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SUB-SAHARAN AFRICA

Tackling Rising Inflation in Sub-Saharan Africa

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Tackling Rising Inflation in Sub-Saharan Africa

Inflation has risen significantly in the past two years, driven largely by external factors, including global food prices, oil prices, and supply chain disruptions. Because domestic demand has played a more limited role given the slow recovery, central banks potentially have scope for a more gradual approach to monetary policy tightening. But the pace of tightening must be fine-tuned to changes in inflation expectations, the credibility of policy frameworks, and the extent of exchange rate pressures.

INFLATION IN SUB-SAHARAN AFRICA IS LARGELY EXTERNALLY DRIVEN

Inflation has been increasing in sub-Saharan Africa since the start of the pandemic. Median inflation reached almost 9 percent as of July 2022 compared with a prepandemic (2009–19) average of a little more than 5 percent. Although inflation is currently at its highest in a decade, it remains below the peak of 12 percent (median) in the region during the global financial crisis.

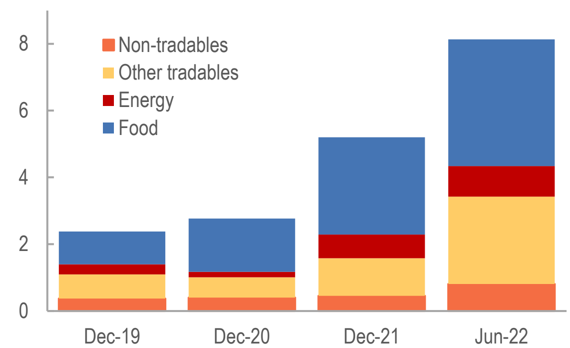
With limited domestic demand pressures, external factors—such as global commodity prices and supply chain disruptions—have been the major drivers of inflation over the past year.[1]

- Food inflation has increased sharply since 2019 (Figure 1). Given that many countries in the region rely on food imports, the recent surge in international food prices has increased pressure on domestic food prices. As a result, food inflation has averaged more than 10 percent since the second half of 2021, contributing up to two-thirds to inflation in fragile states and one-half elsewhere. However, even for this component, there is significant heterogeneity across countries, suggesting that domestic factors such as climate shocks, have also played an important role.

- Domestic energy inflation has remained contained so far. This suggests a largely incomplete pass-through, likely because of subsidies and price controls. However, in many countries, higher global energy prices have fed through indirectly, affecting food price and core inflation.

Figure 1. Sub-Saharan Africa: Drivers of Headline Inflation

(Contributions in percent, year-over-year, median)



Sources: Haver Analytics; and IMF staff calculations.

Note: Using monthly data for 28 sub-Saharan African countries, based on work by Choi and M'Boueke (Forthcoming).

- Non-tradable core inflation, which better reflects domestic demand-side pressures and inflation expectations, has been relatively subdued. Tradable goods have been a major contributor to core inflation, while prices for non-tradable goods and services have increased only modestly. The modest increase in the contribution of non-tradable goods may reflect the fact that domestic demand pressures have remained subdued across the region, and that output is still well-below its pre-COVID-19 trend. That said, domestic demand pressures remain important in a few countries where fiscal policy has been loose (for example, Ethiopia and Ghana).

[1] The finding on the limited role of domestic demand is confirmed by an econometric regression of the change in headline inflation on international food prices, oil prices, the Global Supply Chain Pressure Index of the New York Fed, and exchange rates. This analysis shows that (1) external factors have a large explanatory power and (2) residuals (which capture domestic factors) have not been above average in the recent period.

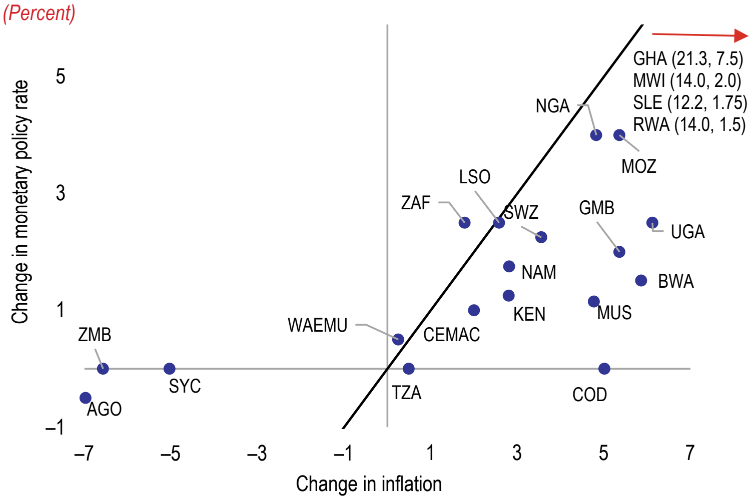
Despite the greater role of supply shocks, central banks still need to closely monitor second-round effects from imported inflation. With the high share of food, energy, and tradable goods in consumption baskets, large movements in global prices and exchange rates can result in large swings in living costs, which can then feed into larger wage demands and a subsequent increase in prices. As a result, even if the initial global shock is temporary, food and energy inflation can still have a significant and long-lasting impact on inflation expectations—a key variable that is difficult to measure in most African countries (October 2011 *World Economic Outlook,* Chapter 3). It also affects poorer households disproportionately, because these essential items represent a larger share of their consumption baskets.

While significant strides have been made in recent decades, monetary policy credibility in sub-Saharan Africa remains generally weaker and inflationary expectations less well anchored than in advanced economies. Headline consumer price inflation has generally trended downward over the last two decades, reflecting improved macroeconomic policies. Many countries have strengthened central bank independence, reduced fiscal dominance, and improved monetary policy transmission channels. But policy frameworks are still relatively weak in some countries, and high debt levels can raise the prospect of future monetary financing of the fiscal deficit (Unsal, Papageorgiou, and Garbers 2022). These factors tend to undermine the inflation-fighting credibility of the central bank, making second-round effects from external shocks more likely, and lowering the effectiveness of monetary policy.

MOST CENTRAL BANKS SHOULD TIGHTEN, BUT THE PACE WILL DEPEND ON COUNTRY-SPECIFIC FACTORS

Maintaining macroeconomic stability and preserving hard-earned policy credibility are critical for sustained economic development. Even though domestic demand pressures have played a limited role so far, rising domestic inflation and the fast exit from accommodative monetary policies in advanced economies is prompting most sub-Saharan African central banks to tighten monetary policy. More than two-thirds of sub-Saharan African economies have already started to raise monetary policy rates since the second half of 2021 (for example, the Central African Economic and Monetary Union, Ghana, Kenya, Malawi, Mozambique, Nigeria, Uganda, and the West African Economic and Monetary Union). Additionally, commercial bank reserves at central banks have decelerated significantly relative to the peak observed at the onset of the pandemic. Countries with more acute inflation pressures have generally tightened more. But the increase in policy rates has, so far, not been commensurate with the increase in inflation, signalling that real short-term interest rates (measured ex-post) are still decreasing in many countries (Figure 2).

Figure 2. Sub-Saharan Africa: Change in Monetary Policy and Inflation Rate Since December 2021
(Percent)



Sources: IMF, International Financial Statistics; and Haver Analytics.

Note: Inflation and policy rate data updated as of end of September 2022. Data labels use International Organization for Standardization country codes.

How fast should central banks tighten? Each country is different, and the appropriate pace of the response depends on domestic circumstances.

- Central banks in many countries should raise policy rates cautiously given that the recovery is still fragile and domestic demand pressures have not been as important a driver of inflation for most countries. Looking ahead, demand is expected to remain soft, including as a result of fiscal consolidation. Nonetheless, countries should keep a close eye on inflation developments—to detect the emergence of second-round effects—and the level of foreign exchange reserves.

- Some countries may need to tighten faster or more decisively, including: (1) countries where domestic demand pressures are acute or inflation is very high (Ethiopia, Ghana, Malawi, Nigeria, Zimbabwe)—because of a history of domestic imbalances or emerging second-round inflationary pressures; (2) countries with less credible monetary policy frameworks, where inflation expectations are less well anchored; and (3) countries experiencing large capital outflows and rapid currency depreciation that fuel inflation by increasing import prices and de-anchoring expectations.

- While countries with pegs or heavily managed floats have, so far, experienced lower inflation (particularly for tradable goods) than those with more flexible exchange rates,[2] their ability to control the pace of monetary policy tightening is constrained by their currency arrangement.

Is it going to hurt? Output in sub-Saharan Africa is still significantly below its prepandemic trend. Central banks are thus facing a difficult trade-off between supporting the recovery and containing inflation. Empirical analysis using the Ball (1994) methodology suggests that, in the past, the sacrifice ratio for sub-Saharan African countries has been lower than for advanced economies.[3] This result, in line with the literature, may reflect the fact that supply is often more rigid in developing economies because of various capacity constraints.[4] However, there are reasons to believe that disinflation costs may be higher in the current context: first, the reduction in domestic demand coming from monetary policy tightening will compound existing social hardships from food insecurity and the pandemic; second, the global growth slowdown means that external demand will not provide any offset; and third, the large size of recent global supply shocks raises the risk of inflation expectations de-anchoring compared to past inflationary episodes. Overall, policymakers should assess country-specific trade-offs by closely monitoring inflation developments and expectations.

What is the role for other policies? The prospect of significant further capital outflows is a major concern for many central banks. In many countries with flexible exchange rates, some depreciation could absorb part of the shock and help macroeconomic adjustment, alleviating the pressure to raise interest rates. The IMF's most recent External Balance Assessment shows that external positions in many sub-Saharan African countries are weaker than warranted by fundamentals and the exchange rate for the median country tends to be overvalued ("The Role of Foreign Exchange Intervention in Sub-Saharan Africa's Policy Tool Kit," Analytical Note to the April 2022 *Regional Economic Outlook: Sub-Saharan Africa*.). However, large exchange rate movements that result in volatile inflation may risk de-anchoring inflation expectations and undermining financial stability, especially in countries with significant foreign currency exposure on their public and private sector balance sheets. In these circumstances, foreign exchange interventions to reduce excessive volatility could be justified to help preserve domestic price stability but only for those countries with sufficient international reserves.[5] In the few countries with excessively loose fiscal policy, fiscal consolidation should also be part of the disinflation strategy.

[2] Monthly median inflation averaged 5½ among peggers compared to 9½ among floaters between January and July 2022.

[3] The "sacrifice ratio" refers to the output losses observed for a given drop in trend inflation.

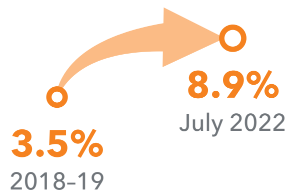
[4] Thus, rapid increases in demand can generate intense price pressures, and, symmetrically, disinflation can be achieved through more modest demand contraction.

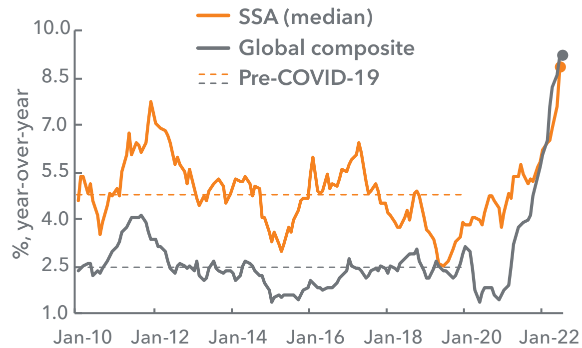
[5] Currently, one-quarter of sub-Saharan African countries have reserves below 3 months of imports and more than three-quarters have reserves below 5 months.

TACKLING RISING INFLATION IN SUB-SAHARAN AFRICA

Inflation is climbing

Inflation in sub-Saharan Africa has been **rising**, with floaters experiencing double the rates compared with pegged exchange rates.



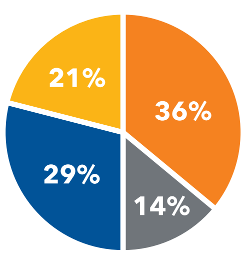


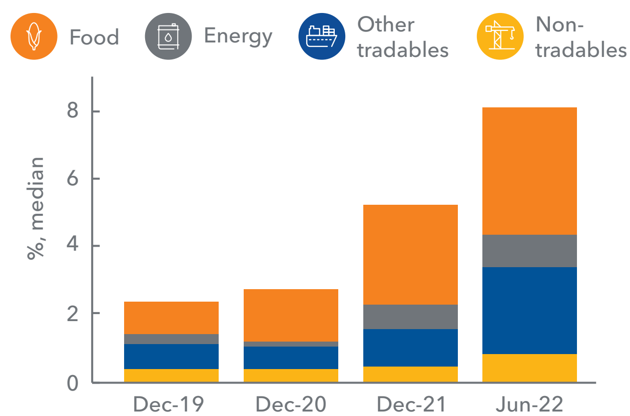
CPI Inflation, 2010–22

Inflation is driven by external factors

Food and tradable goods are major contributors to headline inflation, with a high share in consumption baskets.

The sub-Saharan Africa Consumption Basket





Drivers of Headline Inflation, 2019–22

Countries must respond to rising inflation taking into account their specific circumstances

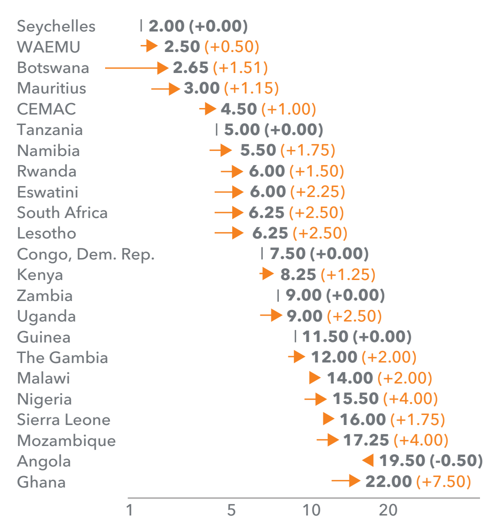
Policymakers should **tighten gradually** while **monitoring second-round effects.**

The **pace of tightening** will depend on country-specific factors, including:

» Domestic demand pressures
» Monetary policy credibility
» Exchange rate regime
» Currency movements

Increase in Policy Rate

(percent, change in policy rate since Jan 2022)



CEMAC = Economic and Monetary Community of Central Africa; CPI = consumer price index; SSA = Sub-Saharan Africa; WAEMU = West African Economic and Monetary Union.

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