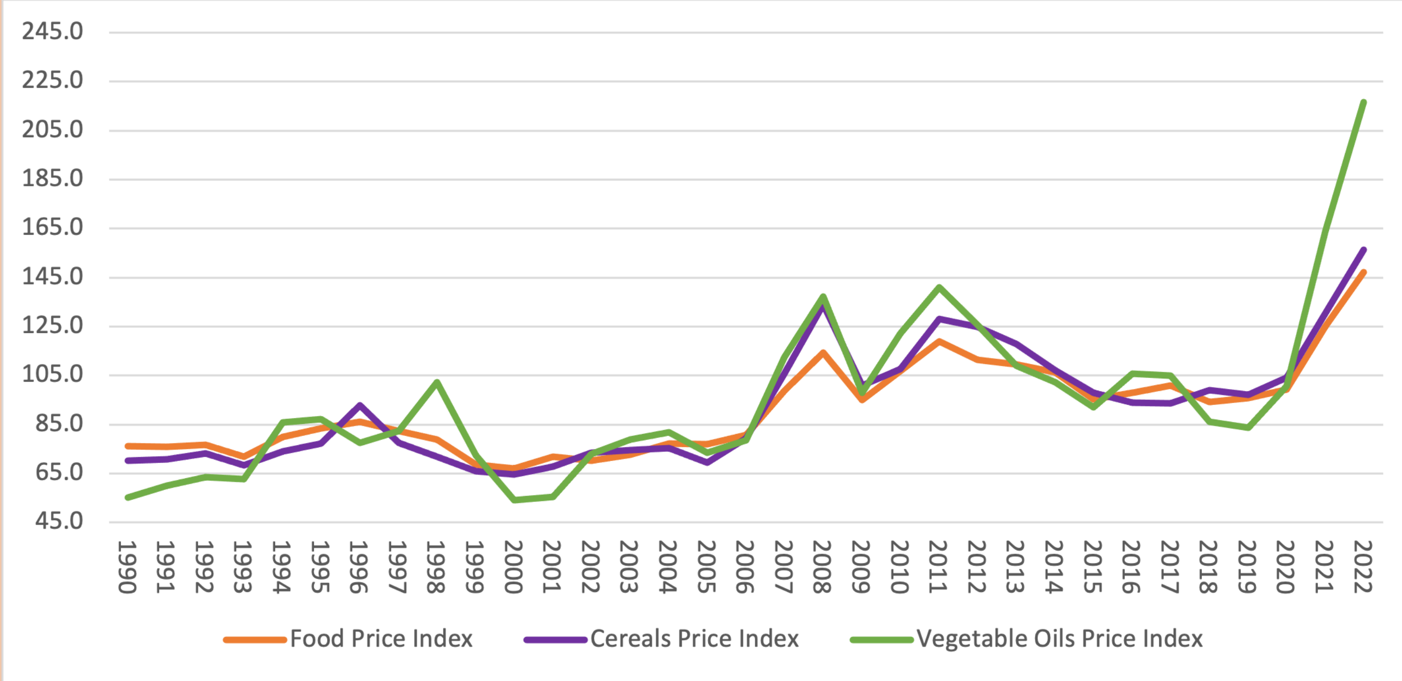
Common Market for
Eastern and Southern Africa



Policy Options for COMESA Member Countries Amidst Multiple Shocks

Special Report

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This article examines the multiple shocks the world is currently experiencing and proposes several policy options that the economies of the COMESA region can implement to go through the storm and possibly find their path to a quick recovery

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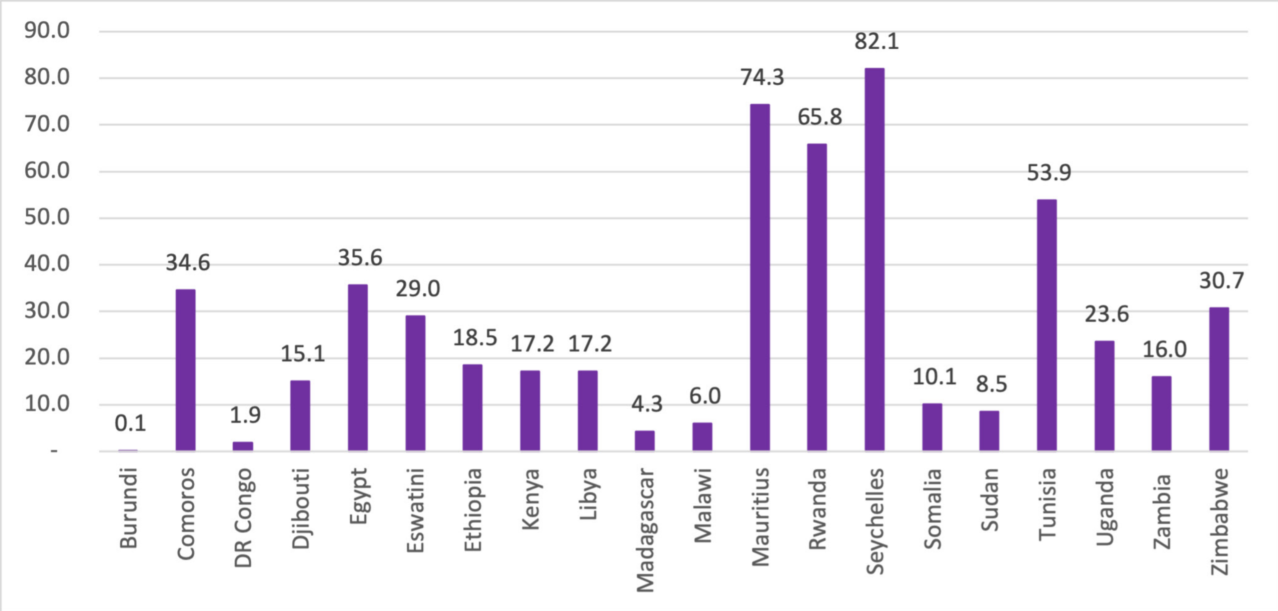
The world is going through a period of unprecedented multiple shocks. The effects of the COVID-19 pandemic, the war in Ukraine and tighter-than-expected global financial conditions are adversely affecting the world economies. The Common Market for Eastern and Southern Africa (COMESA) region has also not been spared. Besides, several economies in the region have been severely affected by climate related shocks including acute droughts while others have faced severe floods in the recent past, armed conflicts and/or heightened terrorism threats. Consequently, the region is faced with an environment marked by increased vulnerability to new waves and/or variants of COVID-19 pandemic, higher and more volatile commodity prices, higher fiscal and trade deficits particularly for commodity importers, exchange rate and inflationary pressures and headwinds from lower global demand on slowdown in global economic activity. This article examines these shocks and proposes several policy options that the economies of the COMESA region can implement to go through the storm and possibly find their path to a quick recovery.

COVID-19 Pandemic Shock

The COMESA region continues to face some headwinds dealing with the COVID-19 pandemic, marked by heightened vulnerability to new waves and variants of infections due to low rate and pace of vaccination in most countries in the region. The outbreak of Monkeypox epidemic adds to the already complex health situation.

Vaccination rates against COVID-19 have accelerated in Mauritius, Rwanda, Seychelles and Tunisia, with the percentage of the population that is fully vaccinated reaching well above 50 percent. Even so, the rates and pace of vaccination remain both inadequate and comparatively much slower in a majority of COMESA countries (Figure. 1). The slow vaccination roll-out in the latter countries increases the vulnerability to new COVID-19 waves and the risk of new variants. Nonetheless, the ramp up of vaccination drive in the few countries above suggests that it is possible to vaccinate even more people in all COMESA member countries.

Figure 1: Percentage of persons fully vaccinated with the last dose of primary series from 3 January 2020 to 22 June 2022



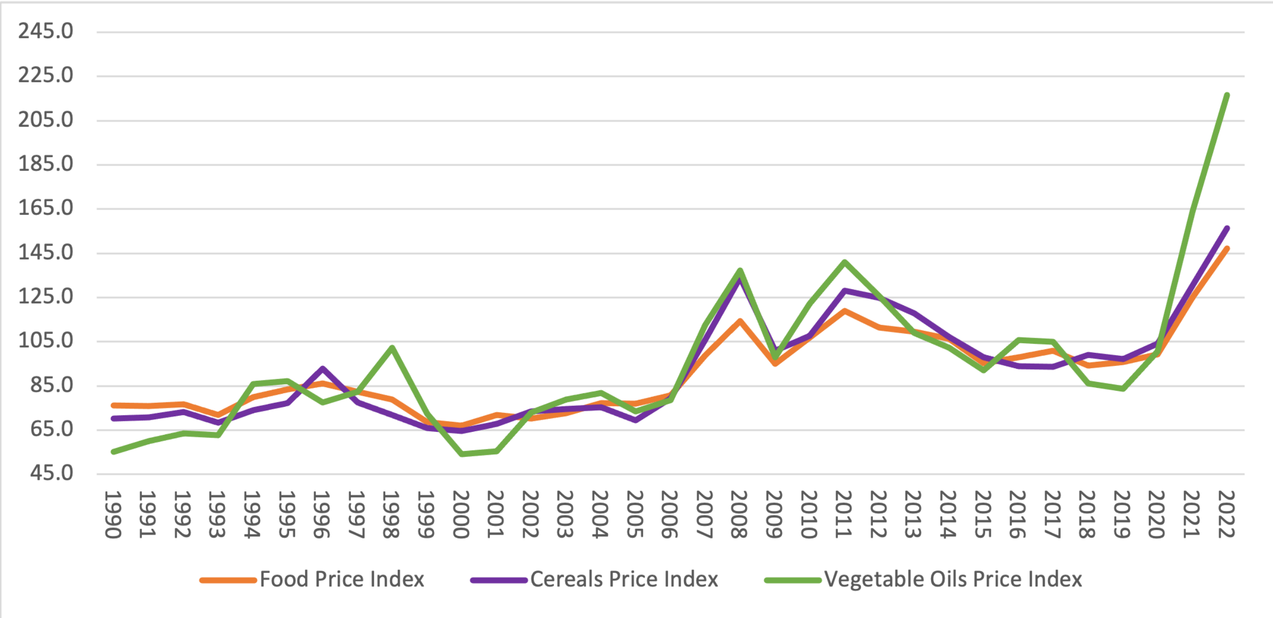
Source: World Health Organization Coronavirus (COVID-19) Dashboard @COVID19.WHO.INT

The COVID-19 pandemic situation has resulted in persistent supply chain disruptions that have translated into increases in food and energy prices, elevated inflationary pressures and caused turbulences in financial markets. For some economies that have shown signs of recovery, the exceptionally high demand for goods is also associated with rising prices and the strain on the global supply chain as a result of economic sanctions on Russia. Economic recovery and higher food and energy prices means a larger import bill for the import dependent economies and larger trade deficits, in a situation that has been exacerbated by these multiple shocks. Trade deficits are also leading to inflationary spillovers through imported inflation or by worsening the scarcity of tradable goods in the global markets. This has further worsened the tradeoff between inflation and economic growth in the rest of the world.

The War in Ukraine

The Russian invasion of Ukraine has affected the global supply of food and energy and farm inputs, particularly fertilizers. Russia and Ukraine accounts for about 14 percent of global trade in corn and 75 percent of global trade in sunflower oil - used as a key cooking oil. Supply disruption due to the war has resulted in higher prices for these commodities not only to the region but globally. The effects of sanctions on Russia have further hampered the agricultural supply chain. As indicated in Figure. 2, the Food and Agriculture Organization (FAO) price index has risen to an all-time high of 147.2 in 2022 mainly driven by a spike in cereals and vegetable oils prices.

Figure 2: Real Food, Cereals and Vegetable Oils Price Indices

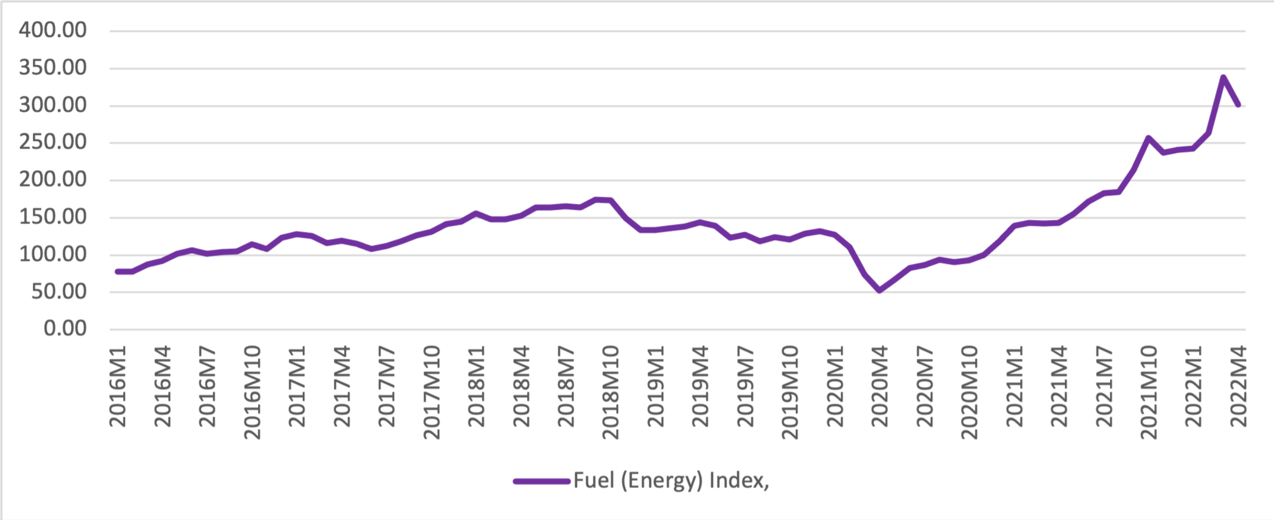


Source: Food and Agriculture Organization (FAO), where 2016=100; Food Price Index includes meat, dairy products, cereals, vegetable oils and sugar.

Save for a few countries in the regions that are commodity exporters that could generate some fiscal windfalls as they face stronger global export demand, higher commodity prices could undermine fiscal and external balances in commodity importing countries.

Similarly, oil prices have steeply increased from April 2020 largely on account of global supply disruption and recently due to the war in Ukraine (Figure 3).

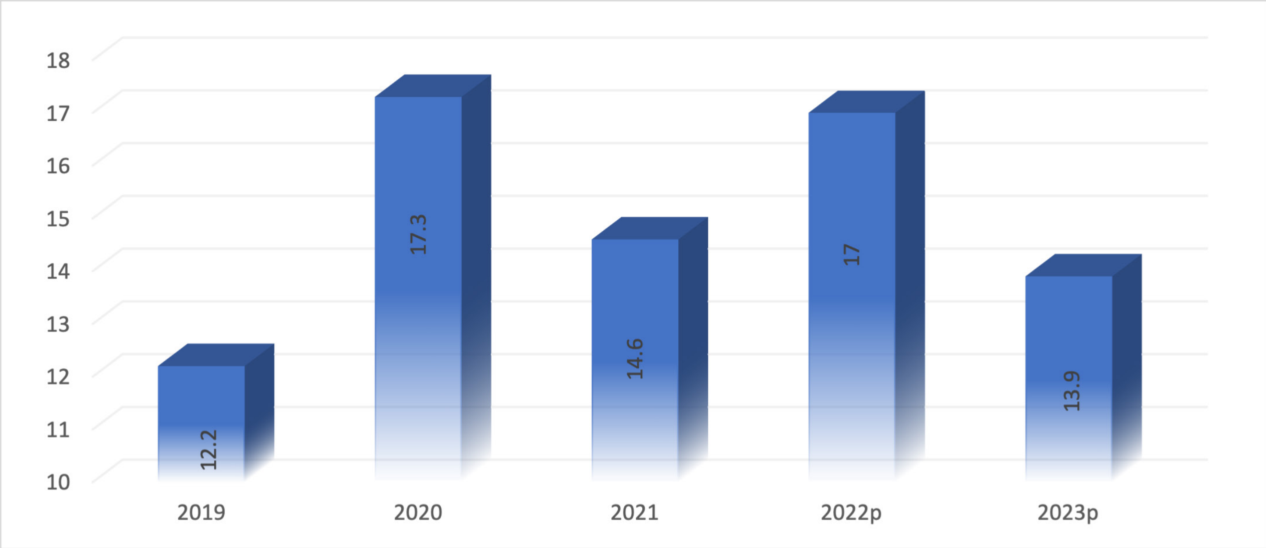
Figure 3: Fuel (Energy) Index



Source: IMF Fuel (Energy) Index, 2016 = 100, includes Crude oil (petroleum), Natural Gas, Coal Price and Propane Indices

In the COMESA region, increase in fuel and energy prices spiked the average inflation to 17.3 percent in 2020 during the height of COVID-19 pandemic disruptions. Although, the region wide average inflation rate decreased to 14.6 percent in 2021 on account of some normalization of global supply chain and hence lesser disruption of trade during the year (Figure. 4), country level data suggests strong build-up of inflationary pressures in most countries. This has been particularly so in countries that have either experienced larger depreciations of their currencies or have greater reliance on food imports or have suffered droughts, storms and floods which has amplified the effect of distortions in global supply chain and a significant increase in oil prices.

Figure 4: COMESA average Consumer Prices (annual av., % Change)



Going forward, the region wide inflation is projected to rise to 17.0 percent in 2022, largely on escalation of the war in Ukraine and sanctions on Russia, and the tightening global financial conditions. The latter could lead to strong exchange rate pressure feeding through to domestic inflation while the former could push even higher oil prices—putting further upward pressure on food prices, accelerate further global supply shortages and export restrictions in major commodity and food exporters. Inflation is expected to ease somewhat to 13.9 percent in 2023 on expected easing of global and local supply chain challenges, and the likelihood that region's Central Banks would anchor inflation expectations should inflationary pressures strengthen even more (Figure. 4).

US Monetary Tightening Shock

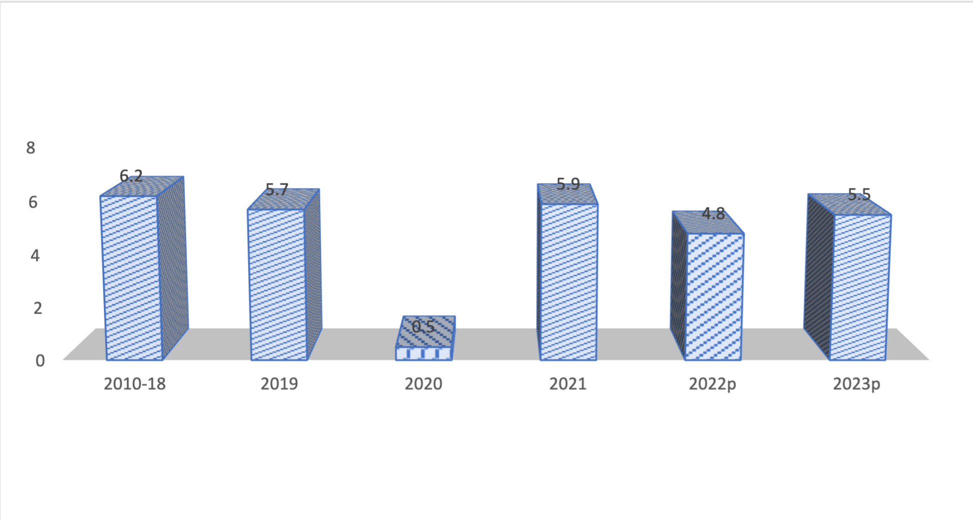
Even with significant differentiation across economies, many countries are experiencing elevated inflationary pressures partly due to supply chain disruption caused by the COVID-19 pandemic, war in Ukraine and onset of recovery in several countries. As a result, some advanced countries notably the United Kingdom (UK) and the United States withdrew monetary accommodation and started a tightening cycle. This weighed down global growth by sharper-than-expected tightening in financial conditions in advanced economies. Countries in the region therefore require to be ready to combat the potential capital flow reversal and address the ensuing inflationary pressures.

Droughts and Floods

Extreme weather patterns have particularly affected the COMESA region. The region is faced with severe climate related shocks including droughts in several countries in the horn of Africa, and floods during the year in southern African countries. These have severely affected food security, induced a sharp increase in staple food prices, higher prices of basic foods and livestock feeds. The weather-related shocks are taking place at a time when most countries in the region are facing little fiscal capacity to offset these shocks especially after devoting most resources in dealing with COVID-19 pandemic.

The multiple shocks pose a real prospect of rollback of hard-earned gains in poverty reduction of the last two decades in the region. Low-income households are disproportionately adversely affected by higher prices because food accounts on average for the largest proportion in the consumption basket. Notably the COMESA region average growth rate fell from 5.7 percent in 2019 to 0.5 percent in 2020 largely because of the impact of COVID-19 pandemic. Growth somewhat recovered to 5.9 percent in 2021, but primarily on the base effects owing to the sharp contraction in most countries in 2020, significant remittance inflows, rapid vaccination roll-out and return to close to normalcy in global trade (Figure 5). This growth momentum could however be short lived as the region's growth is projected to slow to 4.8 percent in 2022 on account of multiple shocks discussed above.

Figure 5: COMESA average real GDP Growth (y-o-y % change)



Source: IMF REO Sub Saharan Africa April 2022

Risks

In the context of the war in Ukraine and sanctions on exports from Russia which has quickly reverberated through global financial and commodity markets, the risks to the inflation outlook remain heightened. Output levels, at the same time, remain well below the pre-pandemic level. Regional Central Banks, thus, face a difficult balancing act between curbing inflation and supporting recovery. Moreover, the slow vaccine rollout increases the vulnerability of the region to new COVID-19 waves and could favor the emergence of new variants. This, compounded with climate related shocks, and several armed conflicts and terrorist threats pose serious risks to economies of the COMESA region.

Policy options

During the period 2020 and 2021 and to address the adverse impact of COVID-19 pandemic, monetary policy in the COMESA region remained largely supportive - including shifting priority to crisis management objective instead of strict price stability. Most central banks in the region pursued an accommodative monetary policy stance and allowed the exchange rate to depreciate while conducting foreign exchange interventions to smooth disruptive volatility. Central banks also relaxed reserve and capital conservation buffers requirements for banks to boost their daily liquidity needs. They also allowed commercial banks to restructure outstanding loans of borrowers facing temporary cash flow challenges and increased limits on agents and corporate wallets for digital transactions, among other measures.

However, going forward, the increase in inflation in most countries while at the same time output levels remain well below the pre-pandemic level, require a different policy mix. Some of the policy options could include the following:

a) The need to speed up vaccination efforts to reduce the risk of new COVID-19 waves and the emergence of new variants and the outbreak of Monkeypox. Countries in the region need to address logistical challenges, counter vaccine hesitancy and enhance vaccination uptake through aggressive awareness campaigns as well as bolstering the resilience of local health systems - by investing in therapeutics, testing, and epidemiological surveillance - to reduce over reliance on the donor community.

b) Coming from the loose monetary policy, regional central banks may need to tighten monetary policy to anchor inflation expectations and tighten financial regulations that may have been relaxed during the pandemic to guard against financial stability risks arising from tight monetary policy. In countries where inflation is not an immediate concern, central banks could consider holding back on tightening monetary policy in order to provide the economy with the necessary impetus for recovery. Where inflationary pressures have picked, the pandemic period policy rate cuts should be reversed to anchor inflationary expectations. An important lesson from the proliferation of crypto currency is for regional central banks to seriously consider introduction and adoption of digital currency. This would accelerate financial inclusion more than any other effort ever in place, giving central banks leverage to strengthen the transmission of monetary policy.

c) The tight global financial conditions could disrupt capital flows to the region at a time they need the flows most, putting a strain on the required resources to deal with the pandemic and support economic recovery. Going forward, should the war in Ukraine escalate, and tight global financial conditions persist, governments might have to either cut spending, or have a buildup in arrears, or allow an increase in domestic borrowing while balancing the consequences this might have on domestic credit and economic recovery, but this should be on market terms.

d) Some countries in the region are trying to limit the rise in domestic prices as international prices increase by either cutting taxes or providing direct price subsidies (note that reduction in consumption taxes does serve, in many ways, as a subsidy). However, such support measures, which do not allow the effect of external inflation to affect domestic inflation, have the disadvantage of exerting extra pressure on the budget that is already strained by the pandemic, and is, given the increasingly shrinking fiscal space in many of the regional countries, not sustainable. Subsidies also amount to fiscal costs which may signify future cuts in other public services. It is important to note that subsidies suppress price signals crucial for letting demand and supply adjust and induce a demand response, with high prices encouraging people to be more energy efficient. Subsidized prices encourage more consumption putting further pressures on energy prices, hence costly. They crowd out more productive spending, and reduce producer and distributor incentives. It is therefore ideal for countries with existing energy and or food subsidies to consider to gradually pass international prices through to consumers while committing to the elimination of subsidies in the medium-term depending on the available fiscal space.

e) Countries in the region may allow high global prices to pass through to the domestic economy. However, there is need to in turn, institute measures to protect the vulnerable households affected by the increase in general prices, without worsening the already high post-pandemic debt vulnerability. This is by reprioritizing spending, including holding back on tax holidays and other incentive packages that are in place in many countries for foreign investment attraction and sealing chronic leakages in public finances, among others. Such resources could then be deployed in a targeted manner, to benefit the most vulnerable segments of the population.

f) To deal with potential capital flow reversals as a result monetary policy tightening in advanced countries, the following could be considered:

(i) The exchange rate could be allowed to be an automatic shock absorber for countries in the region under flexible exchange rate regimes and enjoying low inflation and absence of large currency mismatches. Foreign exchange interventions to smooth exchange rate volatility will be desirable for countries with shallow foreign exchange markets and large un-hedged balance sheet exposures. Exchange rate intervention should be within the limits imposed by international reserve holding. Countries under fixed exchange rate regimes may consider adjusting the peg through foreign exchange interventions, again depending on the extent that their international reserves can accommodate or by increasing the policy rate. Therefore, monetary tightening may be needed in some countries to support exchange rates, even in the face of weak economic activity.

(ii) Some form of capital flow management measures may be instituted to stem out speculative foreign exchange behaviour, tame disruptive exchange rate volatility and ensure a safe move through the monetary tightening cycle.

g) It will be important for countries to address fiscal sustainability especially now when the room for maneuver has been critically reduced by the various fiscal stimulus measures used to deal with the impact of COVID-19 pandemic. Scaling down fiscal support especially for countries on the recovery path will also help reduce demand and help curtail inflation. Tied to this is the need for domestic resource mobilization, prioritization and efficiency gains on spending and need for more grants and concessional financing to close the financing gap in most COMESA member countries. Beyond this revenue and spending measures, governments need to maximize the fiscal space by improving their fiscal frameworks to credibly balance the need for short-term support with medium-term consolidation.

h) COMESA countries need to leverage African Continental Free Trade Area (AfCFTA) to strengthen value-addition and industrial growth and consider increasing the role of digitization to continue playing an important role in their economies. This will increase intra-regional trade required for long-term structural transformation and economic diversification of individual economies in the region. COVID-19 has clearly demonstrated that with disrupted trade channels, local manufacturers have been able to set in. There is therefore need to sustain emerging pharmaceutical and medical supply industries in a post COVID-19 era. COMESA member countries need to continue with the ongoing investment in medical research, disease surveillance and health systems that serve all and especially the most vulnerable. This will increase resilience both to potential new variants of COVID-19, and future pandemics that could pose systemic risks. Investment in research in vaccines should be aimed at protecting against a range of pathogens in readiness of the next new virus. Also, as we have experienced during the COVID-19 pandemic, there is a need for more diversified global supply chains. Countries will require structural reforms that will ensure food security and availability of alternative sources of clean energy.

i) Finally, COVID-19 pandemic and its repeated mutations and the war in Ukraine have shown that problems that happen in one part of the world have serious ramifications to the rest of the world. There is need for swift and strong international cooperation to face global challenges especially those related to climate change. Money spent on global challenges should not be viewed as aid but as an investment that benefits all nations.

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