

# Why Monetary Policy Is Irrelevant in Africa South of the Sahara

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The International Monetary Fund places great importance on monetary policy in its programmes for developing countries in sub-Saharan Africa. It regards such policy as crucial to holding down inflation and stabilising the real exchange rate. But such an approach is absurdly inappropriate since the vast majority of governments of sub-Saharan countries lack the instruments to make monetary policy effective (see Weeks 2010).

Implementing monetary policy can use two channels: 1) trying to influence the creation of private credit through so-called open market operations or 2) seeking to influence the borrowing rates for the private sector by adjusting the interest rate at which commercial banks can borrow from the central bank.

Open market operations, namely, the buying and selling of government securities, require a domestic bond market that can support substantial trading of securities. If there is no such market, then the central bank has to resort to adjusting its policy interest rate in the hope that it can influence lending by commercial banks to the private sector. Such a hope is based on the assumption that commercial bank credit plays a substantial role in financing private investment.

Hence, the effectiveness of monetary policy relies on a viable domestic market for trading public securities and a commercial banking sector willing and able to lend to the private sector. However, with the exception of South Africa, no country in the sub-Saharan region has these necessary conditions.

## Securities Markets

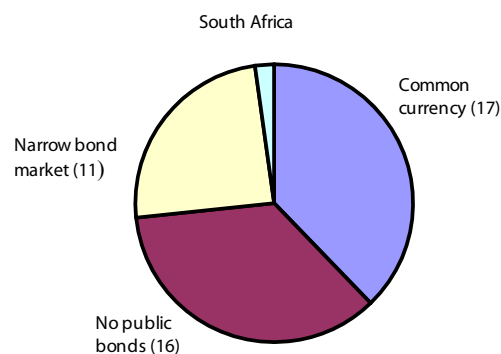
For over a third of the countries in sub-Saharan Africa, monetary policy is obviously irrelevant because they share a common currency. Thus, they have no national central banks. The West African Economic and Monetary Union has eight members and the Central African Economic and Monetary Community has seven more. All 14 use the CFA (*Communauté Financière Africaine*) franc.

To these 14 countries can be added another three: Lesotho, Namibia and Swaziland. Their membership in the Common Monetary Area (CMA) means that their currencies are tied *de facto* to the South African Rand (see Figure 1). The CFA governments cannot even go through the motions of monetary policy (since they have no central banks), and the CMA national central banks lack operational independence.

Sixteen additional countries do not issue public bonds or have no domestic market for such securities. Another 11 countries have domestic markets for public bonds but these markets are extremely shallow (Figure 1). In all of the countries mentioned above, except South Africa, the only potential purchasers of public bonds are a few expatriate banks, typically no more than four or five, which dominate the financial sector.

With the exception of South Africa, there are few statistics available on trading volumes in sub-Saharan bond markets. However, relevant information for Zambia, which has one of the more developed financial sectors in the region, reveals the characteristic problems of domestic bond markets in the region (Weeks et al. 2006).

Figure 1: Distribution of 45 African Countries by Bond Markets



## The Lack of Domestic Credit

The Zambian experience demonstrates that if the yield on public securities is low, commercial banks would hold only the statutory required minimum in their reserves. So central banks have to offer a high yield to induce commercial banks to hold government bonds. Since such bonds are almost risk-free, commercial banks are much more inclined to hold them as assets than riskier loans to non-financial businesses. These factors reinforce the already existing reluctance of commercial banks to finance productive private investment because of the perceived risks of doing so.

Raising the interest rate on government securities can further discourage commercial banks from lending to the private sector through the following process. In response to a weakening of the exchange rate or a perception that inflationary pressures are excessive (or both), the central bank would most likely increase the interest rate on government bonds.

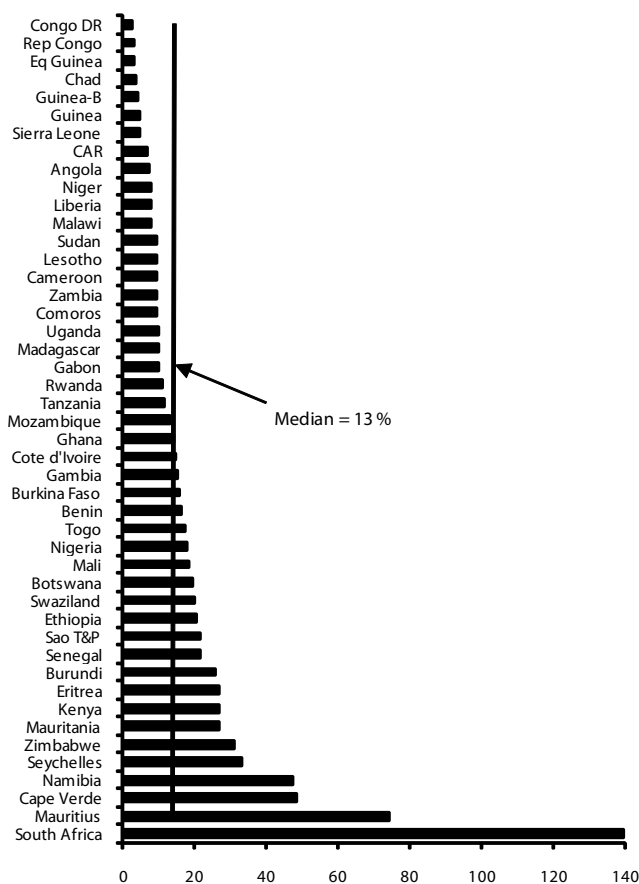
In most sub-Saharan countries the demand by commercial banks for bonds does not readily respond to changes in the interest rate. One reason is that there is little competitiveness in domestic bond markets and another is that the bonds of African governments have extremely low credit ratings from Standard and Poor's or Moody's—if they are rated at all.

Given these factors, the main impact of the central bank's raising of the bond interest rate will be to induce commercial banks to replace loans

to the private sector with government bonds because the relative return from the former has fallen. This is a perverse result because when bonds increase the assets of commercial banks, they should expand their creation of credit. But because of the high yields received by banks on government securities, it is profitable for them to hold excess reserves instead of lending.

This process is fundamentally different from the so-called 'crowding out' of private investment, about which the IMF repeatedly warns national policymakers. But the ultimate effect is the same. 'Crowding out' allegedly occurs when government borrowing to cover public expenditures competes with private borrowing. The dynamic that we are describing is different because the increase in the central bank rate does not originate from a need to cover public expenditure, but from the false expectation that the higher rate would appreciate the exchange rate and reduce inflationary pressure.

**Figure 2: Domestic Credit Extended to the Private Sector in 46 African Countries (% of GDP, average 2001-2008)**



Though raising the central bank interest rate is usually intended to reduce the weakening of the exchange rate by inducing more capital inflows, such investment rarely increases in response to a such a hike. A major reason is that domestic bond markets in the region lack the institutional mechanisms to facilitate and safeguard foreign capital flows.

The fundamental problem is centred in the financial sector itself. Even if the policy interest rate of the central bank could influence commercial lending rates and thereby reduce credit expansion, credit from the banking system is of relatively little importance in most sub-Saharan countries (see Figure 2).

Across 46 African countries, the median ratio of domestic formal-sector credit to GDP was only 13% during 2001-2008. Only two countries (Mauritius and South Africa) had ratios above 50%. And only six had ratios above 30%. For 20 of the 46 countries the ratio was less than 10%.

### The Rise of Public Debt

In summary, the reality in sub-Saharan Africa is that, with very few exceptions, monetary policy has no meaningful impact on inflation or the real exchange rate. But monetary policy that is committed to maintaining high real rates of interest does have adverse consequences since the burden of public debt is determined overwhelmingly by the interest rate at which it must be serviced.

Thus, the IMF's lobbying for inflation-retarding high real rates of interest ends up reinforcing the diversion of public funds into debt servicing. And the main beneficiaries are a few large and powerful domestic commercial banks.

In the process, one of the fundamental rules of debt management—namely, that the real interest rate on public debt should not exceed the real growth rate of the economy—is violated. As a result of such a fiscal burden, the country's rate of economic growth is unnecessarily constrained, without having achieved any mitigating benefits through lowering inflation and maintaining a competitive exchange rate.

#### Sources:

Basic information on monetary institutions: Wharton Financial Institutions Center of the University of Pennsylvania, for all but Mauritius, Namibia, Nigeria and Seychelles, and <http://www.afdb.org/en/news-events/article/donor-workshop-on-african-bond-market-4443>

For information on financial statistics: World Development Indicators, <http://publications.worldbank.org/>

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