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Monetary and exchange rate policies in the EAIO

In concise…

Vulnerable to external shocks and climatic hazards, the EAIO countries had an average inflation rate of 12.4% between 2010 and 2019. However, there are wide disparities within the region, with annual average inflation rates ranging from 2.0% to 96.0%. Excluding Sudan (32.1%) and South Sudan (96.0%), which have experienced very high inflation rates over the past decade, the average in AEOI is 5.4% between 2010 and 2019. The rise in inflation in 2022 in all countries of the region, **following the Covid-19 crisis and the war in Ukraine, has tested the capacity of countries in the region to respond to external shocks.** Indeed, rising international prices for food, energy and fertilizers have resulted in imported inflation, which monetary policy has little control over**. Depending on the level of development of the country, the domestic market and the financial sector, and on the exchange rate regime, the monetary authorities have different mandates and different instruments at their disposal**. However, the transmission of monetary policy to the main economy remains constrained by the small size of the domestic market, the size of the informal sector and the fragility of the financial sector. In countries where the exchange rate is fixed (Comoros, Eritrea, Djibouti, Burundi) or administered (the other, with a more or less strong intervention), central banks must inject foreign currency into the economy to counter fluctuations in their exchange rate. However**, in the context of a deteriorating trade balance, the increase in the price of imported basic goods has led to tensions on foreign exchange reserves**. Some of these countries face the emergence of a parallel foreign exchange market.

In detail …

Inflation is rather volatile and sensitive to weather conditions

Inflation in the AEOI area averaged 12.4% over the 2010-2019 period, varying significantly between countries (96.0% in South Sudan on average over the same period, compared to 2.0% in Comoros or Djibouti, while Kenya recorded 7.1%). Inflation has also varied widely from year to year: in 2010, average annual inflation was 5.5% for the 15 EAIO countries, while it reached 11.1% the following year and 14.4% in 2012. Indeed, **the countries of the zone are particularly sensitive to external shocks:** the economies of the zone being predominantly agricultural, are characterized by **increased vulnerability to climatic hazards** affecting crops and **to conflicts**. In 2020 and 2021, the rise in commodity prices[1] had begun as a result of the consequences of the Covid-19 crisis and disruptions to supply chains. In 2021, average annual inflation reached 7.9% on average in the 14 countries of the zone (excluding Sudan), compared with 6.5% in 2020. The most affected countries were Ethiopia (26.8% y/y) and South Sudan (30.2% y/y). Comoros and Rwanda, on the other hand, had very low inflation, with respective inflation rates of -0.2% and 0.8% a.m. in 2021[2] , as a result of a decline in Comorian demand and an improved harvest in Rwanda. According to the IMF, **annual average inflation in EAIO would rise to 11.0% (excluding Sudan) in 2022**, with food inflation rising to 35.1% in Ethiopia and 32.7% in Rwanda, adding to an already critical food insecurity situation in the region.

A large share of the consumption basket devoted to food and energy, making households sensitive to external shocks and climatic hazards

Food and energy alone account for more than half of the household consumption basket in the countries of the region. On average, food accounts for 42.2% of the consumption basket of the countries in the AEOI region for which information is available, and energy for 9.1%. The weight of food in the Consumer Price Index (CPI) varies quite widely across countries, ranging from 15.8% in the Seychelles to 71.4% in South Sudan; and accounting for more than half in Burundi, Comoros, Ethiopia, Madagascar and Sudan. The effects of the war in Ukraine have thus had a major impact on food security in the EAIO, which was already under pressure from persistent drought. This has led to a sharp rise in cereal prices - up to 234% in Bay region, Somalia - exacerbating food insecurity, which is in turn exacerbated by the escalating conflicts in the region. In November 2022, there were 48 million people in IPC3[3] category or more in the region, including 20.4 million in Ethiopia.

Moreover, although it represents a smaller share of the consumption basket, energy varies just as much from country to country: it weighs the most in the household consumption basket in the Comoros (10.7%) and the least in Sudan (2.6%) - an exporter of production from South Sudan. While some countries benefit from an energy mix that relies heavily on renewable energy for their electricity (Tanzania, Ethiopia, Kenya[4]), **the consumption of oil products remains significant**. In 2022, it represented 23% of Kenya's final energy consumption, mainly for transport (3.2m tonnes) and industry (0.7m tonnes). Oil consumption in Ethiopia and Tanzania was around 10%. The countries of the zone are almost **entirely** dependent on **hydrocarbon imports,** either because deposits are insufficient to meet needs, or because the countries do not have refining capacity (South Sudan, only oil exporter in the region)[5]. As a result, **they are subject to the volatility** of **barrel prices**, which has become even more pronounced with the energy crisis since 2021 and accentuated by the war in Ukraine.

Also, inflation in the food and energy sub-components[6] has risen sharply since 2021, and even more so with the war in Ukraine. Food inflation is particularly high in Ethiopia (30.7% y/y in October), Rwanda (39.7% y/y in October), Burundi (26.3% y/y in September), Uganda (22.2% y/y in October), and Kenya (15.8% y/y in October). As for energy inflation, it increased in all countries, and was very high in Comoros (31% in y/y) and Ethiopia (20.2%). Moreover, **this food and energy inflation has started to be transmitted to domestic and core inflation through second-round effects**. Since the outbreak of war in Ukraine, core inflation has risen sharply, reaching 14.4% y/y in Rwanda in October, or 8.9% in Uganda, compared to 2.6% and 2.1% y/y respectively in October 2021.

As Central Banks have to trade-off between growth and price stability and the effect on public debt, the effectiveness of monetary policy remains limited

The EAIO countries are heterogeneous in terms of their monetary institutions and mandate. Six[7] out of the fifteen countries in the region have a Central Bank that targets inflation, often around 5.0%. Since the introduction of the inflation target, inflation has always been around the target range, and prices have been relatively stable, barring

[1] In 2020, the price of Brent crude oil averaged 42.3 USD/barrel, and almost doubled in 2021, reaching 70.4 USD/barrel. The price of natural gas was USD 2.0/mmbtu on average in 2020, while it reached USD 3.9/mmbtu on average in 2021.

[2] Sources: IMF, WEO October 2022. The Central Bank of Comoros estimated average annual inflation in 2021 at 0.1%.

[3] The IPC classification (Integrated Food Security Phase Classification) defines the severity and extent of food insecurity and malnutrition in countries. From category 3 onwards, the food situation is considered to be in crisis (*see* LM March 2022).

[4] In Kenya, 80% of energy is generated from renewable energy sources, with 43% from geothermal and 32% from hydropower in 2019.

[5] When Sudan was partitioned, South Sudan inherited the majority of confirmed oil reserves, estimated at 3.5 billion barrels (compared to Sudan's 1.5 billion barrels), the largest in the region, but has no refining capacity. In contrast, Sudan imports South Sudanese oil and has two refineries, but their capacity is not sufficient to cover national needs (*see* LM February 2022)

[6] Or alternatively, the sub-component 'Housing, water, electricity, gas and other fuels'.

[7] These are the most developed countries in the region: Kenya, Rwanda, Tanzania, Uganda, Seychelles, Mauritius.

exceptional events such as extreme weather events affecting crops, internal conflicts or external shocks. In general, central banks act on key interest rates, the main instrument of monetary policy, in order to anchor agents' expectations, *via the* interest rate and credit channels. **The transmission of monetary policy is, however, hampered by the weakness of the domestic market and the widespread informality, as well fragility of the financial sector.**

Faced with the acceleration of prices, **the region's central banks – apart from the Seychelles – had to react so as to bring inflation back to their target. The authorities had to intervene in order to avoid second round effects and depreciation which could accentuate imported inflation** The Kenyan, Ugandan, Rwandan and Mauritian central banks[8] have raised their rates to 8.25%, 10.0%, 6.5% and 4.0% respectively. **This monetary tightening is a trade-off for maintaining price stability, and could be detrimental** to **growth,** access to credit, and the economic rebound in the post-Covid-19 countries. **Despite this monetary tightening,** the effects of rising commodity prices are expected to persist, and **inflation is expected to continue to rise**. According to the IMF, inflation at the end of 2022 reach 12.6% on average (excluding Sudan - 129.5%) in AEOI, compared to 7.5% in 2021 and 5.8% over the 2010-2019 period[9]. On an annual average basis in EAIO (excluding Sudan) inflation is expected to reach 11.0% in 2022 and fall to 8.8% in 2023, still high and well above the inflation targets of the region's monetary authorities.

Governments, whose room for manoeuvre has been reduced by the Covid-19 crisis, will find themselves under pressure, forced by the need to respond to the precariousness caused by inflation, while imported inflation contributes to increased public spending and monetary tightening makes public borrowing even more expensive**.**

Authorities intervene on the exchange rate, maneuvering between parallel exchange rates and pressure on reserves

The specificities of the exchange rate regimes vary within the EAIO: Comorian franc is pegged to the euro, Djibouti franc and Eritrean nafka are pegged to the USD, Somalia has a *de facto* dollarised economy, South Sudan adopted a floating regime in 2015 but still faces a significant parallel exchange rate, Sudan has also formally liberalized the exchange rate, but controls the parity of the SDG vis-à-vis the USD, and the Ethiopian birr is strongly controlled and overvalued. As a result, the responses of the monetary authorities are different, and many countries have embarked on exchange rate reforms, with the help of the IMF and other donors, to move towards exchange rate liberalization. However, liberalization would create a risk of immediate depreciation, which would be unwelcome in an already highly inflationary context. **For countries with a floating exchange rate regime, the level of intervention varies, and the authorities retain a regulatory role when the exchange rate is administered,** as in Kenya, Rwanda, Tanzania, and South Sudan. By injecting or withdrawing foreign exchange into their economies, they can smooth out exchange rate volatility and limit depreciation.

The countries are sensitive to capital flows and volatile international commodity prices, which put pressure on their exchange rates. Following the Fed's monetary tightening, capital inflows to the United States have led to a **relative, albeit contained, depreciation of the region's currencies** (with the exception of the Seychelles rupee, which has appreciated against the USD), **as well as to an increase in *premia* between the parallel and official exchange rates**, for countries with a split Forex market. The rise in international commodity prices, especially oil, on which most of the region's economies depend, and also fertilizers and other basic foodstuffs, has reinforced the deterioration of their external situation and the depletion of their foreign exchange reserves, thus limiting the room for maneuver of central banks.

In sum...

After an average inflation rate of 12.4% between 2010 and 2019, the rise in inflation in 2022 in all countries of the region, following the Covid-19 crisis and the war in Ukraine, has tested the capacity of countries in the region to respond to external shocks. Therefore, the central banks in the region employed different strategies to counter the inflation, depending on the exchange rate regime. Transmission of monetary policies remain however constrained by structural factors and limited access to forex reserves.

[8] The Tanzanian Central Bank did not raise its policy rates, but began to reduce the amount of liquidity injected into the economy.

[9] Excluding South Sudan for the period 2015-2017.

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