion, or 427.1 per cent underpinned by an expected surge in private capital flows. Net outflows of other investment is expected to decrease from D389.1 million in 2003 to D43.8 million in 2004 while net inflow of foreign direct investment (FDI) is estimated at D1.5 billion compared to an outflow of D28.4 million.

The projected improvement in the overall BOP should cause gross official reserves to increase by D466.5 million adequate to cover approximately five months of imports.

(3.0) Monetary Developments

Growth in money supply decelerated to 30.3 per cent at end-May 2004 compared with 40.9 per cent a year earlier. Both narrow money and quasi-money recorded significant increases.

(3.1) Reserve Money

Despite the vigorous use of the monetary policy instruments, reserve money grew by 36.1 percent relative to the previous year. After declining in the second quarter of 2003, currency issued by the Central Bank increased slightly in the third and fourth quarters of 2003. The growth trajectory continued in the first quarter of 2004. Compared to end-march 2003, currency issued grew by 47.1 percent.

Deposit money banks reserves, on the other hand, increased steadily between the first and the fourth quarters of 2003 mirroring the increase in the reserve requirement from 14.0 percent to 18.0 percent of deposit liabilities. However, bank reserves declined by 9.6 percent in the first quarter of 2004 relative to the fourth quarter of 2003. Compared to end-May 2003, bank reserves rose by 31.1 percent.

(4.0) Money Market Developments

The total outstanding stock of interest bearing debt increased to D3.0 billion at end-March 2004, or by 7.1 percent from a year ago. The composition of the debt is as follows:

1. Treasury bills –76.78%
2. Development stock –0.68%
3. Discount note series –3.51%
4. Others – 19.03%

The non-bank public, including the parastatals held the bulk of the debt, followed by the deposit money banks and the Central Bank.

(5.0) Private Sector Business Sentiment Survey

The survey covered sixty (60) private sector enterprises and four (4) parastatals to obtain timely data on an area of the economy that is not well covered by official data and to monitor business and economic conditions. The panel was carefully selected to accurately replicate the true structure of the formal economy.

From the survey data it could be discerned that most of the respondents are of the view that the overall level of economic activity would either decrease (35.0 per cent) or would be unchanged (38.0 per cent) relative to the previous year. The remainder (27.0 percent) felt economic activity would be higher in 2004. At the enterprise level, most firms in the industrial and agricultural sector projected lower sales and decreased profits. Services firms, in contrast, estimated higher sales, but reduced profits.

Inflationary expectations were also quite high. The majority of firms projected high prices (50.0 percent) against 8.9 percent who indicated that inflation would be lower.

(6.0) Real Sector

Assuming normal rains, which should boost agricultural production, coupled with the expected robust growth of building and construction, mining and quarrying and re-exports, on balance, growth in GDP is projected at 6.0 per cent in 2004.

Risks

The projected growth rate of 6.0 per cent could, however, be undermined by the following:

- Poor rainfall;
- Further increase in world oil prices, which could negatively impact the terms of trade;
- Larger-than-expected decline in tourist arrivals;
- Higher than projected budget deficit financed by the Central Bank and the concomitant increase in inflationary pressures.

(7.0) Fiscal Developments

In 2003, total revenue and grants amounted to D1.81 billion, an increase of 19.3 per cent from 2002. Total expenditure and net lending stood at D2.27 billion, substantially below the programmed target of D2.49 billion. Interest payments on the domestic debt and external debt rose significantly by D237 million, or 64 per cent. The Budget deficit was 8.8 per cent of GDP compared to 9.4 per cent of GDP in 2002. The budget deficit was financed from domestic sources (D320.5 million) and external sources (D234.7 million). The primary balance improved from a surplus of 3.3 per cent of GDP in 2002 to 5.9 per cent of GDP in 2003.

The 2004 budget seeks to reduce the budget deficit by improving revenue collection and containing expenditure. Several policies and programmes are to be implemented to enhance revenue and contain expenditure, including:

- Establishing a Revenue Authority;
- Modernising the income tax, sales tax and Customs Acts;
- Creating the National Emergency Fiscal Committee (NEFCOM);
- Increasing taxes on petroleum products
- Widening the coverage of income tax to include the informal sector
- Upward revision of tax on imported water and soft drinks and
- Increased fees for alien identification cards, drivers license and residential permit.

(7.1) Revenue Q1 2004

Total revenue and grants amounted to D658 million, an increase of 37.8 per cent from end-December 2003. Domestic revenue increased to D638.3 million, or 55.4 percent. Tax revenue rose to D584.8 million, or 53.6 percent mainly due to improved performance of taxes on international trade, which increased by 76.3 percent to D335.3 million. Taxes on income and property rose to D174.7 million or 37.9 per cent. Non-tax revenue increased to D53.6 million, or 36.4 per cent from end-2003.

(7.2) Expenditure Q1 2004

Total expenditure and net lending amounted to D936.7 million, registered an increase of 86.8 per cent over the same quarter last year.

(7.3) Deficit

The overall budget deficit including grants on commitment basis totaled D278.6 million or 2.8% of GDP. On cash basis, the deficit amounted to D384.8 million. This was financed by domestic sources (D208.0 million), external sources (D176.8 million)

(8.0) Financial System Soundness Indicators

(8.1) Capital Adequacy

This measures the ability of the banking sector to absorb shocks resulting from its operations. The average ratio for end-March was 27.2 percent which compares favourably with the 25.9 percent for end-December 2003. All the banks met this requirement. Minimum capital of D60.0 million has recently been introduced. All existing banks are required to comply with this requirement by March 31, 2006.

(8.2) Asset Quality

As at March 31, 2004, the total non-performing loans stood at D261 million. The lowest was D5.4 million and the highest D156.8 million. The non-performing loans accounted for 15.9 percent of gross loans. Provisions as a percentage of problem loans stood at 44.9 percent from 42.5 percent at end-December 2003, implying inadequate provisioning of problem loans.

(8.3) Earnings and Profitability

The Banking sector continues to operate with reasonable profitability. The highest profit after tax was D58.9 million and the lowest was D0.99 million for the three months ending March 31, 2004.

(8.4) Liquidity

The Liquidity ratio at end-March stood at 73.89 percent. The lowest was 63.0 percent and the highest was 78 percent. The ratio was well above the 30.0 percent requirement.

(9.0) Inflation Outlook and Analysis

End-period inflation, as measured by the consumer price index of low-income population of Banjul and Kombo St Mary area, declined from 17.7 percent in May 2003 to 15.8 percent in May 2004. Average inflation rate at end-May 2004 (12 month moving average) stood at 17.8 percent.

Food consumer price inflation declined to 20.1 percent in May 2004 compared to 21.9 percent in the previous year owing mainly to the decline in the prices of ‘‘meat, poultry, eggs and fish’’ and ‘‘other foods’’. Non-food inflation, on the other hand, rose from 9.3 percent at end-March to 13.3 percent in May 2004 as a result of increased prices of fuel, housing and miscellaneous items.

(9.1) Core Inflation

The measures of core inflation attempts to strip out the effects of temporary disturbances from the headline inflation in order to uncover the underlying rate of inflation. The first measure of core inflation, which strips out fuel, light and transportation, showed inflation rising from 15.1 percent in April to 15.5 percent in May 2004. The second measure of core inflation, which excludes energy, transportation and volatile food items showed inflation declining from 14.2 percent in March to 13.1 percent in April but rose marginally to 13.2 percent in May 2004.

(9.2) Inflation Forecast

- A short-run error correction model (ECM) and calibration technique were used to forecast inflation for 2004

(9.2.1) Forecast Assumptions (ECM)

- Growth in money supply of 20 percent.
- Government expenditure and net lending at 25.5 percent of GDP
- Stale exchange rate for the entire 2004.

The forecast for 2004 using the ECM are: 13.8 percent for end-September 2004 and 12.3 percent for end-December 2004.

(9.2.2) Forecast Assumptions (Calibration method)

- Maintaining the same inflation path as was in 2003
- Assuming average trend in 2002 and 2003
- Petroleum price adjustment by 20 percent and sales tax on building materials of 15 percent.

The forecast for the three scenarios are:

- 2003 path: 17.6 percent for end-September and 17.6 for end-December 2004

- Petroleum price increase by 20 percent and sales tax of 15.0 percent on building materials: 19.1 percent and 19.7 percent for end-September and end-December 2004 respectively.
- Average have 2002 and 2003: 15.1 percent and 15.3 percent for end-September and end-December 2004 respectively.

(9.2.3) Factors that might affect the inflation dynamics in 2004

- Significant domestic demand pressure in 2004 due to expansionary fiscal and monetary policies;
- Exchange rate movements would not only increase the input cost of imported intermediate goods, but impact inflation directly via imported consumption goods;
- The budget-financing requirement may increase, including financing from the Central Bank.
- Sustained increase in world oil prices may put pressure on the exchange rate and invariably consumer prices