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Side event

Round-table meeting of governors of central banks in Africa on monetary and exchange rate policy and Africa's debt burden and sustainability

Concept note

I. Introduction

1. A round-table meeting of governors of central banks in Africa and governors and executive directors of multilateral and regional development banks will be held on the theme of monetary and exchange rate policy and Africa's debt burden and sustainability. The meeting, which provides a platform for reflection on how to enhance the effective engagement of African central bank governors with the continent's development agenda, is geared towards delivering clear outcomes and new ideas.

2. Over the past 16 years, African economies have been buffeted by exogenous and endogenous shocks. Their response to these shocks has not only defined short- and medium-term policy direction, but also their long-term abilities to adjust. In some instances, short-run responses might have robbed economies of their long-term policy thrust and capacity for future defensive action. All in all, it is evident that economic management is taking a new turn in many African economies in the wake of an external environment that has barely recovered after the global financial crises. There has been ample debate in Africa on how to conduct monetary policy and at the same time manage exchange rate policy amidst the global economic slowdown, declining commodity

prices and the need for debt sustainability. At the centre of the policy debate is the role that central banks play, first, in providing appropriate coping strategies for insulating economies against exogenous shocks and, second, in aligning their strategies to the African transformative policy agenda.

3. African economies have experienced a variety of challenges and opportunities concerning monetary and exchange rate policy in response to exogenous and endogenous shocks. Policy responses have been driven by the shocks themselves, as well as the degree of exposure and policy flexibility in economies. African central banks need to successfully steer through the current twin policy minefields of a global economic slowdown and sustained commodity price slump, while also keeping an eye on the looming threats of fiscal imbalance and fiscal policy dominance to monetary policy.

4. African central banks must confront and overcome possible conflicts between adhering to inflation targeting regimes and intervening in foreign exchange markets so as to synchronize action in an optimal manner to achieve desirable outcomes and provide stability in domestic prices. In some economies, the exchange rate is a major determinant of inflation and the pass-through effects on domestic prices are more than unitary. In one African economy, for example, empirical work has shown that a 10 per cent depreciation leads to 20 per cent change in inflation.

5. In addition, issues such as financial inclusion, the development of financial systems beyond banking, closing the (soft and hard) infrastructure gap, managing sovereign debt, addressing the shortage of finance for productive investments, ensuring intergenerational savings and facilitating regional integration by linking cross-border payments systems, are all concerns that African central banks must address as part of their countries' developmental policy priorities. It is important that the choices that central banks make on monetary and exchange rate policies do not jeopardize the broader developmental agenda.

6. The policy dialogue during the round-table meeting will centre on the following four objectives:

(a) Assessing global economic developments, their impact on macroeconomic indicators in Africa and the response of African central banks, with a special focus on exchange rate changes and their impact on Africa's external debt burden and debt sustainability measures;

(b) Evaluating short-term monetary and exchange rate policy choices by African central banks in the face of macroeconomic volatility resulting from commodity price declines and other global financial and economic shocks, and their implications for medium- and long-term development priorities and challenges;

(c) Identifying long-term transformative measures that central banks can undertake to respond to such shocks;

(d) Identifying policy lessons and good practice, and recommendations on how central banks can advance Africa's agenda for structural transformation.

II. Policy menu for African central banks

1. Policy directions for monetary and exchange rate policy in Africa

7. The responses of central banks to exogenous and endogenous shocks are necessarily conditioned by the need to discharge their core mandate, which is essentially to manage inflation on the basis of the tenet that low and predictable inflation is good for economic growth and promotes macroeconomic stability. Stability implies that prices are predictable, including the exchange rate. In addition, the economy's degree of exposure and the availability of policy flexibility afforded by the type of the exchange rate regime a country has adopted are also important determinants of the approach a central bank will employ in the face of exogenous and endogenous shocks.

8. In the policy arena, the African central banker has to contend with the added dimension of the global economic slowdown, with its accompanying prolonged period of unconventional monetary policy in developed economies. The African central banker is also faced with the challenges of, first, how to conduct monetary policy in the presence of supply shocks and declining commodity prices, second, how to build foreign exchange reserve buffers to protect the economy and, third, how to engineer the optimal use of those foreign exchange reserve buffers to smooth volatility from perceived transitory exogenous shocks.

9. In most African economies, the primary objectives of the central bank can be summarized as:

(a) To manage inflation, either by way of an explicitly targeted rate for those countries that have undertaken inflation targeting, or implicitly, whereby a medium-term price target is announced by the ministry of finance at the start of each fiscal year;

(b) To minimize the output gap around the "potential" or trend level of GDP growth;

(c) To minimize exchange rate deviations from the level implied by medium-term fundamentals.

10. Should this be the general policy setting for a typical central bank in the African context, it can be expected that the central banker walks a tight rope. In the midst of negative shocks, the central banker must tolerate a slightly more depreciated currency. However, in the case of positive shocks, the tendency will be to tolerate a more appreciated nominal exchange rate. Most African economies buffeted by exogenous and domestic shocks lack the full policy credibility that comes with successful and prolonged periods of price stability. Credibility is usually short lived when exchange rate volatility dominates and domestic prices mimic exchange rate movements. In addition, supply shocks – usually food and energy prices – will drive domestic inflation together with exchange rate pass-through effects.

11. The African central banker will need to consider:

(a) The best approaches to avoid a potential conflict between price stability and exchange rate objectives;

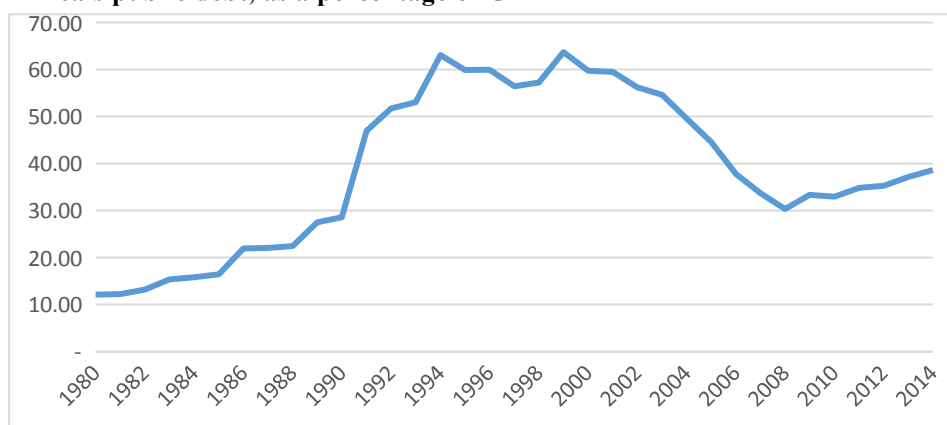
(b) Under what conditions inflation targeting might prove useful or when it needs to be abandoned;

(c) The best policies to simultaneously manage domestic prices, the exchange rate and capital controls.

2. Implications for Africa's debt burden and long-term debt sustainability

12. African economies that are highly dependent on exporting commodities (such as Nigeria and Zambia) have recently registered lower export revenues and low growth, fiscal imbalances, current account deficits and a rise in the ratio of public debt to gross domestic product (GDP) (see figure). Indeed, most African countries have exhibited an increase in that ratio since 2008, with the exception of a few, such as Côte d'Ivoire, whose ratio shrunk by nearly half from 2010 to 2015 (from 63 to 34 per cent) and the Democratic Republic of the Congo, where the ratio decreased from 27 to 22 per cent over the same period. Part of the rise in the levels of debt for most countries has been necessitated by the demands for infrastructure financing. The removal of quantitative easing in most advanced economies has also seen the return of expensive finance.

Africa's public debt, as a percentage of GDP



13. Both monetary and exchange rate policies should be used creatively to allow African countries to generate the large volume of development finance, including external borrowing, required for Africa's structural transformation, including quality skills development, improved agricultural productivity, infrastructure, industrialization, and enhanced regional integration and investment. Additionally, accountable and transparent public finance management needs to be in place to ensure that external debt finance is channelled to development projects with long-term social and economic returns. Countries need good debt-sustainability frameworks.

14. It is clear from the figure above that total public debt as a percentage of GDP declined in Africa since the Monterrey Consensus of the International Conference on Financing for Development, particularly in the period from 2002 to 2008, because of debt relief, sustained GDP growth and economic size expansion induced by GDP rebasing. Despite a declining trend in total foreign debt, the share of net foreign debt in some countries is not negligible. Mineral-rich and oil-importing countries in particular have positive net foreign debt.

15. Africa's public investment driven growth momentum fuels a growing sovereign debt appetite. Hence, fast growing economies in

Africa are moving towards market-based loans by issuing sovereign bonds in addition to getting concessional loans. Accountability, effective use of borrowed funds and fiscal discipline will help to avoid any potential debt problem. Oversubscriptions and favourable international terms of Africa's sovereign bonds have shown that the continent has gained the attention of international investors, which has in turn opened up the continent's borrowing space. Countries run the risk of having enormous debt problems if current commodity price headwinds continue. Such trends require effective central bank oversight on government borrowing, including the use of open market operations.

16. African sovereign debt losses may reach \$10.8 billion, which is equivalent to 1.1 per cent of the region's GDP. Sovereign debt- is a riskier option for investment even if it has better terms relative to concessional loans. Changes in macroeconomic fundamentals such as terms of trade (e.g., due to commodity price collapse) can affect sovereign debt spread significantly. The existing arrangements are driven by laws in advanced and powerful economies. In this regard, a global framework on sovereign debt restructuring is essential.

17. In the light of the above, debt sustainability requires sound fiscal policies and debt management emphasizing on growth. For countries with borrowing space, this includes borrowing for growth-enhancing outlays. However, the interest-growth differential is subject to shocks; while Africa's growth prospects are promising, the real interest could be rising in the future. The sovereign debt restructuring mechanism was proposed by the International Monetary Fund more than a decade ago, but there is no international agreement so far. There is general consensus that existing rules are too creditor-friendly. Equally, a push for an international agreement that is too borrower-friendly might not be the way forward. Therefore, any global agreement should strike the right balance on the basis of fairness to both sides.

18. In the long run, it is not just the volume and terms on which countries borrow that determine debt sustainability, but what they borrow for. Unsustainable debt levels might be an outcome of poor macroeconomic management and a feature of a structural economic malfunction. Most countries in Africa have benefited from initiatives such as the Heavily Indebted Poor Countries initiative and the Multilateral Debt Relief Initiative, and this has been made possible by the sensible policies pursued by the beneficiaries. Therefore, continuing the sound macroeconomic management in addition to sustained growth is critical for debt sustainability. Moreover, resource-poor countries do not have the advantage of tapping savings accumulated from the commodity price boom and thus rely on sovereign borrowing. Therefore, debt sustainability is crucial for them. African Governments and their partners need to consider the following:

- (a) Appropriate countercyclical fiscal and monetary policies, optimum mix of long-term bonds issued in local and foreign currencies with the aim of reducing exposure to the risks of currency volatility and appropriate mechanisms by central banks for managing national capital reserves to

ensure appropriate import cover and debt servicing;

(b) Mechanisms for creditors to share responsibility with the sovereign debtor to resolve potential future debt crises, the establishment of a multilateral legal framework for sovereign debt restructuring that ensures the stability of the international financial architecture and delinking potential future debt relief from aid allocations by donors.

3. Building resilience to manage external shocks in African economies

19. African policymakers often ask how African economies can build internal and external resilience to better navigate shocks. However, usually, only after shocks have already occurred and at a time when making adjustments is also more difficult. Both short- and medium-term policies are usually necessary to build resilience and this implies that policy interventions by the central bank need to be anchored by a long-term vision.

20. When faced with external shocks, African policymakers have often reacted by reducing long-term development budgets and ring-fencing recurrent expenditures. This approach has typically had the effect of robbing African economies of their capacity for future growth and their ability to manage future shocks.

21. In the light of this experience, the African central banker needs to consider:

(a) What buffers might need to be in place to manage shocks in the short-term, including foreign exchange reserves and stabilization funds;

(b) The remedial actions that might be necessary in the light of medium- and long-term shocks, such as making the necessary public investments to close the infrastructure gap and address changing country demographic profiles, boosting private investments with a view to accelerating industrialization and enhancing the profitability of existing and future private investments, and facilitating regional integration.

4. The role of the central banks in creating a transformative financial system

22. A transformative financial system is one that not only ensures that sufficient capital is channelled to the productive sector, but also facilitates financial inclusion. The primary points of entry into the financial system for the majority of the population is banking and payments services, which, in turn, facilitate the accumulation of savings and access to credit. Financial inclusion is now recognized as an important policy goal for sustainable poverty reduction and growth in Africa.

23. Financial inclusion in Africa has been shaped and supported by developments in the mobile telephony platforms for financial services. It will be important not only to push the innovation frontier, but also to interrogate how this revolution could be consolidated to support a financial revolution in the development of financial systems in Africa.

24. The development of financial systems and accompanying financial infrastructure through innovations in technology must be primarily driven by central banks in Africa, through their regulation of commercial banks and other deposit-taking institutions.

25. The African central banker should consider and take proactive action on the following issues:

(a) Whether to adopt a telecom-led or bank-led model in the digital financial services evolution, and the role of banking regulations in facilitating financial technology revolutions;

(b) The efficiency and flexibility implications of financial technology revolutions and enhanced financial inclusion for monetary policy.

5. Developing bond markets for long-term finance in Africa

26. Central banks are well placed to leverage the positive outcomes from sound macroeconomic management and economic growth in Africa to drive policies for structural transformation and inclusive growth by creating the environment for the development of markets for long-term finance. In most African economies that have reported a strong economic performance in the past 15 years, it can be observed that strong central banks have driven financial sector vibrancy, financial stability and seeds for financial development.

27. The African central banker needs to consider the role of the central bank in:

(a) Fostering the development of long-term capital markets and the establishment of national development banks;

(b) Ensuring public investments can be financed without accumulating unsustainable debt levels.