Macroprudential regulation in Africa in the context of the Covid-19 pandemic

Sources of external instability

- Weaknesses in the current account
- Excessive debt or non-debt inflows on the capital account that raise the possibility of destabilising outflows
- Not unrelated
- Pre-empting systemic fragility requires measures that help address current account shocks without excessive dependence on volatile capital flows, measures to prevent volatile movements of the exchange rate, as well as measures to curb excessive capital

Some mechanisms

- Widening trade and current account deficits set off currency depreciation.
- Such depreciation can fuel itself by aggravating currency speculation, including through the delayed repatriation of export receipts. Reduced access to foreign exchange and currency depreciation can also lead to debt stress and even bankruptcy.
- Vulnerability to systemic crises is greater when the cause of balance of payments difficulties is capital flight resulting from the sudden exit of foreign financial investors investing in bond and equity markets or residents choosing to transfer wealth out of the country.

Covid-19 and systemic risk

- The Covid-19 pandemic heightened systemic risk in Africa.
- Dollar shortages and depreciation were major consequences of the pandemic. With travel and transportation adversely affected, export revenues and earnings from tourism fell. The near stop in economic activity globally meant some loss in earnings of migrant workers in foreign locations, leading to a fall in remittances. Heightened economic risk made it difficult to access new foreign credit, especially from private sources.

Africa's commodity dependence

- Given Africa's overwhelming dependence on exports of primary products the demand for and international prices of which are volatile, the trade and current account on the balance of payments are routes through which shocks could be transmitted to the domestic economy, triggering systemic difficulties.
- For commodity exporters the 21st century has thus far been a mixed bag. The first decade saw the upswing in commodity prices as part of a supercycle, with only the global financial crisis proving a temporary spoiler. But, after 2011, most commodity prices have been falling.

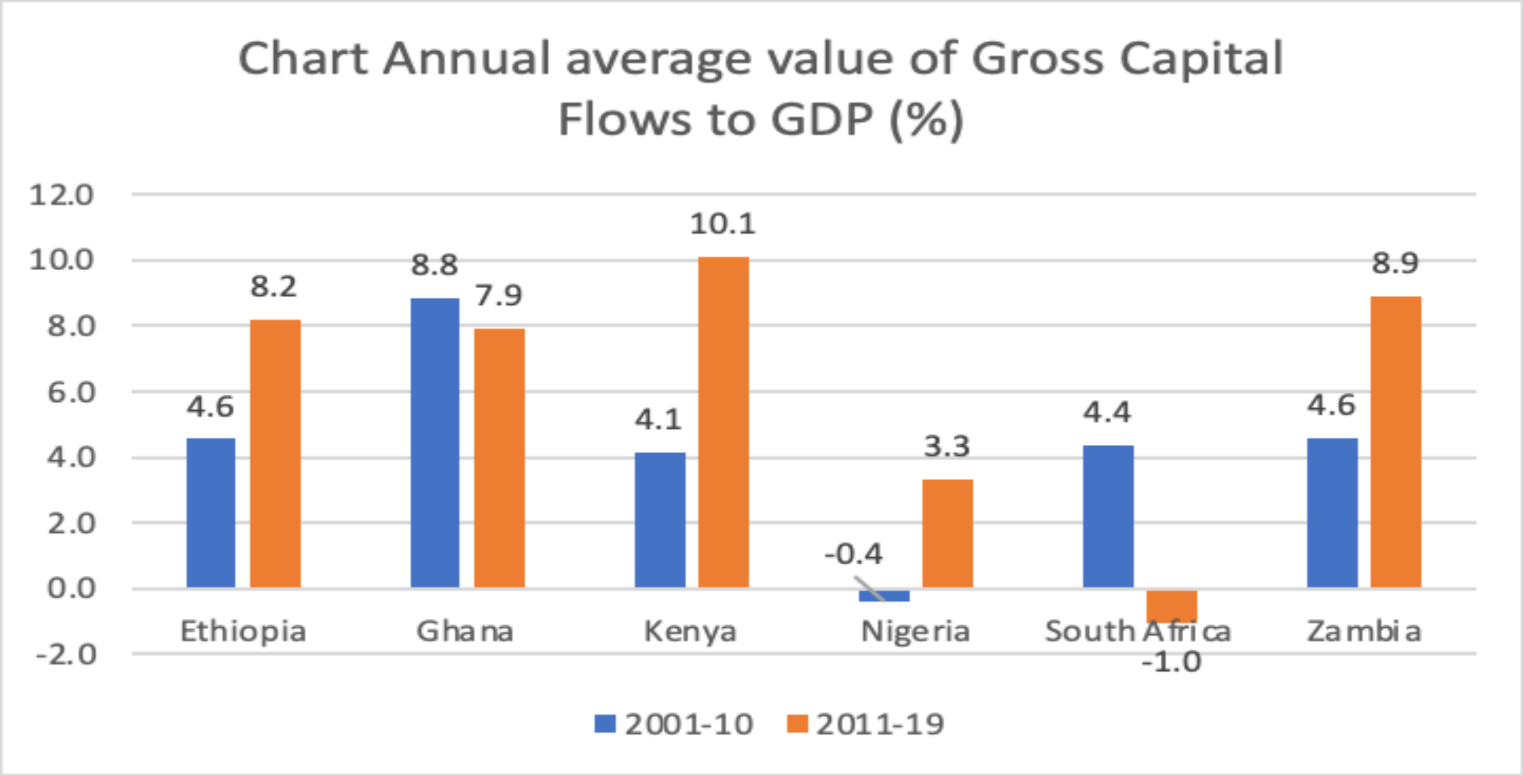


Chart Annual average value of Gross Capital Flows to GDP (%)
12.0
10.0
8.0
6.0
4.0
2.0
0.0
-2.0
4.6
8.2
8.8
7.9
4.1
10.1
-0.4
3.3
4.4
-1.0
4.6
8.9
Ethiopia
Ghana
Kenya
Nigeria
South Africa
Zambia
2001-10
2011-19

Magnitude of Increase in Net Inflows Between End and Beginning of Periods (Ratio)			
	1998-2000 rel to 1990-92	2007-08 rel to 2001-03	2017-19 rel to 2009-11
Ethiopia	0.72	1.85	4.17
Ghana	2.07	7.08	0.50
Kenya	2.53	10.18	1.97
Nigeria	0.64	0.54	0.21
South Africa	-2.03	-13.50	0.70
Zambia	1.62	0.30	-0.05

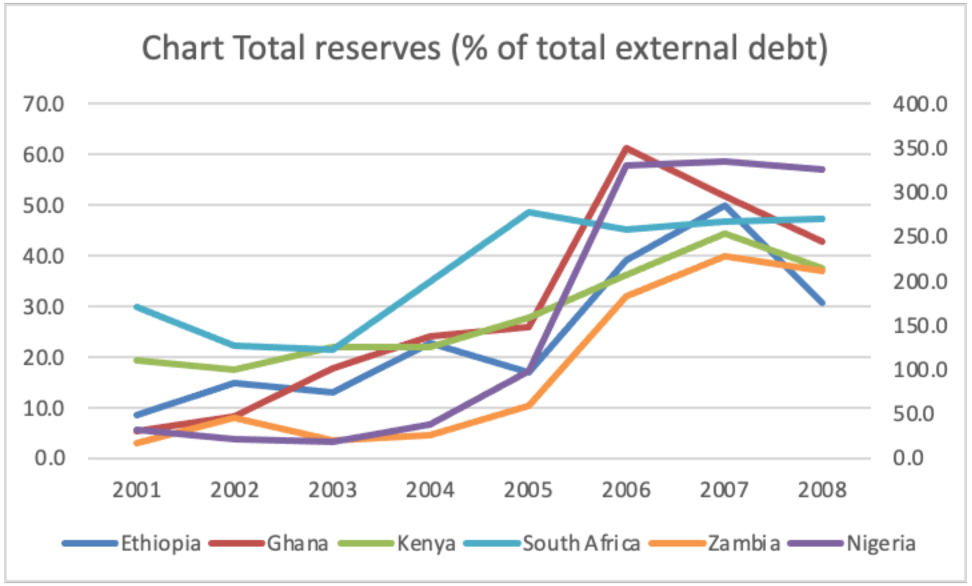


Chart Total reserves (% of total external debt)
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
400.0
350.0
300.0
250.0
200.0
150.0
100.0
50.0
0.0
2001
2002
2003
2004
2005
2006
2007
2008
Ethiopia
Ghana
Kenya
South Africa
Zambia
Nigeria

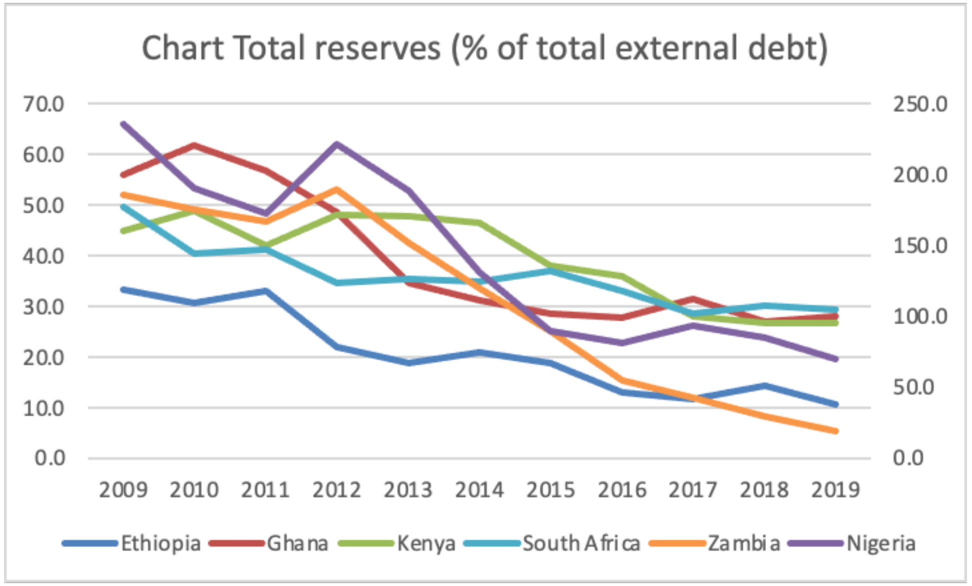
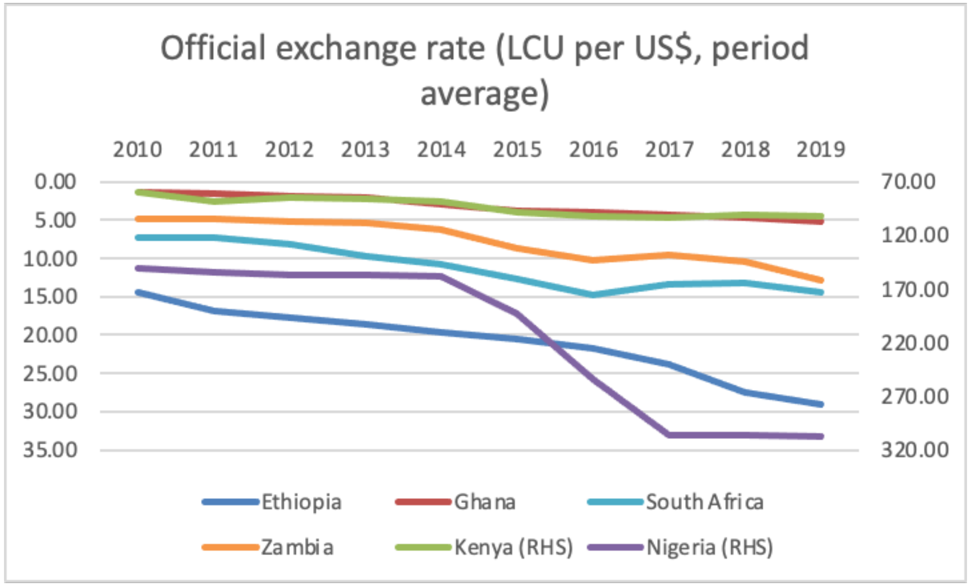


Chart Total reserves (% of total external debt)
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
250.0
200.0
150.0
100.0
50.0
0.0
2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019
Ethiopia Ghana Kenya South Africa Zambia Nigeria


Official exchange rate (LCU per US$, period average)
2010
2011
2012
2013
2014
2015
2016
2017
2018
2019
0.00
5.00
10.00
15.00
20.00
25.00
30.00
35.00
70.00
120.00
170.00
220.00
270.00
320.00
Ethiopia
Ghana
South Africa
Zambia
Kenya (RHS)
Nigeria (RHS)

Exchange rate management: Ethiopia

- With shift to system of exchange rate determination in the interbank market after 2001, exchange rate sought to be managed with central bank intervention with eye on export competitiveness.
- Given persistent inflation, the nominal exchange rate put on a trajectory involving continuous depreciation so as to keep the real rate near stable and protect the competitiveness of exports.
- When reserves with the central bank fall, difficult to sustain the exchange rate. This happened in 2017, for example, when the birr depreciated by 15 per cent overnight.

Exchange rate management: Zambia

- When Chinese growth slowed demand for copper decelerated and copper prices fell. Set of a slide in the Zambian kwacha. Triggered an increase in dollarized transactions.
- In 2012 the government issued Statutory Instrument 33, which banned quoting in, paying or receiving foreign currency as legal tender for goods, services sold domestically or for any other domestic transactions.
- Exporters were required to repatriate foreign currency earned from exports back to Zambia and report on the receipt of export proceeds within 120 days of receipt. That directly affected large transnational metal giants like Glencore, Vedanta, First Quantum and Vale.
- The weak intervention did little to halt the depreciation of the kwacha, which driven by a more than 10 per cent decline in the copper price in the first half of 2014 depreciated by 13 per cent during that period. Regulatory measures withdrawn and have been abjured since.

South Africa: Market mediated intervention

- In S Africa efforts at countering rand depreciation focused initially on market-mediated measures rather than use of reserves. Such intervention often increased rather than reduced systemic risk.
- During the late 1990s the South African Reserve Bank (SARB) ran an “oversold forward book”. Simultaneous with the sale of dollars to stabilise the rand the SARB entered into a parallel swap transaction involving buying dollars spot and selling dollars forward. Since there was a simultaneous sale and purchase of spot dollars, the SARB’s current holding of dollars remained unchanged. But its commitment to deliver dollars in the future increased. Despite the risks associated with a large net open foreign position (NOFP - or open position in the forward market less its net international reserves) the SARB repeatedly resorted to this technique of managing the exchange rate. Whenever the rand depreciated the forward book exposure spiked and had to be brought down through purchases. In 1998, the SARB announced an end to this mode of intervention and a shift to a “market driven” floating exchange rate.

Capital management techniques

- Controls on capital movements by pre-empting excess capital inflows serve macroprudential objectives as well.
- Private borrowers in developing countries often assume that the real exchange rate will remain stable when making decisions to borrow abroad. But the very act of borrowing and the resulting inflow can strengthen the domestic currency reducing the local currency burden of foreign borrowing.
- This effect often encourages more borrowing leading to an excess of borrowing that increase the probability of a systemic crisis.

Capital management techniques: Ethiopia

- In Ethiopia, despite managed depreciation of the ETB, the current account deficit has remained high forcing dependence on external debt. To counteract the resulting vulnerability, Ethiopia has attempted to curb capital transactions in the private sector. Ethiopia's capital control regime is quite strict.
- Till 2000, banks could borrow or enter into an agreement with banks abroad only with the authorization of the National Bank of Ethiopia. All investments (except for services and generation and supply of electricity) had to be approved and certified by the Ethiopian Investment Commission (EIC).
- Maximum limits on investment by resident institutional investors in securities issued by non-residents and on the investment portfolio held abroad.

Capital management techniques: Nigeria

- Given the volatility in oil prices and the tendency for capital flows to move in tandem with those prices in oil-rich Nigeria, one policy option chosen was to adopt countercyclical external policies geared to accumulate foreign reserves during periods of oil price buoyancy and defensively deploy those surpluses when international prices were low.
- In the context of the oil price booms of the early 2000s Nigeria launched efforts to manage its oil surpluses, starting with the creation of the Excess Crude Account (ECA) in 2004. The ECA was transformed into the sovereign wealth fund established under the Sovereign Investment Authority Act in 2011. Starting with an initial corpus of $1 billion, the sovereign wealth fund had more than doubled its corpus to $2.15 billion by 2019 and had declared profits every year for the preceding five years. The policy served the country well at the time of the global financial crisis when oil prices fell sharply, albeit for a short period of time.

Liberalisation and debt

- After a short post-2008 crisis period when gross capital inflows into Nigeria were restrained, the volume of flows rose from 2011 to more than double their earlier levels and stood at around $20 billion in 2017. About two-fifths of that were loans under the other investment head.
- With substantial differences in domestic and foreign interest rates (20-25 per cent as opposed to 7 per cent), financial and non-financial corporations borrowed heavily abroad, without hedging adequately against the foreign exchange risk involved.
- Recognising that external borrowing by non-official sources, especially banks, was excessive, the Central Bank of Nigeria issued a set of “Guidelines for Foreign Borrowing for On-Lending by Nigerian Banks” in November 2001.

Measures adopted

- The guidelines were however liberal. Banks were not required to notify the CBN before entering into negotiations with foreign lending institutions, but had to submit details of the arrangement, such as terms and conditions of the loan to the Banking Supervision Department of CBN before signing agreements. Banks were encouraged when disbursing loans with foreign financing to “ensure that they do so to projects/institutions that have the ability to generate foreign exchange that will be used to service the loan.” These were weak macroprudential measures at best.
- Besides a specified single obligor limit, a ceiling was set on the aggregate borrowing by a bank from foreign institutions which was 200 per cent of its shareholders funds unimpaired by losses. But when starting 2014 declining oil prices and the significant build up in debt resulted in volatility in the naira’s exchange rate vis-à-vis foreign currencies, the CBN decided to impose stricter ceilings. In October 2014 it issued a new circular with a set of “Prudential Regulations for the Management of Foreign Exchange Risks of Banks”. This circular considerably reduced the ceiling on aggregate foreign currency borrowing of a bank to 75 per cent of its shareholders’ funds unimpaired by losses.