Central banking in Africa: prospects in a changing world

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1. Introduction

Governors and senior officials representing some two dozen central banks met at the BIS in May 2011 to discuss the monetary policy and financial stability issues facing Africa after the global financial crisis.[1] It was encouraging to note the progress that much of Africa has made in recent years. African economies have on the whole performed well over the past decade. From the early 2000s until the start of the crisis in 2008, growth was generally high, with inflation on the decline and fiscal balances strengthening. The good performance was due partly to a prolonged upswing of the global economy, which led to a sustained increase in commodity prices, and partly to improved domestic policies. The crisis of 2008–10 has led to a marked but only temporary slowdown in growth. The conditions of macroeconomic and financial stability have been preserved, and by mid-2011 there were encouraging signs that many African countries were returning to the pre-crisis growth path.

Against this background, the agenda for this meeting covered four broad areas where the crisis could have made potentially the largest impact on central banking in Africa: financial access; governance arrangements for financial stability; changes in monetary policy transmission mechanisms; and capital flows, commodity prices and exchange rates.

To initiate proceedings, Professor Muhammad Yunus, the 2006 Nobel Peace Prize laureate, gave a talk on financial inclusion and the regulation of microfinance, and discussed related issues via a video link from Dhaka, Bangladesh. Professor Yunus's stimulating talk and the following exchange of opinions provided much food for thought. Many of the themes he touched upon resurfaced in the discussion during subsequent sessions. Professor Yunus argued, among other things, that central banks should not be directly involved with microfinance. Instead, he recommended, microlending should be regulated and supervised by a separate entity whose staff would have specialised skills and an understanding of poverty issues. He also addressed questions such as how to ensure that microfinance institutions funded investment rather than consumption; differences between microfinance and lending to small and medium-sized enterprises; and how new technologies and financial innovation affected the environment for microfinance.

The notes that follow are not intended to be comprehensive but distil what I saw as some of the main points raised in the discussions and in the BIS background papers. They are organised, as was the meeting, around the four topics mentioned above, which are further elaborated in the background papers published in this volume.

2. Financial access

One of the most significant financial innovations in Africa over the past five to six years has been the ability to conduct financial transactions, such as payments and money transfers,

[1] Earlier BIS roundtables focusing on Africa are reported in BIS (2006) and South African Reserve Bank and BIS (2007).

through mobile phones. Mobile phone technology has played a critical role in broadening financial access. In Kenya, for instance, over 80% of the population has access to mobile phones but only 20% has a bank account. Customers can pay in funds at a mobile phone shop and alert recipients via text message that they can collect the funds from their nearest mobile phone shop against proof of identity and payment of a small commission. Another example is the biometric national identification cards developed in Uganda. Without such identification, access to debit and credit facilities, mobile banking and electronic transfer facilities would be almost impossible for a large population that lives in rural areas, often with no fixed address.

As discussed in the paper by Penelope Hawkins in this volume, these and other innovations have greatly improved the access of poor African households to basic financial services. While the crisis has dealt a temporary setback to financial inclusion, the process is set to continue. For central banks, this development raises the question of how best to manage the trade-off between promoting the spread of financial services, on the one hand, and limiting the potential financial stability risks from such innovation, on the other.

Most African central banks participating in the discussion had a cautious approach to financial innovation. They noted that new and inadequately regulated financial instruments had contributed to the recent crisis in advanced economies. Mobile phone banking had implications for the functioning of the payment, settlement and clearing systems. It could also affect a central bank's liquidity management – and hence its lender of last resort function – not least because it could potentially account for a large part of the float in countries where mobile banking is popular. The resilience of the payment system worldwide during the financial crisis at a time when many other parts of the system malfunctioned provides strong support for a more cautious approach.

To ensure that financial access through new technologies is appropriately designed and does not conflict with their stability mandates, central banks in Africa will probably have to widen the scope of their regulatory oversight. While this will impose some additional burdens, central banks agreed that the benefits of wider financial access far outweighed the costs of any additional tasks that they will have to perform.

3. Central bank governance and financial stability

The global financial crisis has led central banks worldwide to re-examine their role in the area of financial stability. The need for central banks to look beyond the risk position of individual institutions to risks affecting the system as a whole – the macroprudential dimension of financial stability policy – is now widely accepted. The authorities in many advanced economies are introducing new arrangements that attempt to deal with identified weaknesses. The macroprudential dimension to supervision is also relevant for African countries, given that their financial markets are generally concentrated and thin.

The paper by Serge Jeanneau in this volume argues that, although many countries in the region are less developed financially, they are eventually expected to face some of the same issues that have prompted a review of financial stability arrangements in other parts of the world. This could lead to calls for a reconfiguration of existing financial stability arrangements, and potentially a stronger involvement of central banks in macroprudential oversight. This raises governance questions, such as how best to specify a financial stability mandate and how to give central banks the tools they need to implement such mandates. Further, it could result in challenges to central banks' policy autonomy.

How can central banks best position themselves in such an environment? The discussions revealed that the concept of financial stability was not firmly incorporated in the law of many African countries. Financial oversight is often in the hands of several authorities that do not have the capacity to act jointly and rapidly. Together with thin and concentrated banking systems, this creates substantial systemic risks. In an effort to manage these risks, a number of central banks in Africa have established a macroprudential framework that comprises a financial stability committee. These committees are usually expected to monitor financial sector developments and facilitate the exchange of information between the central bank and the microprudential supervisor. But the lack of skills needed to fulfil the financial stability mandate hampers such arrangements.

Like their counterparts around the world, African central banks are also starting to ask how the financial and price stability mandates could best be coordinated. There were several approaches to this issue. Some central banks had established an internal macroprudential framework and drafted legislation restricting the scope of universal banking. All saw that central banks faced a major challenge in fulfilling multiple mandates. Some thought it more important to strengthen domestic banking systems than to draft new governance arrangements for financial stability. One Governor noted that any potential conflicts between mandates disappeared when an appropriate time horizon was applied. Several central banks also noted a need for better cooperation with foreign banking regulators, either in neighbouring countries or in the home countries of foreign-owned banks operating in their jurisdictions.

All in all, much remains to be done in this area. The good news is that central banks in Africa recognise the importance of solid financial stability arrangements and are well aware of ongoing policy debates on this issue worldwide.

4. Monetary policy transmission

African economies and their financial systems were, in general, not directly affected by the global financial crisis, but many – if not most – felt an impact through the trade and investment channels. The effects were stronger for middle-income economies with close financial linkages to international capital markets. But most African countries were also in a stronger economic position in terms of fiscal and external balances as well as inflation performance than during previous exogenous shocks. This allowed a number of central banks, especially those with flexible exchange rate regimes, to pursue countercyclical fiscal and monetary policies during the crisis. In particular, a lessening in fiscal dominance has made monetary policy more effective.

As elaborated in the paper by Benedicte Vibe Christensen in this volume, and confirmed in discussions at the meeting, the main channels for the transmission of monetary policy during the crisis were the exchange rate and credit. Most central banks allowed greater variability in the exchange rate during the crisis. A few initially resisted downward pressures on their currency, in part because depreciation made it more difficult to achieve their inflation objective. But eventually central banks let the exchange rate go, especially in cases where the external deficit pressure had built up. Regarding the credit channel, the crisis led to a sharp slowdown in bank lending throughout Africa. The reasons included tighter regulatory and lending standards, as well as reversals of the capital flows that had helped to fuel credit growth in the run-up to the crisis.

Changes in policy rates have also become more important, although their impact on the whole remains weak. In some cases, the spread between the policy rate and lending rates increased after the hike in policy rates due to general risk aversion on the part of the banks. And where central banks had lowered policy rates in an effort to provide countercyclical support to economic activity, the pass-through in lending rates charged by local banks was often incomplete. In countries with hybrid inflation targeting regimes (eg Ghana and Mauritius), policy rate changes would pass rapidly through the financial system, but they usually had little effect on credit conditions due to inelastic demand or the banks' practice of keeping spreads constant. Another reason for the weak transmission of policy rate changes was that limited competition allowed banks to change profit margins rather than pass on the policy rate changes to borrowers. And as in other developing regions, countries in Africa face structural changes that make the demand for money unstable and complicate monetary policy implementation.

Despite these differences, the discussion indicated that the essential features, goals and needs of monetary policy were similar in Africa to those in other regions. Governors repeatedly stressed that price stability remained the prime objective of monetary policy; that central banks need independence from the government to pursue monetary policy free of political interference; that public finances must be sound if monetary policy is to be effective; and that central banks must be credible both at home and abroad in their pursuit of monetary policy goals. Several countries, including Angola, Nigeria and Uganda, were moving rapidly towards hybrid inflation targeting regimes. Some central banks have established monetary policy councils with external members. Central bank officials in several countries are communicating closely with the financial industry. And there are concerted efforts to improve coordination with fiscal authorities, though with varied success so far.

Unlike many other developing regions, Africa suffers from the poor state of its economic and financial statistics. This impedes the timely and accurate economic analysis so necessary for effective monetary policy. The effectiveness of monetary policy is also undermined by the shallow financial markets, the poor enforceability of contracts, and the high exposure of the African economies to exogenous shocks. But it was encouraging to see that the African central banks are well aware of these constraints and actively seek solutions that will improve their monetary policy effectiveness.

5. Capital flows, commodity prices and exchange rates

Capital inflows have played a key role in financing investment and external deficits in Africa over the past decade. Higher commodity prices in particular have helped to lift external balances and growth in commodity-exporting countries. But capital inflows tend to rise as commodity prices increase. The combined effect of these two forces is often to increase macroeconomic volatility. This can lead to reduced external competitiveness and the build-up of balance sheet vulnerabilities.

Private capital inflows to Africa have been dominated by foreign direct investment, which accounted for two thirds of all net inflows over the past decade. FDI inflows were essentially unaffected by the crisis, reflecting the strong rise in commodity prices and high real rates of return in Africa's extractive industries. In the past few years, Africa has also strengthened its investment ties with developing countries as a result of growing South-South FDI flows. In particular, there has been a strengthening of investment relations between emerging Asia and Africa.

Portfolio capital inflows were also rising before the crisis, especially to Africa's emerging markets. In the past three years, however, these flows have become very volatile, reversing during the crisis and returning again strongly in 2010.

Regarding other capital flows, the paper by Logan Rangasamy and Dubravko Mihaljek in this volume notes that, unlike other developing regions, African countries held in aggregate more in deposits with BIS reporting banks than they received in loans from them. This imbalance reflects the underdevelopment of Africa's banking systems – a large part of export revenues is not intermediated by local banks but rather placed in overseas banks, which recycle a part of these deposits as cross-border loans back to African banks and the non-bank sector.

For commodity exporters, the effects of higher commodity prices have generally been expansionary. In the past, aggregate demand pressures resulting from positive terms-of-trade shocks have often resulted in inflationary pressures. However, the experience in the last few years has been more positive – most African countries have improved their inflation performance by not spending fully the windfall gains from commodity price booms. Greater restraint in expenditure, more consistent use of commodity and sovereign wealth funds, and more flexible exchange rate policies have supported these efforts.

Governors confirmed that high commodity prices and capital inflows have contributed greatly to Africa's strong performance since the mid-2000s. But these external factors have also exposed many countries to greater macroeconomic volatility. Governors emphasised the importance of the composition of capital inflows for managing their effects on the domestic economy and financial system. There was a general perception that Africa would continue to benefit from inflows in the future, partly because of the shift in risk perceptions in favour of African investments after the crisis. In this context, there was some concern about the lack of strategy on the part of African governments for dealing with large FDI flows into natural resource industries, including the recent increase in investments from some Asian emerging markets.

Despite greater exchange rate flexibility than in the past, few African central banks were prepared to let the exchange rate fully absorb the external shocks. The role of exchange rates as an anchor for inflation expectations was still judged to be important. In this regard, foreign exchange intervention and sterilisation were seen as costly, though probably unavoidable, policy tools. In addition, Governors emphasised the importance of fiscal sustainability for dealing with the domestic consequences of capital flows.

6. Concluding remarks

All were struck by how well most African economies have performed over the past few years. Despite the global financial crisis, growth has held up well, macroeconomic and financial stability have been preserved, and African countries have by and large continued to pursue prudent policies and promote market-friendly initiatives. African central banks have played a key role in promoting these developments. Central bankers from Africa see essentially eye to eye with their colleagues from other parts of the world on the analysis of key policy issues. This roundtable also provided a great opportunity to exchange views on the lessons learned from the recent financial crisis, and to strengthen ties among African central banks.

References

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