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Monetary policy and financial stability in Africa during COVID-19

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19 May 2020

Key messages

- African countries will not only see a contraction in economic activity, but also a likely resurgence in financial instability.
- African central banks have lowered interest rates and reserve ratios, bought government bonds, and provided additional liquidity, but in some countries there are now limits to more action (e.g. lower interest rates).
- Ensuring both financial stability and increased economic activity in Africa needs careful monitoring and additional steps.

Africa's liquidity challenges

The cost of COVID-19 for Africa is considerable. The IMF, the World Bank, UNECA and ODI all forecast economic costs of at least 5% of GDP in 2020. More than 20 million jobs will be lost. Foreign portfolio flows are fast receding; remittances and FDI are slowing considerably. African countries will not only see a contraction in economic activity but also resurgence in financial instability, driven in part by the need for (and in some cases the shortfall in) liquidity and monetary stimulus.

An EABC survey suggests major reduction in cash flow in East Africa varying by sector: tourism (92%), logistics (75%), retail and real estate (60%), financial (50%) and other sectors (25–50%). In April 2020, in Kenya, the seven largest banks restructured loans worth KSh 176 billion or 6.2% of the industry's total gross loan book, including tourism (31%), real estate (17.2%), building and construction (17%) and trade (12.4%). The share of non-performing loans (NPLs) in the total loan book rose to a high 12.7% in February 2020 from 12% in December 2019. Defaults are growing in the manufacturing, energy and household sectors. The NPL ratio is above a five-year average of 8.2%, meaning that banks are cautious of new lending.

ODI's fiscal monitor shows that fiscal responses as a share of GDP in Africa are 7.5 times smaller than the average of G20 countries. The IMF forecasts a widening of the government deficit in sub-Saharan Africa from -4.3% in 2019 to -7.0% of GDP in 2020. Given limited use of fiscal expansion, monetary policy is an important policy lever to address the economic fallout.

Africa's monetary policy responses

Central banks in sub-Saharan Africa are increasingly focused on supporting growth in a countercyclical framework, which is a positive trend. African monetary authorities have responded to COVID-19 (see Table 1). Some combined intervention targeting interest rates and/or exchange rates is warranted.

Table 1. Monetary policy options

	Pros and cons	Examples
Lower base rates	More general liquidity but risks of more inflation	Reduction in Egypt (3 pp), others by between 1 and 2.5 pp
Lowering banks' cash reserve ratios	Increased liquidity if this is passed on to borrowers, which depends on normal banking regulations	Kenya (by 1% to 4.5%), Rwanda (by 1% to 4%) and Ghana
Government bond buying by (central) banks	Amplifies liquidity impact; risk is the central bank's credit accumulation	Rwanda, South Africa
Delay (loan/interest) repayments to banks	Lower distress in bank clients but liquidity foregone that could have been used for increased bank lending	Repayment holiday for loans in Ghana, target credit facility in Nigeria, Rwanda
Loans directly to sectors	Targeted but risks of insolvency. Fiscal grants more appropriate than using banks with high NPLs	Tourism in Egypt, direct cash injection into commercial banks in Ethiopia
Special category of bad loans owing to coronavirus	Banks may not need to cover NPLs	Kenya
Increase daily transaction amounts on credit card	Increased liquidity and increased household debt	Several countries
Lower in mobile money fees	Lower fees, easier to use mobile money	Uganda, Kenya, Nigeria

Can Africa cut interest rates further?

Given inflation dynamics in a number of sub-Saharan African economies (e.g. Nigeria's inflation has been above target for several years), the scope to allow significant exchange rate depreciation is limited (Table 2). Inflation has increased in African countries in recent months, driven in part by food prices (which may continue as a result of possible food scarcity), although lower oil prices and slower growth will lead to deflationary pressure.

Table 2. Policy snapshot: selected SSA economies

	Current Policy Rate (%)	Inflation (%)	Exchange rate vs USD YTD (c)	Monetary Stimulus (%GDP) (d)	Currency measures	Expected change in interest rates
Nigeria	13.5% (a)	12% (a)	-6.2%	2.5%	15% adjustment	Likely to hold
Kenya	7% (b)	5.6% (b)	-5.1%	0.5%	none	Scope for decreases in rates
Ethiopia	7% (b) 9 year low	23% (b)	-6.4%	-	None	Scope for decrease in rates
Ghana	14.5% (a) 8-year low)	7.8% (a)	1%	0.8%	None	Liquidity to sectors, not cut in rate
Rwanda	4.5% (b) (Record low)	10% (b)	-1.3%	0.6%	Ready to intervene	Scope for further decreases in rates
Uganda	8% (b) (Record low)	3.2% (b)	-3.5%	-	Ready to intervene	Scope for further decreases

(a) March 2020 (b) April 2020 (c) Currencies from Bloomberg May 12 (d) Monetary stimulus includes central banks' explicit monetary liquidity injection (e.g. through lending facilities, open market operations) and expected impact from lowering policy interest rates. Weighted average for country aggregates. See ODI policy country response tracker

Inflation in Zambia is at a four-year high following a 20% devaluation this year. Elsewhere, a low exchange rate passthrough to prices provides some policy space to reduce interest rates further. On average, a 10% depreciation of the local currency leads to a 4% increase in domestic prices in sub-Saharan Africa. Transmission differs in poor economies as a result of informal finance, with monetary policy effects tending to have low passthrough to the real economy; low levels of banking sector competition also result in larger interest margins.

Exchange rates, capital controls

The fallout from the COVID-19 pandemic crisis has been significant. Global financial conditions have tightened sharply in 2020: investors have withdrawn over $90 billion since the start of the crisis (IIF, 2020), the largest capital outflow on record. Government bond spreads in sub-Saharan Africa increased by 700 basis points since February 2020, reaching all-time highs.

Most problematic for many sub-Saharan African economies will be the multiple shocks that could trigger financial instability. The global economic slowdown, the oil price collapse and the US dollar's strength will bring their currencies under acute pressure. Currency weakness has already contributed to an inflation acceleration in the resource-exporting economies, such as Zambia and Nigeria. Unanchored inflation has typically led in the direction of currency pegs. However, Nigeria's experience with regard to the mismanagement of its declining reserves suggests that such a regime is more credible when coupled with economic diversification.

Sub-Saharan African economies, especially the commodity exporters, may consider a strategy that includes targeted capital controls on outflows. This was successful in countries such as Malaysia after the East Asian crisis and in Iceland in 2008. Crucially, controls created space for bank restructuring and expansionary policy. Capital controls themselves function better if they are part of an existing instrument, are applied counter-cyclically and reflect core economic policy as a package instead of being seen as a 'silver bullet'.

Financial sector stability

There is a balance between inclusive growth and standards for financial stability. Implement too few rules and the financial sector risks becoming unstable. However, implement rules too aggressively and there is no scope for a dynamic financial sector to support growth. Measures used to assess financial risks include solvency (tier 1 capital ratio, total capital ratio, leverage ratio); credit risk and asset quality (NPL ratios); profitability (return on equity, return on assets, cost to income ratio); and funding and liquidity (loan to deposit ratio, liquidity coverage). These need careful monitoring over the coming months.

In past crises, higher capital adequacy ratios have contributed to a withdrawal of cross-border lending from developing countries. The same may be happening now. In addition, borrowers face lower incomes and may not be able to repay obligations, which will increase NPLs (already at 11% in Africa).

Governments can address such a crisis by taking on bad debt through acquiring banking assets at minimum prices, capitalising banks, taking equity stakes in companies and encouraging lending through government-backed guarantees or other instruments and/or institutions, like development banks. Governments and international institutions can also work together. The Vienna Initiative set up in 2009 at the height of the financial crisis provided a forum for decision-making and coordination. Africa may need this in coming months and years. Development finance institutions could help.