Common Market for
Eastern and Southern Africa

Monetary Tightening Cycle and it's Implication on the Economies of the COMESA Region

Special Report

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Introduction

The world economy is undergoing a period characterized by multiple overlapping global risks that are making policymaking and investment decisions very challenging. These risks include among others, the lag effects of COVID-19 pandemic, spillovers effects of the Russian-Ukraine war and the tightening global financial conditions, all presenting serious headwinds to economies in the COMESA region. These shocks have led to substantial volatility in global financial markets, fueled inflationary pressures, increased cost of capital and cost on debt servicing, and disrupted global supply chains for food and energy products. These shocks have also led to a slowdown in economic activities in Europe and China, who are Africa's main trading partners, which in turn have led to a decline in demand for exports to these markets.

Consequently, to contain the resultant high inflationary pressures, advanced economies have instituted interest rate increases. This has led to tightening global financial conditions and the appreciating US dollar. With most foreign debt in these economies denominated in US dollars, the two factors have increased the cost of servicing the existing debt and heightened the risk of debt distress. The tight financial conditions have also restricted access to international capital markets for new financing, greatly amplified by instability in foreign exchange markets. For most of these countries, the resultant excessive depreciation of the local currencies has led to further inflationary pressures. This article provides a brief analysis of these shocks, the resultant policy response and implications to the economies of the COMESA region.

Drivers of Inflationary Pressures

Geopolitical tensions and the prolonged Russia-Ukraine war continue to elevate global uncertainty, disrupting global supply chains which is resulting in persistent increase in commodity prices and inflation. This resulted in a steep increase in oil prices in 2022 reaching a peak of USD 122.71 per barrel in June 2022. Crude oil prices rose fastest by around 29.4% from $86.5 in January 2022 to $112 in May 2022, before settling at an average of $91.8 between June and September 2022. The oil prices have since eased to an average of USD 74.84 per barrel in June 2023. (Figure 1). The lower oil prices appear to reflect weaker outlook for global growth, while prospects for supply remain mixed with production cuts announced by the Organization of the Petroleum Exporting countries (OPEC), partly offset by the unexpected resilience of Russia oil production.

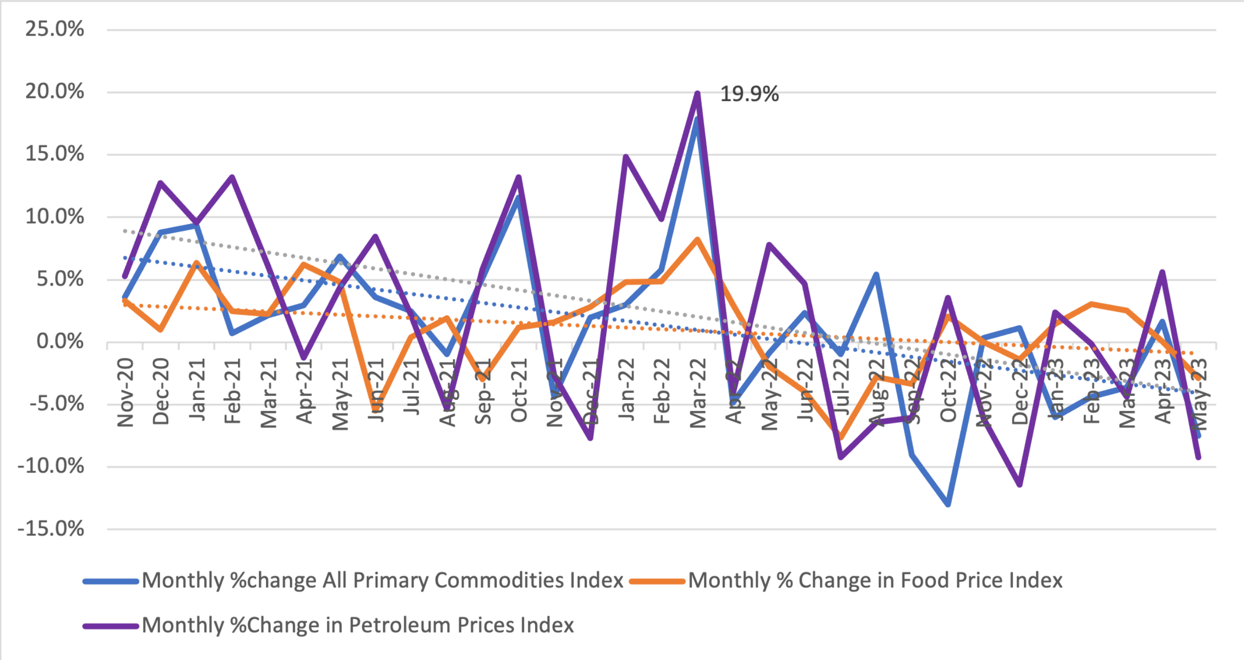
Figure 1: Brent Spot Price FOB Dollars per Barrel

Data Source: Thomson Reuters

Commodity prices also drastically increased following the invasion of Russia on Ukraine in March 2022. Russia invasion of Ukraine in February 2022 exacerbated the already weak global supply chains, raising commodity prices and increasing inflationary pressures. From a drop of negative 4.4 percent in November 2021, the percentage change in the monthly primary commodities index rose sharply to 17.9 percent in March 2022. Similarly, the percentage change in the monthly petroleum price index increased from negative 2.6 percent in December 2021 to 19.9 percent in March 2022. Similarly, food price index monthly changes increased from 1.6 percent in November 2021 to 8.2 percent in March 2022 (Figure 2). The instability in global energy supplies and prolonged conflict continue to fuel inflation.

In some countries, high fuel prices have resulted in higher cost of living and could lead to 2nd round effects as workers demand compensation in form of increased wages, putting further upward pressure on prices in a self-reinforcing spiral. Other key factors that explain these inflationary pressures include domestic factors such as expansionary public investment spending, direct effects of imported inflation, exacerbated by supply chain disruptions.

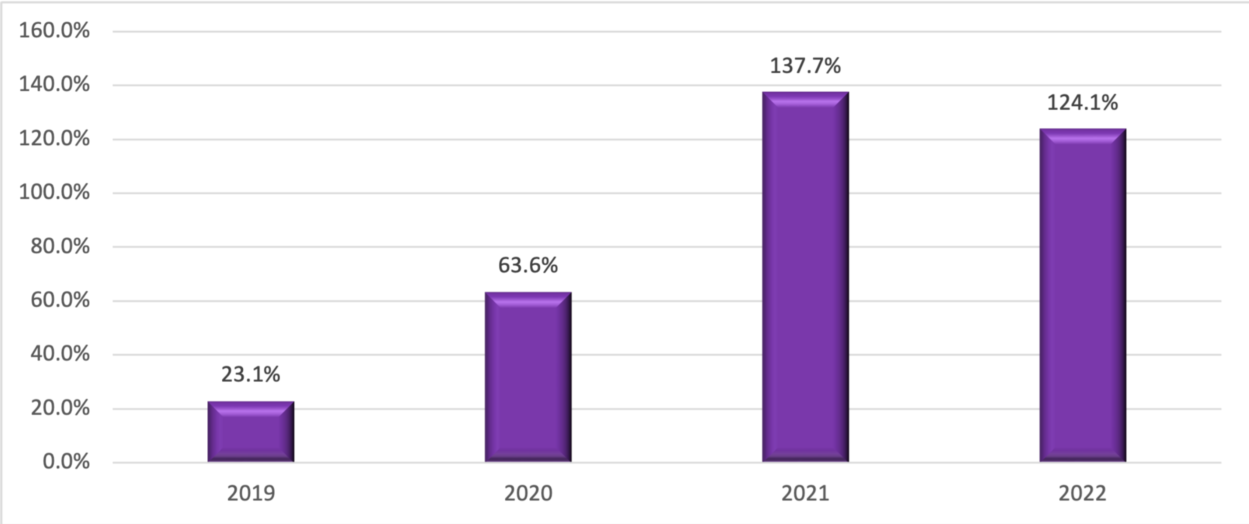
Figure 2: Monthly Percentage Changes in All Primary Commodities, Food, and Petroleum Price Indices



Source: IMF International Commodity Price Indices

For the COMESA region, the average annual inflation rate stood at (+124.1 %) in 2022 compared to (+137,7%) in 2021. The higher inflation in 2021 reflected the effects of supply chain disruptions at the peak of COVID-19 pandemic (Figure 3).

Figure 3: Percentage Average Annual Inflation in the COMESA Region



Source: COMSTAT data base

However, the overall annual inflation in the COMESA region measured by the Harmonized Consumer Price Index (HCPI) declined from 45.1% in April 2023 to 35.4% in May 2023. This is a significant decline from 142.6% in May 2022 (Figure 4). The decline in inflation can be attributed to falling food prices in recent months reflecting partly the easing of supply disruption from the Ukraine Russia war, falling fuel prices and improving food supply as a result of favorable weather conditions.

A closer look at individual economies as at May 2023, reveals that countries have experience very differentiated inflation experience with some countries posting single digit inflation such as Eswatini (8.2%), Kenya (8.8%), Madagascar (9.6.%), Mauritius (7%), Seychelles (-0.1%), Uganda (6.2%) and Zambia (5.4%). Some other countries experienced hyperinflation including Zimbabwe, Sudan and Ethiopia at 74%, 40.7% and 39.9% as at May 2023 (Figure 4).
Figure 4: COMESA Member States annual inflation rates (%) as at April and May 2023

Source: COMSTAT data base
The concern to contain inflation emanates from the serious and lasting costs it poses on the economy and people.

Even though the distributive effects of inflation are complex with the impact varying across countries and across income groups, high inflation, among others, adversely affects economic growth. It erodes the value of income and saving and leads to high nominal interest rates. This is because high inflation increases the uncertainty about future relative prices and the price level, and so domestic and foreign financial markets require a higher risk premium as compensation for this increased uncertainty. Inflation causes spending not to keep pace with the rise in the monetary value of the economy's output. For instance, faster increase in food prices hurt the poor most since food constitutes the largest share of their total consumption. Inflation also erodes monetary value of assets and liabilities held by households, with borrowers gaining at the expense of creditors; and it erodes the real value of government debt at the expense of bond holders.

When inflation is high in the long term, inflation and depreciation expectations generally become fixed in the decision-making of economic agents. Inflation causes several other economic distortions that reduce the long-term growth potential of the economy. That is, it redistributes income from creditors to debtors; it creates distortions in the tax system; and it represents a hidden burden on savers, who are unable to safeguard the purchasing power of their incomes and savings. In the presence of inflation, being efficient and competitive at the production and distribution of goods and services becomes less important to the real outcome of economic activity.

Current Monetary Policy Tightening Cycle

Monetary policy is an art of how Central Banks adjust the supply of money in the economy to achieve a given objective. For most central banks, the main objective is to achieve a combination of inflation and/or output target. Some central banks also have a financial stability objective as one of their mandates.

How exactly does monetary policy help achieve inflation and or output objective? In the long run, output is fixed and therefore changes in money supply only result in inflation – an increase in the general price level. However, in the short run, because prices and wages do not adjust immediately, changes in money supply affect actual production of goods and services, making monetary policy a very important policy tool for achieving both inflation and growth objectives. For instance, during periods of high inflation, the economy is said to be overheating, in which case, the central bank needs to tighten monetary policy. Tight monetary policy entails central bank increasing the reserve requirement or an increase in the discount rate or selling of government securities, which causes money supply to decline which in turn leads to higher interest rates and a reduced quantity of loanable funds. In turn higher interest rates and a reduced quantity of loanable funds leads to a fall in investments and aggregate demand, closing the output gap and resulting in fall in prices. Business investment will decline because it is less attractive for firms to borrow money, and even firms that have money will notice that, with higher interest rates, it is relatively more attractive to put those funds in a financial investment than to make an investment in physical capital. In addition, higher interest rates will discourage consumer borrowing. Conversely, an expansionary monetary policy that leads to lower interest rates and a higher quantity of loanable funds will tend to increase business investment and consumer borrowing. This leads to an expansion of output and an increase in prices. As the economy gets closer to producing at full capacity, increased aggregate demand will in turn put pressure on prices including wages. Consumers with the extra income will even demand more goods and services, bidding up prices and wages and generally lead to higher inflation.

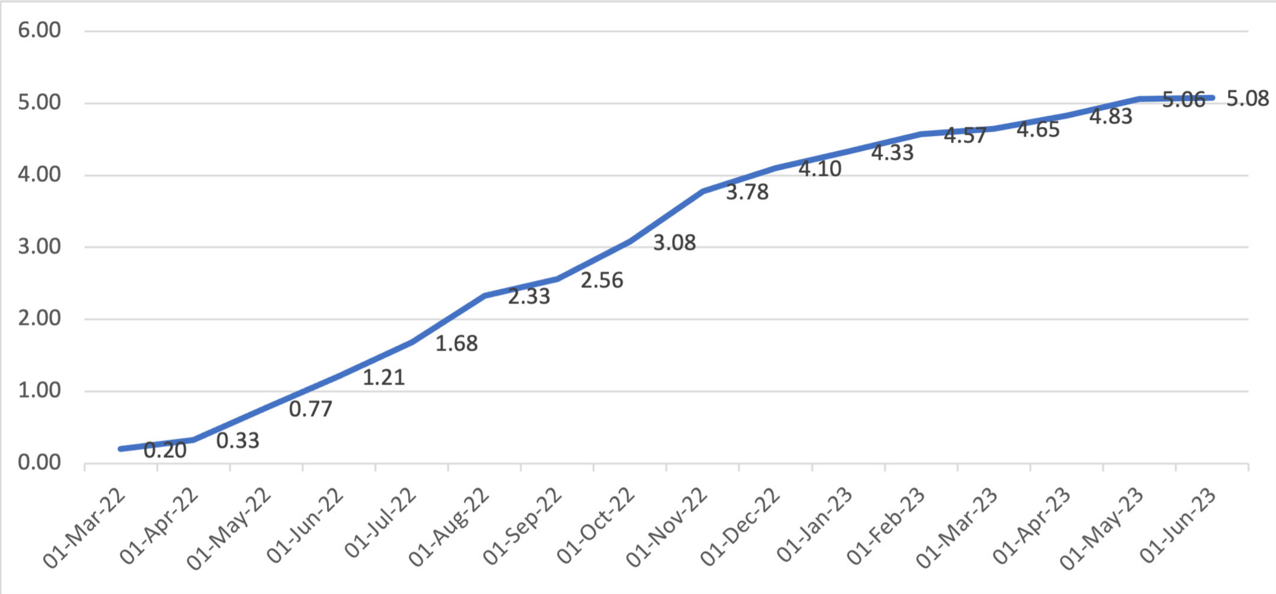
In practice and to anchor inflation expectations, central bank publicly announces one policy interest rate it would like to see rather than any specific amount of money. However, to achieve the policy rate may require changes in money supply. The policy rate is generally a short-term, often overnight rate that banks charge one another to borrow funds. The central bank focus on this policy rate by either loosening policy (a rate cut) through injecting money into the system by buying government securities or tightening (a rate hike) when central bank withdraw liquidity by soaking up reserve through selling of government securities. The policy rate is expected to feed through all other interest rates in the economy.

Monetary Tightening in Advanced Countries

Economies of the world are emerging from an era of structurally low demand and low inflation. However, increased government spending to boost employment from very low level, with inflation at its lowest for over a decade resulted in some form of fiscal dominance, with central banks acting to accommodate government's fiscal spending. A combination of these policy actions resulted in long period of low interest rates and high liquidity. However, the negative effects of the COVID-19 pandemic and the effects of war in Ukraine have fueled an increase in inflation globally. Together with the policy of monetary accommodation across several advanced countries, have resulted in a turn of the curve that now sees many countries in the world experience higher inflation.

The United States Federal Reserve has raised its policy rate over ten consecutive times between March 2022 and June 2023 and cumulative by 420 basis point to anchor inflation that peaked at 9.1 percent in July 2022 – a 40 year high, bringing US interest rates to the highest level in over a decade. Consequently, the average monthly US policy rate (Federal funds Effective rate) has increased from a low of 0.2 percent in March 2022 to a new high of 5.08 percent in June 2023 (Figure 5). Other advanced economies have also been increasing their policy rates in the recent past to contain inflation.

Figure 5: US Policy Rate, Percent, Monthly, Not Seasonally Adjusted



Source: US Federal Reserve Economic Data

Monetary policy has however not been very successful as a tool to ensure low and more stable inflation due to the problem of "time inconsistency". This is the case where central banks that are not independent from government initially commit to low and stable inflation but still have the urge to boost employment and economic growth. As such they increase money supply but as the economy responds through increased economic activities, the central bank is unable to resist further increases in money supply leading to increases in prices. Instead, the central bank surprises the economy with even further increase in money supply. With time, people would soon recognize this "inflation bias" and increase their expectations of price increases, making it difficult for monetary policy to ever achieve low inflation. To overcome the time inconsistency problem, central banks independence is being entrenched for most monetary authorities in the region and the world. Central bank independence is now associated with low and stable inflation for many central banks in the region and the world.

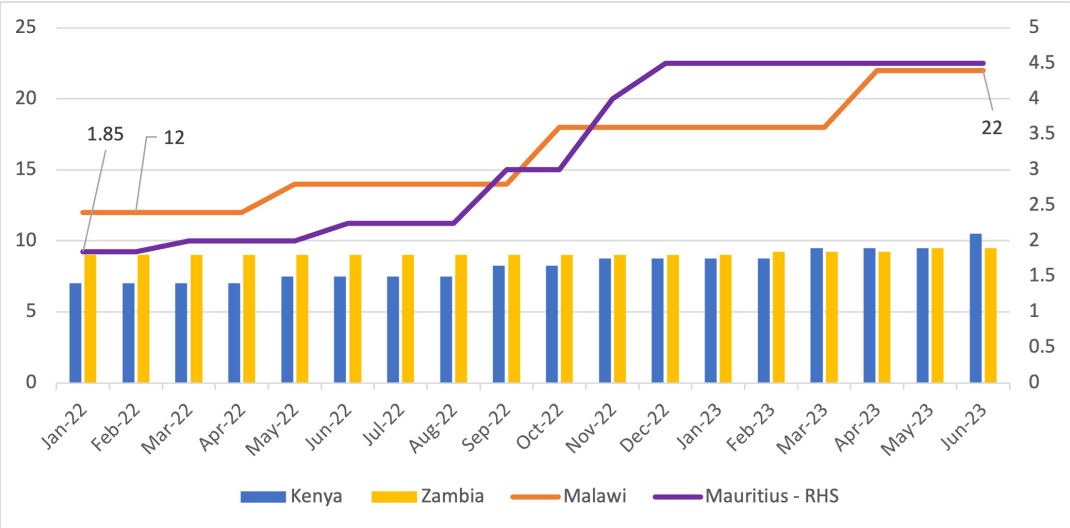
The rise of interest rates to contain inflation has also brought to the fore the increased risks to financial stability.

However, investors are fairly optimistic and expect inflation to decline without more increase in interest rates, although the recession is expected to be modest. But this does not mean that policy makers relent but instead should stand ready to act if financial sector distress was to have severe repercussions for the broader economy. In this case, monetary policy should be directed towards ensuring financial stability, with clear communication that central bank resolve to bring inflation back on target as soon as possible once financial distress lessens.

Implication of Monetary Policy Tightening

Monetary policy tightening in advanced countries has resulted in increased uncertainty, weak global sentiment and increased imported inflation and depreciation of local currencies in several COMESA member countries. In response, several regional central banks have followed suit and embarked on a monetary tightening cycle with the aim of containing inflation and mitigating disruptive capital outflows and currency depreciations. However, the magnitude and frequency of policy rate adjustments vary across countries. For instance, since January 2022 to date, Seychelles has not raised the policy rate but maintained it at 2 percent, Zambia raised the policy rate 2 times, Malawi has raised it 3 times, while Kenya and Mauritius raised their policy rates 5 times each (Figure 6).

Figure 6: Selected COMESA Central Banks Policy Rates Jan 2022 to June 2023



Source: Authors compilation from individual Central Banks Websites

These policy rate hikes have resulted in increases of varying magnitude ranging from a zero-rate increase in Seychelles to a 1000 basis points increase in Malawi (Figure 6). Even with the aggressive policy rate increases, some countries have not managed to tame inflation (Figure 4). This may mean that either the transmission mechanism of monetary policy does not work in these countries or there are considerable lags in the transmission mechanism.

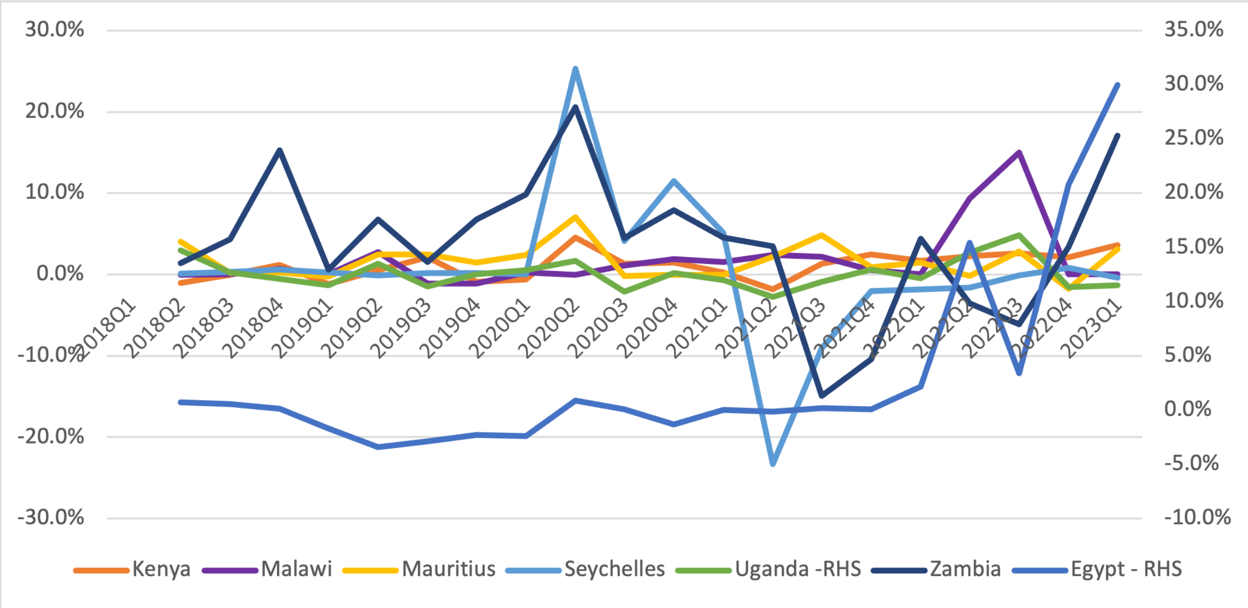
Exchange Rate Depreciation

The tightening of global financial conditions has exerted considerable pressure on most domestic currencies in the region, raising the risk from already high inflation. Even though the dynamics of exchange rates are mixed, many countries in the region have experienced exchange rate depreciation. This is attributed to interest rate increase in advanced countries in 2022 and global uncertainty which is driving investors away from emerging economies assets, including African currencies towards safe haven US treasuries.

Most currencies lost substantial value against the US dollar due to monetary tightening in the United States. Between 2021Q1 and 2023Q1, most domestic currencies depreciated against the US Dollar. The Egyptian pound, Malawi Kwacha, the Kenya Shilling, and Mauritius Rupee depreciated by 92 percent, 32 percent, 15 percent and 14 percent, respectively (Figure 7). The large depreciation of these domestic currencies can be attributed to severe macroeconomic imbalances including constrained revenues and weak investment flows, pressure from global risk aversion to more safe assets and waning investor confidence, among other factors.

This trend is expected to continue largely due to continuing tight global financial conditions and weak external demand. It is important to note that the depreciation is also acting as a catalyst and fueling inflation further due to exchange rate pass through to domestic prices.

Figure 7: Percentage Change of Exchange Rates of Domestic Currencies per U.S. Dollar, Period Average for selected COMESA Countries



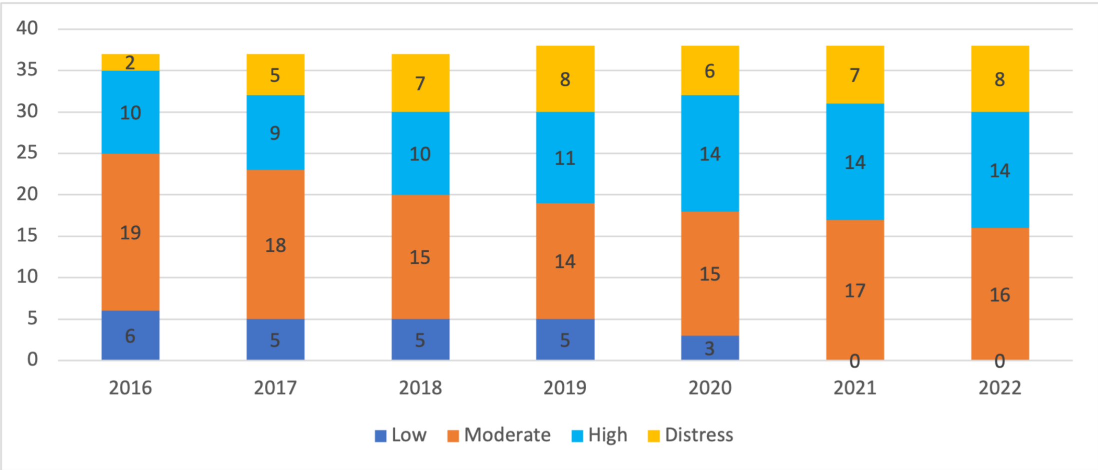
Source: Author's compilation from individual Central Banks Website

A few currencies in the region appreciated during this period. Seychelles Rupee appreciated by 34 percent between 2021Q1 and 2023Q1 while Zambia Kwacha appreciated by 28 percent between 2021Q2 and 2022Q3 (Figure 7). The appreciation of the Zambian Kwacha followed an agreement to restructure the country's external debt and approval of IMF's 3-year Extended Credit Facility of US$ 1.3 billion. The two developments further boosted investor confidence of the country's macroeconomic outlook. The appreciation of the Seychelles currency followed the recovery of the tourism sector from the negative effects of COVID-19 pandemic. Other reasons that explain the relative stability of some currencies in the region include, that a lot of loose foreign capital had already left during the pandemic, meaning that there has not been any significant capital outflow to safe havens in such economies, some countries also are big commodity exporters who benefited from higher commodity prices, and countries that have experienced quick recovery in sectors that were greatly affected by the pandemic such as services sectors.

Debt Distress

Persistent inflation, prolonged tightening of global financial conditions, the high cost of capital, domestic currency depreciations and lower financial inflows could increase the risks of debt distress in some countries in the region. In particular, the rise in US policy rate has resulted in increased debt burden, triggered capital outflows, and caused tightening of global financial conditions. Together with the catalytic effects on debt accumulation of COVID-19 pandemic, most of these countries in the region are now in worse debt position than they were in 2019, with higher debt levels and very uncertain economic environment going forward. This is against the backdrop of deterioration in market conditions that are increasing the rollover risk and difficulties in meeting large foreign debt service payments. Unless measures are implemented to curtail growth in debt, these countries could face an implosion in the stock of external debt and servicing costs. If left unchecked, the rate of debt accumulation could become a major source of macroeconomic instability. Already, some countries have defaulted on their debt obligations and others are facing repayment difficulties, with the risk of debt distress (default) increasing. As a consequence, all the countries in Sub-Saharan Africa are at risk of default with low risk countries reducing to zero from 5 countries in 2019, those with moderate risk of debt default have increased from 14 countries in 2019 to 16 countries in 2022, those countries in high risk of default have increased from 11 to 14 countries during the same period, while those in distress have increased from 2 countries in 2016 to 8 countries in 2022 (Figure 8).

Figure 8: Number of Countries in Sub-Saharan Africa in External Debt Distress



Source: IMF Low-Income Country Debt Sustainability

Conclusion and Policy Implications

The global economy has gone through a phase of persistent disruption in global supply chains, increased volatility in global financial markets and now tightening global financing conditions. This has put considerable pressure on exchange rates in developing countries, which in turn has heightened debt vulnerability and increased domestic inflation.

There is a need to strike a balance between policy rate hikes to control inflation and the easing of monetary policy to boost economic growth and support employment creation. Central banks need to adapt to policies and frameworks that effectively force them to commit to stay accommodative for longer, which allow smoother transition and precipitate orderly regime change. On the contrary, during periods of persistent inflation, central banks need to consider the need to commit to slow and gradual incremental monetary policy tightening for longer, which allows orderly regime change with less disruptive implications on financial markets and economies. The gradual approach gives central banks the power of commitment and ensures they continue being credible. However, aggressive monetary policy tightening to anchor inflation expectations cannot be ruled out in jurisdictions where the second-round effects have set in due to increases in wages or where the domestic currency is experiencing excessive deprecation and volatility. However, for countries where policy hikes have yielded minimal or no gains in terms of containing inflation, there is need to come up with more innovative instruments to deal with non-demand shocks. This may include structural measures to increase food production and in turn tackle imported food inflation.

In the short run, for some countries, especially those where inflation pressures remain moderate and inflation expectations are well anchored, doing nothing may be the optimal policy. Such central banks should pay more attention to supporting economic growth. For countries with moderate or low inflation, a cautious approach will be necessary to ensure inflation remains low or moderate, interest rate measures do not discourage investment through increased cost of credit but instead promote growth, going forward. To counter the depreciation trend, countries need to strike a balance between strengthening their monetary policies in the face of tighter financial conditions in advanced countries, and the need to ensure economic recovery amidst high cost of capital. The regional economies also need to build up foreign exchange reserve buffers, to create room for policy maneuver when global financial markets conditions are unfavorable. Unfortunately, in the short run, the regional economies are likely to be in turmoil as long as advanced economies continue tightening monetary policy to fight inflation in their economies. The sooner the advanced economies put their economies back on track, the more likely the regional economies can embark on a more sustainable growth trajectory. To tame fiscal pressures, there is need for coordination between fiscal and monetary policy actions to optimize outcomes of targeted policy intervention. Fiscal policy can support monetary policy in cabbing inflation, while protecting the most vulnerable. This can be done through fiscal restraint and targeted transfers to reach the most vulnerable. By central bank acting together with fiscal authorities, interest rate increases less to contain inflation. Protecting the vulnerable may entail tax hikes for high income groups and or cuts in lower priority spending combined with large transfers. For instance, at the height of COVID-19 pandemic lock downs, governments used increased spending or tax cuts/relief to boost economic activities or to protect the most vulnerable. However, fiscal policy is not a tool of choice in influencing aggregate demand because tax cuts and spending measures require legislation, which may be lengthy, taking a long time to be implemented. In addition, once effected, tax cuts and spending measures may be politically difficult to reverse. Also, sometimes the consumers may not respond in the intended way with for instance, a tax cuts being saved rather than being spent.

There is need for aggressive action to tame fiscal deficits and contain debt for countries with high risk of debt distress or are already in debt distress. For countries with some fiscal space, there is a need to support the most vulnerable people through targeted interventions in order to cushion the impact of raising food and energy prices. Foreign exchange reserves management measures will also be required to deal with exchange rate volatility and ensure export competitiveness. To counter shrinking external financing because of monetary policy tightening, countries need to take action that can mobilize and leverage private financing for development. Besides, the global financial architecture should better align financial flows with inclusive and sustainable development without further worsening debt vulnerability.

In the medium to long run, there is need for economic diversification, leveraging on the African Continental Free Trade Area (ACFTA) to boost intra-Africa trade, especially in manufacturing to ensure value addition and reduced vulnerability to fluctuations in commodity prices. By boosting intra-Africa trade, the regional economies will enhance resilience to spillovers from external shocks and reduce persistent trade deficits, which in turn ensures less inflationary pressures. Key reforms to boost intra-Africa trade include, accelerating investment in regional infrastructures, promoting free movement of goods and services by removing tariff and non-tariff barriers, and strengthening regional payment and settlement systems, among others. ACFTA has the potential for the region to build economic resilience.

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