Exchange rate flexibility and resilience to external shocks in Sub-Saharan Africa

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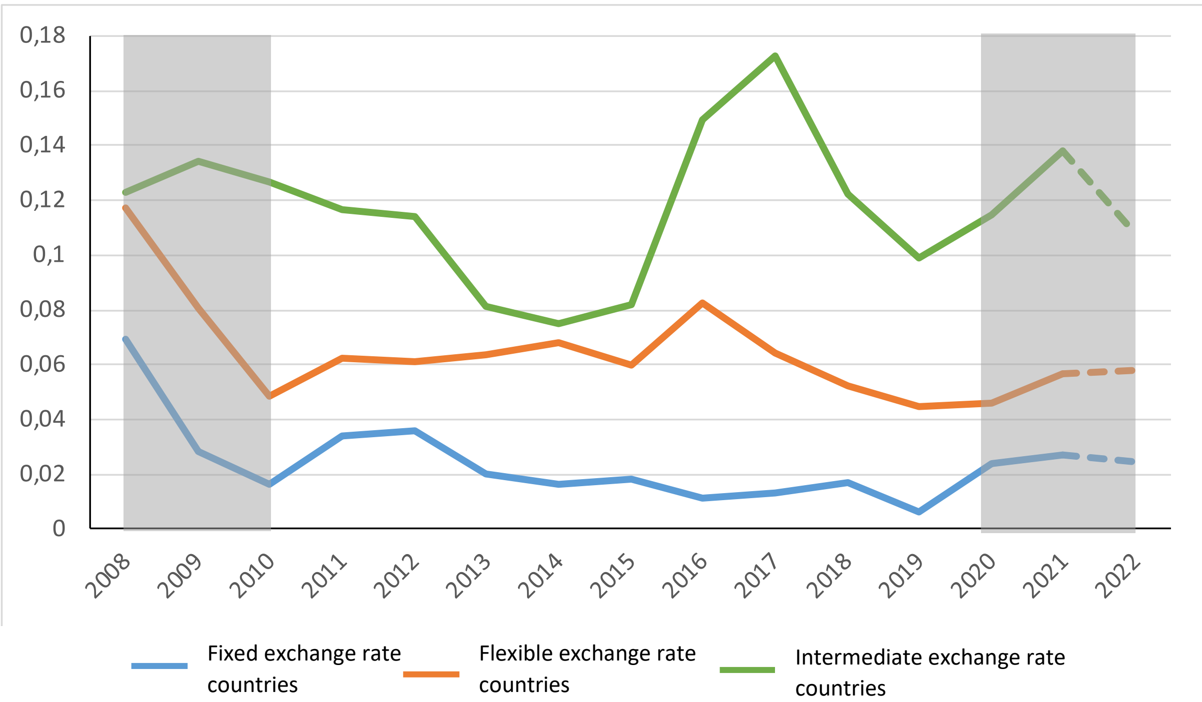
The Covid-19 crisis, combining supply and demand shocks with associated inflationary pressures, provides an opportunity to reassess the advantages of fixed exchange rate regimes over flexible or intermediate exchange rate regimes, in particular in Sub-Saharan Africa (SSA). Indeed, in this context, the anchoring of the currency via the fixed exchange rate gives more monetary policy space…

Inflation in Sub-Saharan Africa



Source: IMF (World Economic Outlook, Oct. 2021, dotted line = forecast) and Banque de France calculations. IMF Annual report on exchange rate arrangements and exchange restrictions, August 2021, for the definition and classification of exchange rate regimes, flexible exchange rate regimes include managed flexible systems.

Note: GDP-weighted averages at current prices. Ethiopia is excluded from the sample (intermediate exchange rate regime) as forecasts are not available.

How has monetary policy space changed with the Covid-19 crisis?

The objective of most central banks in SSA is to ensure the stability of their currency. Even in inflation-targeting countries, this stability is considered as both external (nominal exchange rate) and internal (inflation), with the external anchor still necessary because the internal anchor is not sufficiently effective. The more stable the exchange rate and the more inflation is under control, the more space the central bank has for a counter-cyclical response, and vice versa.

Even if this observation cannot be extended to all SSA countries, the current crisis has, to date, had less of an impact on external stability than the 2008-2009 crisis, thanks to financing conditions on international markets that have been favourable once again since autumn 2020 and thanks to international financial support. This stability is often analysed in terms of two indicators, as the IMF does, for example, in its Regional Economic Outlook for Africa (REO) of October 2021: the evolution of the level of foreign exchange reserves and the exchange rate. On this basis, compared to countries with flexible or intermediate exchange rates, countries with fixed exchange rates have been better shielded from exchange rate pressures in the current crisis, and at no cost to their growth performance. This is particularly true for the countries of the West African Economic and Monetary Union (WAEMU) and, to a lesser extent, for the countries of the Central African Economic and Monetary Community (CAEMC)). According to the IMF, these two monetary unions, whose currencies are pegged to the euro, posted average GDP growth rates of +4.4% and +0.3% in 2020 and 2021, compared with, respectively, +3.1% and -1.7% for the whole of SSA.

In terms of inflation, the observation is also clear, particularly in view of the situation observed in 2021 and early 2022 (see chart above). The current crisis has led to a sharp rise in inflation in SSA (10.7% annual average in 2021, compared with 8.2% in 2019, IMF REO October 2021), in contrast to the previous crisis, which saw inflation fall from 11.7% in 2008 to 7.5% in 2010, IMF REO April 2011 (see chart). The current rise in inflation is leading to a sharp reduction in policy space of some central banks, particularly for countries without fixed exchange rate regimes. According to the IMF (REO October 2021), inflation should rise to 2.1% in CEMAC and 2.9% in UEMOA in 2021, compared with 24.4% in Angola, 22.8% in Zambia and 16.9% in Nigeria, to take a few cases of countries with an intermediate exchange rate regime.

Moreover, it is important to specify that this reduction in policy space is not linear, but tends to accelerate beyond certain thresholds. Indeed, when monetary stability (external or internal) is established, the credibility of the central bank is not called into question, but it may be when the situation is far removed from equilibrium. For the exchange rate, this generally means a fall of over 25% over a short period (Frankel and Rose (1996), p. 353) or a level of foreign exchange reserves of less than three months of imports of goods and services (the so-called Greenspan-Guidotti rule (Jeanne and Rancière (2006), p.6)), standards frequently used by the IMF. In terms of inflation, levels well above the central bank's target are likely to trigger "snowball" effects that could lead to an unanchoring of inflation expectations. According to the IMF (Annual Report on Exchange Rate Arrangements and Exchange Restrictions), two of the four SSA countries that have adopted an inflation targeting regime, Ghana and Seychelles, could be in this situation (see Table).

Inflation targets and inflation rates for the 4 SSA inflation-targeting countries

	Inflation target	Inflation rate (annual change)		
		Dec-19	Dec-20	Dec-21
South Africa	3-6%	4,00%	3,10%	5,90%
Ghana	8% +/-2	7,90%	10,40%	12,60%
Uganda	5%	2,40%	2,50%	2,90
Seychelles	0-4%[1]	2,60%	3,78%	7,95%

Sources: Central banks and national statistical institutes
[1] target for the year 2019

Fixed exchange rate regimes have greater monetary policy space in the face of inflation

In 2020, the majority of SSA central banks were able to carry out more significant monetary easing than during the 2009 crisis. They often innovated, combining standard measures (cuts in key rates and reserve requirements) with non-standard measures (increase in liquidity injections, easing of the collateral eligibility framework, and even purchases of government securities). Between 2019 and 2020, African (including North African) central banks overall significantly increased their balance sheets, from just over a quarter of their GDP to over a third (at end-2020, the Eurosystem's balance sheet accounted for 62% of euro area GDP and that of the Federal Reserve 35% of US GDP). This monetary easing has been an effective counter-cyclical support.

Easing monetary policy in most SSA countries has also been facilitated either directly by IMF financing or indirectly by the actions of reserve currency issuing central banks, which eased international financial conditions. The IMF's strong support to SSA countries has taken the form of facilities totalling USD 27.4 billion for 2020-2021 (including emergency facilities) and a new SDR allocation of USD 23.4 billion in August 2021. In addition, the exceptionally accommodating measures taken by the FED and the ECB have prevented capital from flowing back to their economies and thus putting too much pressure on the currencies of SSA countries.

However, monetary easing is not risk-free for monetary stability, especially for SSA countries that are more sensitive to inflationary risk due to a less effective external anchor. During the 2009 crisis, which was a demand shock, inflationary pressures had receded very quickly at the global level and inflation had stabilised at a very low level. In that context. Thanks to their flexible exchange rate regime, SSA countries were able to cushion the economic shock, without experiencing inflationary risk. The current situation is significantly different. Indeed, the Covid-19 crisis is, at this juncture, characterised by inflationary pressures at the global level due to constraints on supply and a very rapid recovery of demand in the advanced countries, which had returned to pre-crisis levels of activity by end-2021.

In the countries with flexible or intermediate exchange rate regimes that dealt with the shock by depreciating the exchange rate, this depreciation accentuated the transmission of already strong external inflationary pressures in small open economies. These countries were often forced to tighten their monetary policy even before the first effects of the economic recovery materialised. Thus, from the beginning of 2021, some central banks in countries with flexible or intermediate exchange rates had to raise their key rates: Mozambique by 300 basis points in January 2021, Zambia by 100 basis points in February and November 2021, Madagascar by 290 basis points in May, August and November 2021, Angola by 450 basis points in July 2021, Ghana by 100 basis points in November 2021 and finally South Africa by 50 basis points in November 2021 and January 2022, these last two countries being among the four inflation-targeting countries in SSA.

By contrast, in the countries with fixed exchange rate regimes, inflation remained under control, close to the targets, in particular in WAEMU and CAEMC. The pressure on external stability exerted on foreign exchange reserves was limited. Only the Bank of Central African States (BEAC), whose level of reserves is close to the three-month import threshold, raised its rates, and merely by 25 basis points, in November 2021. The higher resilience of countries with fixed exchange rates to rising inflation thus gives them, in the current circumstances, greater monetary policy space.