Louis Kasekende: Key strategic policies needed for Sub-Saharan Africa to sustain growth momentum

Remarks by Dr Louis Kasekende, Deputy Governor of the Bank of Uganda, at the Launch of IMF's April 2016 Regional Economic Outlook for Sub-Saharan Africa, Kampala, 3 May 2016.

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Introduction

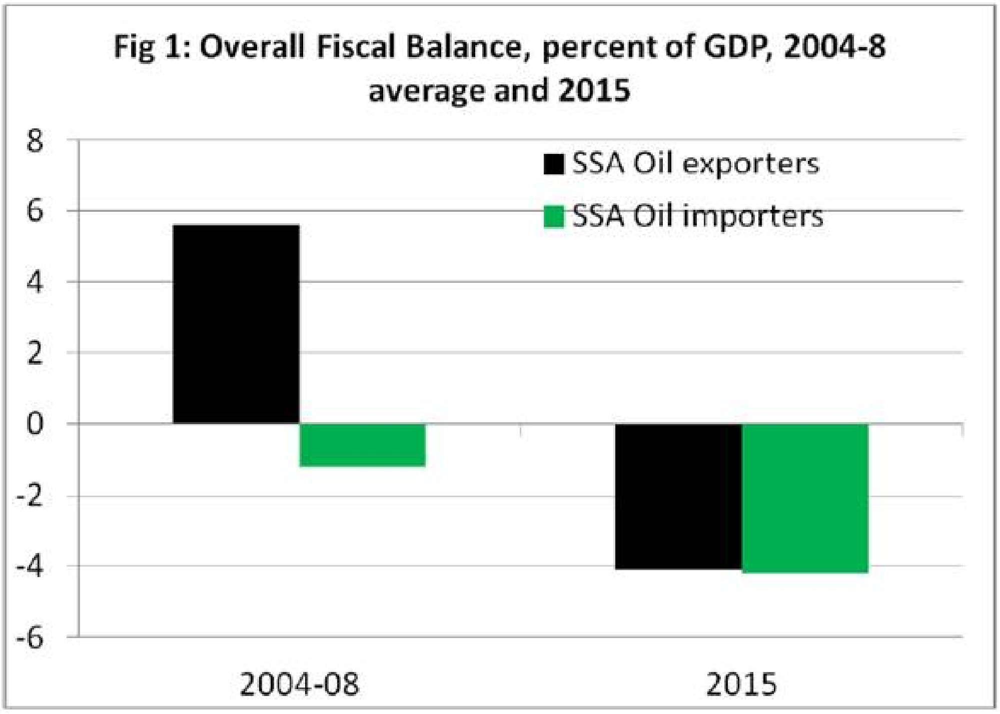
I would like to thank both presenters for very insightful presentations. The trajectories of Africa's economies since the global economic crisis offer important lessons for macroeconomic management on the continent. In my remarks, I will focus on what I believe are the most pertinent lessons for macroeconomic policy for all countries in the region. I also want to highlight the lessons which prospective future oil and gas producers, such as countries in the East African Community, can learn from the current challenges facing the continent's commodity producers.

The importance of macroeconomic and fiscal space

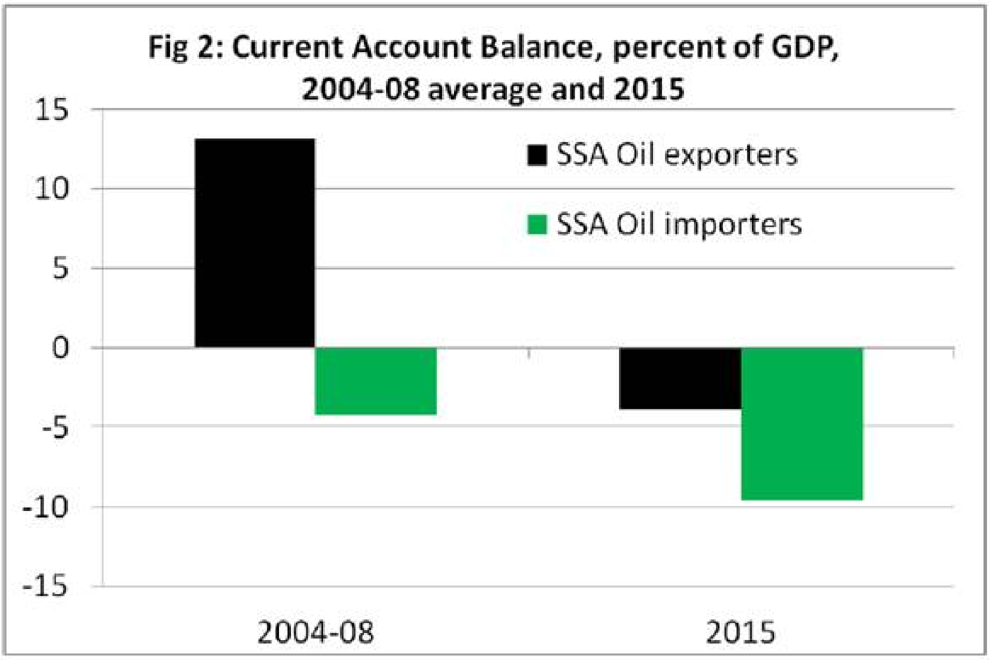
When African economies suffered shocks from the global financial and economic crisis in 2008, many countries in the region were able to use countercyclical macroeconomic policies – monetary and/or fiscal policy – to help offset the negative impact on aggregate demand and thus dampen the adverse consequences for real output growth. A countercyclical macroeconomic policy response was only possible for those economies which had sufficient macroeconomic and fiscal space, in terms of their current account and fiscal balances, public debt ratios and foreign exchange reserves.

Across the continent, macroeconomic and fiscal space has narrowed in the last half decade, as a consequence of deteriorating fiscal and current account balances and lower foreign exchange reserves in terms of months of import cover. This is shown in figures 1–3. The reduction of macroeconomic and fiscal space is most pronounced among oil exporters, but it also affects the region's oil importers. As a consequence, both sets of countries have les scope for addressing the negative consequence of the external shocks facing their economies by implementing countercyclical macroeconomic policies than was the case at the end of the 2000s.

The narrowing of macroeconomic and fiscal space is partly the result of governments adopting more ambitious public spending programmes to address infrastructure needs, mainly financed with external capital. There are sound economic reasons for scaling up public investment, but we have also to recognise that, if it is funded through higher borrowing, it will unavoidably constrain the policy options for macroeconomic stabilisation, leaving the region's economies more vulnerable to negative exogenous shocks. Over the medium term, I agree with Antoinette Sayeh that a gradual rebuilding of macroeconomic buffers is warranted, which means that it would be preferable to fund higher public investment by making savings in recurrent budgets or by strengthening the domestic tax effort, rather than by resorting to higher levels of borrowing.



Source: REO, April 2016, Appendix table SA8 (oil importers exclude South Africa)



Source: REO, April 2016, Appendix table SA20 (oil importers exclude South Africa)

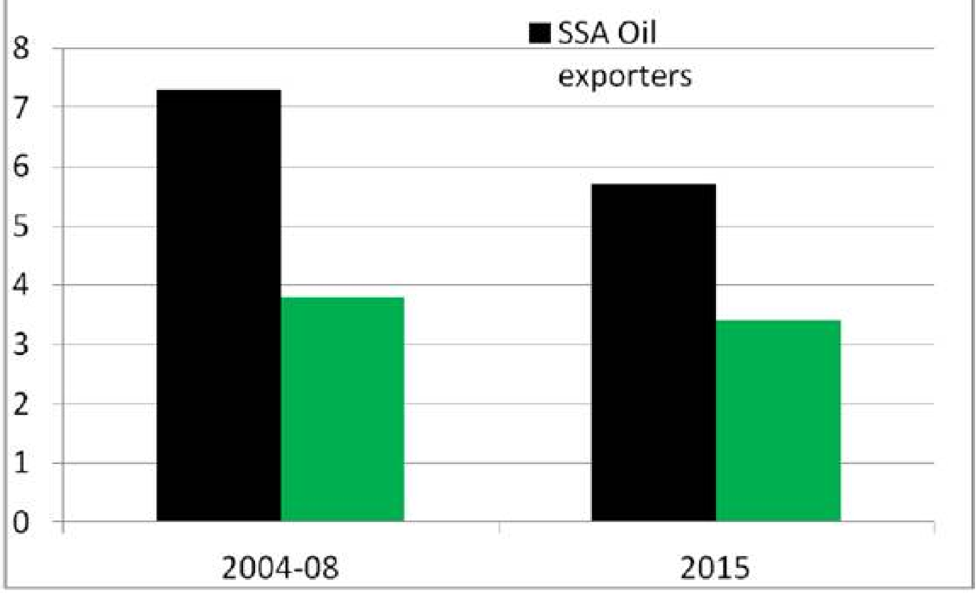


Fig 3: Foreign Exchange Reserves in Months of Imports of Goods and Services; 2004-08 average and 2015

Source: REO, April 2016, Appendix table SA20 (oil importers exclude South Africa)

Exchange rate flexibility and inflation

As discussed by Antionette Sayeh in her presentation, exchange rate flexibility provides a crucial tool for facilitating macroeconomic adjustment to external shocks. Unless shocks are purely temporary and can be financed, which does not apply to the current shocks facing the continent, some form of adjustment to deteriorating external terms of trade and/or a tightening of access to external finance is unavoidable. This adjustment will be less contractionary for the economy as whole if the real exchange rate depreciates.

Table 1: Annual Nominal Exchange Rate Depreciation against US Dollar (September 2014-September 2015) and Annual Headline Inflation (December 2015)

	Annual Nominal Exchange Rate Depreciation; 2015 (percent)	Headline Inflation; (percent)
Ghana	13.8	17.7
Kenya	17.3	8.0
Tanzania	29.4	6.8
Uganda	39.2	8.5
Zambia	92.5	21.1

Sources: Central Banks, National Statistics Offices and Reuters

An argument sometimes advanced to oppose exchange rate flexibility is that nominal depreciation will drive up domestic inflation, imposing hardship on the population and obviating any real depreciation. But the experience of several African countries, with flexible exchange rates and monetary policies which focus on controlling domestic inflation, does not support this pessimism. As shown in the table above, several countries in the region suffered substantial nominal exchange rate depreciations against the US dollar (albeit less so on a trade weighted basis) during 2014 and 2015. The table shows the annual depreciation at the end of September 2015, which for most countries was close to the peak of the depreciation in 2015. Because the pass through to domestic prices is not instantaneous, we would expect the impact of the depreciation on inflation to be at its maximum several months later.

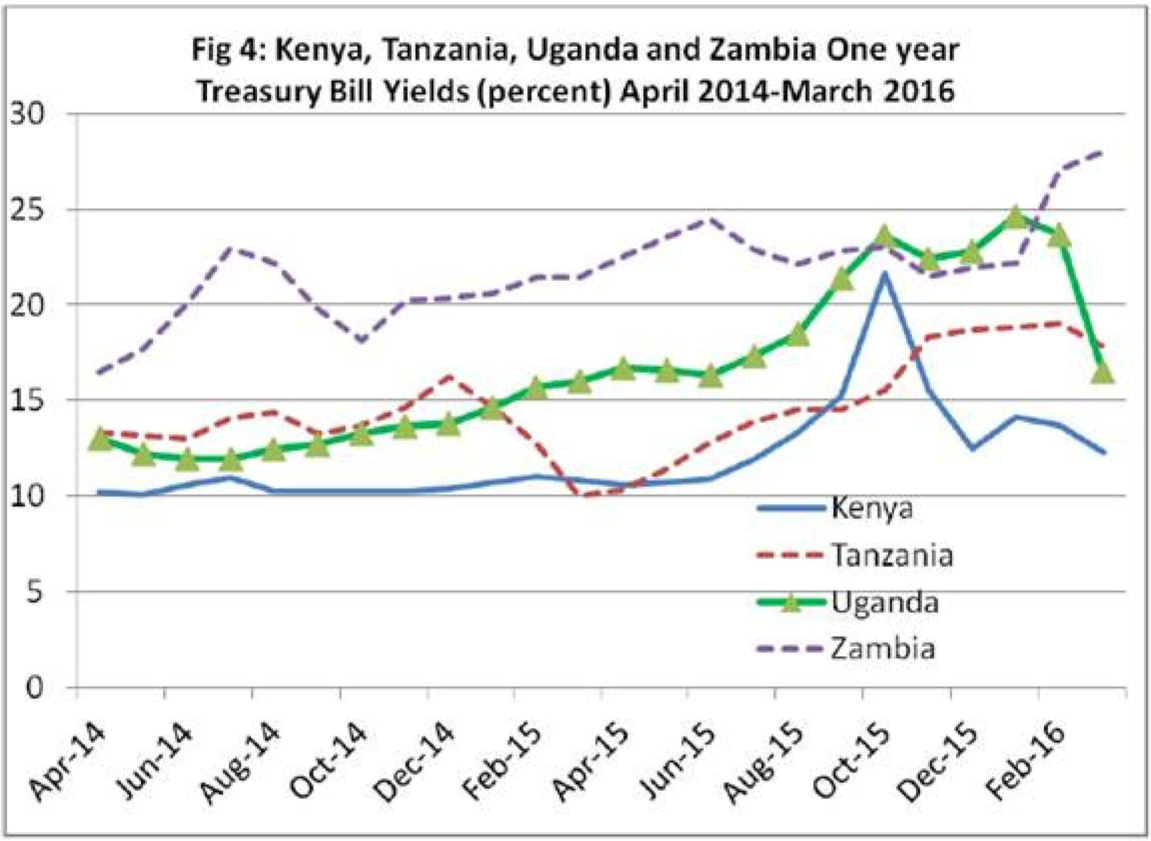
Yet at the end of December 2015, annual inflation rates were much lower than the nominal depreciation in four out of the five countries shown in the table, and have remained at a similar level or fallen since then. Their central banks were able to keep control of inflation, by tightening monetary policy through raising interest rates or reducing money supply growth, as illustrated on slide 17 of Antionette Sayeh's presentation. Good monetary policy can offset the pass through from the exchange rate to domestic prices. The key is tightening monetary policy in a decisive and timely manner. The lesson I would draw is that a combination of a flexible exchange rate and a monetary policy which targets domestic policy objectives is feasible and probably optimal for macroeconomic management for most countries in the region outside of the currency zones.

How robust are estimates of Government financing envelopes?

Governments in the region – especially in the frontier markets – have expanded their access to market finance for their budgets over the last decade, both from domestic (through competitive securities auctions) and external sources via sovereign bond issues. This has been a positive development in many respects, enabling governments to reduce their dependence on donor aid for budget resources, expand their budget resource envelopes and also promote domestic financial market development.

However, the experience of the last year has shown that financing conditions in both external and domestic markets can tighten very rapidly, thereby contracting the space for funding fiscal deficits from the market. Sovereign bond spreads and yields on domestic securities rose sharply for many countries in the region, as a result of both exogenous factors and concerns about fiscal sustainability. Figure 4 illustrates the rise in domestic borrowing costs since April 2014 for four countries in the region: Kenya, Tanzania, Uganda and Zambia. Yields on one year Treasury Bills rose by between 9 and 12 percentage points in these countries during the course of 2015 and the first quarter of 2016.

The sharp rise in financing costs for countries across the region indicates that the stability and predictability of medium term budget financing envelopes might be much less certain than fiscal planners would like. As such, fiscal deficits could become a threat to inflation if conditions in financial markets worsen and monetary financing of the budget becomes inevitable, because government borrowing requirements cannot be met from the market. The lesson is that fiscal policy planners must be cautious in forecasting the magnitude of financeable deficits and leave room within their fiscal frameworks to accommodate the possibility that access to finance from the market might turn out to be much lower than forecast.



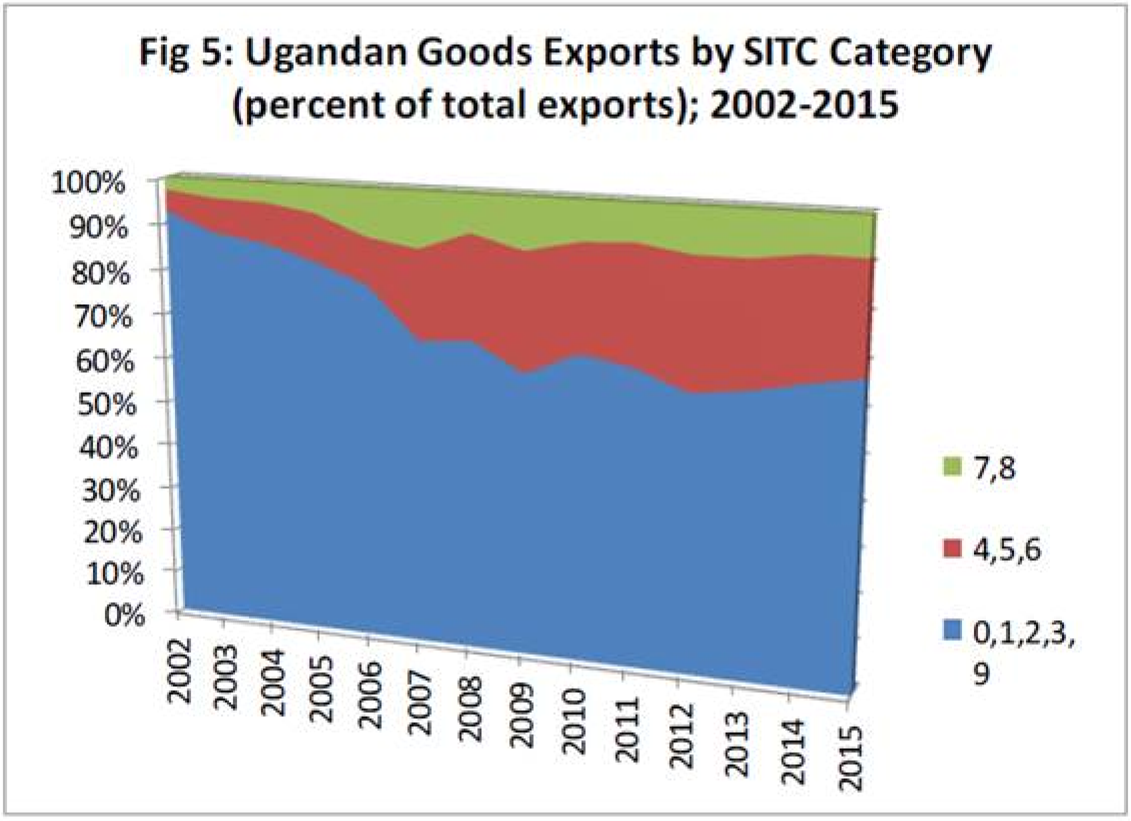
Sources: Central Banks, National Statistics Offices and Reuters

What lessons can prospective oil and gas producers learn from the recent commodity cycle?

The performance of Africa's primary commodity producers and the problems they are facing because of the commodity price slump, provide important lessons for the prospective oil and gas producers in the East African region, which we ignore at our peril. As was pointed out in the second presentation, Africa's commodity producers – about half of the countries in the region – have become more dependent on commodity exports, mainly oil and metals, over the last 25 years. Furthermore, their economies are very vulnerable to shifts in their external terns of trade; commodity price volatility is transmitted to volatility of output.

First, given the sensitivity of output to commodity price swings, it is particularly important for commodity producers to accumulate macroeconomic and fiscal space during periods of high commodity prices, so that countercyclical macroeconomic policies are feasible during price slumps. This requires saving a significant share of the resource revenue earned during price booms, and avoiding accumulating substantial liabilities which will have to be repaid from uncertain future resource revenues. Most of the commodity producers in the region failed to build adequate policy buffers during the commodity price boom and, as a consequence, have no option but to implement fiscal retrenchment during the current price slump, which exacerbates the contraction in demand and output.

The second lesson pertains to the need to avoid becoming over-dependent on commodity exports for foreign exchange earnings and public revenues. The East African economies have begun to diversify their economies away from primary commodities. This is shown in figure 5 for Uganda. The share of primary commodity exports, proxied by SITC categories 0–3 and 9, has fallen from over 90 percent of total merchandise exports in 2002 to less than two thirds in 2015. In contrast, the share of processed commodities (SITC categories 4, 5 and 6) and manufactured products (SITC categories 7 and 8) has risen from 8 percent to 35 percent over this period.



Source: Bank of Uganda

This diversification could be put in jeopardy if hydrocarbon production drives up the real exchange rate and renders existing export industries uncompetitive.

Real exchange rate appreciation is not caused by oil production per se, rather it is determined by the magnitude of additional domestic spending which revenues from oil production make possible. The key to avoiding damaging real exchange rate appreciation when oil starts to be produced in commercial quantities is the careful management of the public spending out of oil revenues. If oil revenues allow a large and rapid expansion of public spending, Uganda will risk suffering all of the negative consequences of the resource curse which have afflicted other oil producers in the region.

Finally, I want to emphasise the importance of building strong institutions. Institutions are crucial for macroeconomic management, and especially so in commodity producing economies. Empirical research from around the world has shown that whether or not commodity producers actually derive benefit from their natural resources, or instead suffer from a resource curse, depends on the quality of their economic governance, which in turn depends on the strength of their institutions. Strong institutions are also important to create a business environment, characterised by transparent and predictable rules and regulations, competitive markets and a level playing field for all participants, which is necessary to attract private sector investment on a large scale. Good governance is also important for the corporate sector, as well as the public sector, not least because companies with good corporate governance are better able to mobilise finance for investment than those whose corporate governance is weak.

Conclusion

To conclude, I would like to emphasise what I think are the key strategic policies needed for sub-Saharan Africa to sustain growth momentum over the medium to long term.

First, policy buffers have to be rebuilt and maintained, to create more fiscal and macroeconomic space to enable governments to implement countercyclical macroeconomic policies in the face of negative macroeconomic shocks.

Second, if SSA economies are to sustain export led growth and diversify away from over-dependence on primary commodities, they must maintain competitive real exchange rates. There is a plethora of empirical evidence to demonstrate how crucial real exchange rates are to sustainable export and economic growth.

Third, regional integration is crucial for many economies on the continent, especially those which are landlocked. It can provide markets for exports, allow traded goods industries to achieve more optimal economies of scale and strengthen competition in markets, thereby stimulating productivity growth.

Fourth, as I have just noted, strong institutions for economic governance are an essential foundation for economic development.

Thank you.