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African governments must act decisively to restore macroeconomic balance

African finance ministers and central bankers gathered in Washington DC last week for the IMF and World Bank Spring Meetings in circumstances far removed from the warm glow of economic success surrounding the "Africa Rising" conference in Maputo, less than two years ago. With the IMF continuing to peg back its growth forecasts for the region, as the hostile global economic environment for developing countries shows little sign of abating, African policymakers are being required to play a hand over the coming months and years that will not only challenge their technical expertise but will place the institutions of economic policymaking under considerable stress. Securing macroeconomic stability has returned abruptly to centre stage in Africa. This time, however, the task is to navigate the difficult waters ahead in a way that doesn't turn a tricky stabilisation challenge into a full blown crisis and undo the gains in prosperity so many countries have enjoyed over the last two decades. Economic reforms over the last two decades mean policymakers currently have more effective macro policy instruments at their disposal than before, but in the end success will depend on how well policymakers make difficult political choices on fiscal policy.

One shock away from a crisis

The favourable tailwinds of two years ago have swung through a full 180 degrees and are now squarely on the bow. Even accounting for the boost to consumers from lower oil prices, the end of the commodity price super-cycle has directly cut primary export earnings for many countries and undermined planned investments in the hydrocarbon sectors in the region. In addition, weak global growth – especially from the Eurozone, China and the other major emerging market economies - has depressed the demand for non-traditional exports from Africa, so that overall current account positions now look decidedly fragile. They are also increasingly expensive to finance: traditional aid donors appear less willing than in the past to provide balance of payments support, and with dollar interest rates expected to edge up and bond spreads widening as global investors reassess market fundamentals and take flight to the shelter of the US market, the risk of 'sudden stops' to private capital flows intensifies. Most African currencies have already fallen by between 20% and 40% against the US dollar since the beginning of 2015, and as growth softens and the cost of capital rises external debt ratios have once more begun to rise across the region, rapidly so in a number of 'frontier market' countries, most notably in Nigeria, Ghana and Zambia.

Weaker external conditions have also exposed latent domestic fiscal vulnerabilities, directly in natural resource-dependent economies, but also more widely as rising debt service costs and import-intensive government expenditures mean that external and fiscal deficits are moving closely together: the fiscal stance is increasingly compounding rather than offsetting external pressures, and vice versa.

How did we get here? A decade of rapid change, high growth and a sudden stop

In retrospect, and with no little irony, the "Africa Rising" moment in mid-2014 represented the (hopefully temporary) high water mark of a period of unprecedented macroeconomic stability and growth dating back to the mid-1990s, when a number of countries embarked on the reforms that have transformed economic prospects across the continent. Boosted by the HIPC debt relief initiative in the early 2000s and supported by strong global demand, especially for the commodity exports in which many specialised, African countries enjoyed rapid growth and high levels of consumption. With China adding huge volumes to global aggregate supply, world prices for manufactured goods remained low; imports were abundant and fiscal revenues buoyant. The scale of this growth was impressive: following a decade and a half of stagnation between 1980 and 1995, the subsequent twenty years saw the Sub-Saharan African economy more than double in size. Crucially, compared to earlier episodes, economic growth was broad-based, with high average growth rates experienced across both the smaller 'frontier economies' – Ghana and Uganda, for example – as well as the large countries including Nigeria and Ethiopia and, latterly, even into hitherto fragile states such as Angola and the Democratic Republic of Congo.

Taking advantage of ultra-low global interest rates and a 'risk on' stance amongst global investors, governments were also able to tap into hitherto inaccessible sources of private capital to finance ambitious and much–needed public investment programmes. Large volumes of capital flowed into the region, keeping currencies strong, and fiscal balances healthy. Current account deficits widened, but with strong domestic growth and low interest rates external debt burdens remained relatively low.

Behind the scenes, many African governments reformed their macroeconomic policy regimes. These reforms were partly outward-looking and aimed at deepening countries' integration with the global economy, to attract capital and to signal commitment to more market-friendly policy regimes. They also partly focussed on domestic demand management, in particular in confronting the threat of 'fiscal dominance' – the inflationary pressures generated from unfunded public expenditures - that had been the bane of effective macroeconomic management across the continent in the 1980s and 1990s. Thus many countries moved more decisively towards floating exchange rate regimes, often coupled with liberalisation of the capital account, while in the domestic arena, increasingly independent central banks started to re-design monetary frameworks along 'Inflation Targeting' lines familiar elsewhere in the world. At the same time, comprehensive tax reforms, the introduction of value-added taxation and the introduction of quasi-autonomous revenue agencies accompanied reforms to public financial management and budgetary systems.

The adjustment imperative

Though many African economies are now more resilient and better placed to cope with the harsh external conditions they currently face, fiscal and external buffers are limited and debt levels are not so low that there is the scope to borrow their way through the crisis, even assuming creditors will continue to lend at other than punitive rates. In addition, the major infrastructure investment drive the region pursued, financed by external borrowing, has ushered in a potential challenge of currency and maturity mismatch in debt servicing as revenue streams from this investment accrue predominantly in local currencies and debt obligations mature sooner than the growth effects of such investment are likely to materialise. Unless substantial aid flows are forthcoming, the logic of debt and external sustainability therefore requires that macroeconomic policy must pursue a conventional adjustment strategy that seeks to restore external balance through a mixture of real exchange rate adjustment and demand management. Exchange rate depreciation will play a role, but at a time when all countries, in Africa and around the world, face the same strengthening US dollar, competitive currency depreciation will not necessarily translate into a strong price advantage in third markets. To the extent this reduces the scope to achieve adjustment to the external balance, it means that 'expenditure reducing' measures – i.e. domestic demand management – will have to bear a greater share of the burden in restoring external balance.

Restoring balance

The first and overriding priority is to resist the temptation to try to restore macroeconomic balance by imposing quantitative restrictions on specific imports or by rationing foreign exchange. The lessons of the late 1980s are clear: such measures worsened rather than improved macroeconomic conditions then and they will do so again. Attempts to defend an indefensible exchange rate by such means are an invitation to rent-seeking and corruption which will corrode the institutional foundations of good economic policy, and jeopardise all chances of a credible macroeconomic adjustment. This is the easiest way to cede the real gains of the last two decades. The truth of this is, unfortunately, painfully evident in those countries currently pursuing this strategy.

The current travails of Nigeria point clearly at these dangers. The Nigerian economy has been hard hit by declining oil prices, but authorities' attempts to restore balance by rationing imports and pegging the exchange rate have been counter-productive. Increasing fuel and goods shortages have reduced investor confidence, and depleted fiscal buffers have generated inflationary pressures damaging exports and growth in non-oil sectors and contributing to higher public debt. Prospects for a rapid recovery in Nigeria are not good.

This does not mean monetary and exchange rate policy must adopt a completely passive stance, however. One payoff from the reforms of the last two decades is that many African central banks now have the capacity to use their exchange rate and monetary policy tools to influence the path of the economy, at least over the short- to medium-term so as to minimise the costs of adjustment. This capacity is of course bounded: domestic asset markets remain relatively thin, which weakens the traction of interest rate movements on demand, while the increased integration of African capital markets with global markets makes it harder to insulate domestic monetary conditions from global factors. Both features moderate the strength of transmission from macroeconomic policy instruments to inflation, output and the exchange rate, and while monetary regimes are in transition central banks need to proceed cautiously to uncover and assess the limits of monetary policy effectiveness.

Ultimately, however, it is fiscal policy that will play the decisive role in ensuring that Africa's macroeconomic adjustment is successful. It will succeed if designed in a way that does not undercut the growth-promoting effects of the recent surge in public investment and does so in a way that does not reverse the inroads made in poverty reduction and in improving service delivery in the health and education sectors. The first step is to ensure that the most critical infrastructure investments – for example in power generation – are completed and maintained: pursuing the traditional 'quick fix' fiscal adjustment of cutting back on the operations and maintenance of public infrastructure capital is almost always a false economy. Expenditure adjustments must, therefore, necessarily fall on other areas, difficult though that may be. New capital projects may need to be postponed; recurrent expenditure programmes scaled back; and, inevitably, the public sector wage bill will need to be kept under tight control.

The accompaniment to expenditure adjustment - and arguably the most important area of fiscal policy in the medium term - is tax reform. Domestic revenue mobilisation has improved substantially in recent decades but tax-to-GDP ratios are still relatively low. There is an urgent need to put in place revenue regimes that capture more effectively the gains from the growth and rapid structural change that countries are experiencing as economies formalise and become more urbanised. But it will be the effective taxation of this widening base (which will also entail the progressive elimination of the vast array of exemptions and leakages that currently pepper tax systems on the continent) rather than any hike in already high marginal tax rates that will be indispensable to boosting tax revenues.

None of these fiscal choices are straightforward, they all have difficult distributional and welfare consequences, and all are intensely political. But fiscal policy is, by its nature, political, and it is in the delivery of a coherent and equitable fiscal adjustment that holds out the best prospects for supporting a smooth adjustment to the current situation and allowing for sustained growth when conditions improve, that will be the ultimate test of the economic transformation that the Africa Rising conference celebrated in 2014.

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