Africa: Inside the Triangle of Devaluation, Inflation and Stagnation

P. Kalonga Stambuli[1]
Senior Research Fellow
Surrey Institute of Global Economics Research
kstambuli@surreyinstitute.org.uk

There appear to be two diametrically opposed interpretations to the pattern of economic policy dialogue between poor *African* countries and multilateral organisations. The first is one that evokes a conception of the IMF as part of a hegemony that subjugates the poor countries to its inexorably capricious dictates of economic policy. This would suggest that the IMF must take responsibility for throwing poor *Africa* into a gridlock of unworkable policies and the challenge to implement corrective action.

Another interpretation conjures up an image of the international economic landscape as the playground of immutably sovereign states that formulate their own economic policies independently. This would revert the challenge of re-enacting the policy agenda to the countries themselves. However, the IMF cannot be exonerated because 'letters of intent' and 'memorandum of economic policies' that bind economic policy direction in *African* countries have covenants that give absolute direction, control and supervision to the Bretton Woods Institution.

This article examines whether devaluation has been successful as a policy advocated by the IMF. The article also examines whether the IMF has also persisted with the policy despite its failures and whether or not the Bretton Woods Institution has performed the task of re-evaluating the policy and ensure that it either works or it is substituted by alternative effective policies.

IMF's conscientious push for contractionary fiscal and monetary policies continues to attract a lot of interest. The stated aim is to control the demand side of the economies of *African* states with a view to achievement of low inflation and consequently, balance of payments sustainability.

It appears from the start, though, that a policy of devaluation imposed on these countries to comply with real exchange rate rules contradicts the inflation objectives. Real exchange rate rules aim to promote export competitiveness, and they require that changes in the nominal exchange rate are linked to the difference between domestic and foreign rates of inflation in order to keep the real exchange rate from deviating too far from its level in some base period.

---

[1] Former Chief Economist and Economic Advisor to the President of the Republic of Malawi

The contradiction arises from the fact that currency devaluation is the instrument used to facilitate such realignment and, inevitably, the implications of devaluation are also that government must lose control over the domestic inflationary policy. This is because by devaluing a currency at every instance of inflation, it implies that the exchange rate is indexed to the domestic price level via the balance of payments and money supply.

A well-known characteristic of *African* states is that government is the largest consumer of foreign exchange, in the context of debt service payments. This means that exchange rate depreciation magnifies the public sector net cash requirement and leads to a faster rate of monetary growth, thus resulting in further cyclic inflation.

Under these conditions, there is no longer any exogenous nominal anchor within the policy menu drawn up by the IMF to allow *African* countries to tie down the domestic price level, thus resulting in a feedback *devaluation-inflation'* spiral which consumes the real value of incomes in a self-constricting pattern that these countries remain in a tailspin despite high volumes of physical production.

If, for example, the covenant of real exchange rate did not exist, a terms-of-trade improvement under stable nominal exchange rates would translate into increased real incomes, and also strengthen demand for all goods in the economy, including non-tradables. A rise in the relative price of non-traded goods may initially be exhibited to restore the home goods market towards equilibrium, but this is likely to be followed by increased business investment to cope with high demand.

The consequent job creation and income effect to rural segments of the economy are a complete contrast to the outcome under real exchange rate rules. In the latter case, the IMF promotes the logic of administering a currency devaluation against the initial rise in the price level to adjust the nominal exchange rate in such a way that the non-tradables/importables ratio or foreign to domestic indices expressed in a common currency is constant. They argue that the purpose of corrective devaluation is to elude currency appreciation towards a new equilibrium, as if currency appreciation is a bad thing.

The approach of IMF has inflationary effects that raise public sector net cash requirement, thus feeding the inflation cycle, escalating transactionary spending and reducing savings in the economy. The corrective devaluation also comes in the way of prospective business investment and actually prevents it.

This is contrary to the objectives of raising savings to finance investment, which is given prominence in IMF literature. This kind of devaluation may also feed into higher interest rates in the form of Irving Fisher's inflation premium that attaches itself to the rate of interest, as inflation expectations remain high.

The perplexing policy stance of IMF arises in the consideration of why the institution advocates a fight against inflation in the fiscal channel while also advocating policies that lead to inflation and high interest rates via channels outside the budgetary framework.

Another argument is that if indeed IMF wish to facilitate broad based participation in the economy in response to liberalisation, then devaluation should be discouraged because banks in *African* countries have [at every time] a significant amount of unhedged foreign currency liabilities. The rationale is that the primary effect of devaluation is to compromise bank balance sheets and lead to contractions in bank lending capacities, which also affect the real economy.

IMF's support of the conceptual framework of the 'bank-lending channel' arise from the fact that fiscal restraint is one way of minimising the crowding out of credit resources in favour of providing credit to the private sector. However, its own advocacy of devaluation ignores the fact that *African* banks hold open speculative positions in foreign exchange, which increase vulnerability of the entire financial system. This works against the same private sector.

In Malawi, a 71% devaluation of the Kwacha in 1994 diminished the dollar value of total commercial bank credit by 60%. Mexico shows a similar experience from the peso devaluation in December 1994 that also transmitted a shock to the asset side of bank balance sheets resulting in a financial sector crisis that curtailed lending for development.

Deleterious effects of devaluation also extend beyond the bank asset base in a sense that deteriorating net worth and further high exposure to currency risk may force banks to liquidate real investments to stave off a self-fulfilling depositor panic along the framework of Diamond and Dybvig's 'bank run'. The alternative is for banks to seek state bailouts, as in the case of Mexico where government intervened with $65 billion.

The fact that devaluation is now leading to the provision of implicit government guarantees to savers, hence moral-hazard-driven banking means that the IMF is pushing governments towards a higher propensity for weak fiscal discipline. Instead of moving away from the private sector as advocated, governments is brought back to carry out bailouts and deposit insurance schemes. In extreme situations foreign financiers crucial to the provision of export finance are withdrawing.

The fact that privatisation in *African* countries has become synonymous with foreign ownership partly emanates from inability of the banking system to finance stock buyouts by domestic citizens. This contradicts IMF pronunciations of public enterprise divestiture in favour of 'broad based domestic ownership of corporate assets'. On the contrary, it is foreigners with hard currency taking advantage of the weakened domestic currency, which translates into acquiring shares at a discount large enough to offset other corporate risks extant in investing in these countries.

Interestingly, these maladies are not unknown to the Bretton Woods family. The World Bank report *The road to Recovery (1998)* observes that the bad loans problem of most poor countries is largely attributed to currency depreciations. However, since 1998 a lot more *African* countries have been put through a series of corrective devaluations at the instance of every surge in inflation.

Even if we pursue the hypothesis that tenacity of the IMF to devaluation is derived from some recorded macroeconomic successes, the balance of payments of *African* countries provides further disappointing testimony. Since a large majority of *African* countries are land locked devaluation reduces the net income reaching exporters because of the transport component that is frequently denominated in foreign exchange.

Even if there is improvement in the merchandise trade account, it is likely to be followed by major deterioration in the overall balance of trade and service because of high freight, insurance, handling and banking charges accruing abroad. The balance of trade and services may worsen from the fact that transport costs also rise against imports.

The process of transforming these economies from agriculture to industry equally fails because by raising import costs, devaluation also raises initial cost of the investment as raw materials and operating costs. Even if terms of trade improvements are taken into account, the leakages arising from international transport costs negatively affect the net present value of investments. The prospect of diversifying Africa's exports in manufactured goods simply stalled before it can start.

If devaluation ever produced a reasonable net income after transport costs, the nature of *Africa's* agriculture is such that rigidities arising from land and technological constraints stifle the impetus for a supply response. That leads to full transmission of costs to manufacturing structures while agriculture fails to utilise the terms of trade gain, if any arises.

The fact that pricing methods chosen by foreign firms are exogenous to destination of their exports also underlines further adverse effects of devaluation the *African* trading firms. Due to strong competition in their domestic markets, most firms practice price discrimination balancing cross-subsidizing domestic sales with high prices from exports. Apart from devaluation magnifying the final import-price pass-through *African* markets are also characterised with such strong demand inelasticities that imported inflation has become a recurring phenomenon. This is true of essential and indispensable imports of petroleum products, fertilizer, spare parts and raw materials.

The sheer complexity of the poverty problem in most *African* countries also presents devaluation as a measure that fails to bring joy to rural areas. Initially, devaluation benefits poor farmers producing cash crops, at the same time increasing the prospects for employment in production of exports or import substitutes. However, declining quality of land in most of these countries has resulted in inelasticities in the demand for imported seed, fertilisers and productivity enhancing inputs. Devaluation, therefore, has the effect of raising costs of production among farmers producing cash crops and further costs of transporting produce to markets, thus taking away the initial gains.

These examples serve to confirm that the IMF's idea of devaluation working via the price mechanism to change the vector of relative prices and therefore operating as an expenditure-switching device is intellectually logical, but its practical role is that of a 'conveyor belt' transmitting costs into production structures and driving inflation quicker than the acclaimed price improvements.

Devaluation jump-starts and stalls industrial diversification more that it hurts agricultural export development. Devaluation also undermines the banks and consequently domestic ownership of privatised assets and performance of the rest of the real economy. Devaluation further hurts firms in trading as well as poor farmers and the urban poor.

Invariably, the IMF has persisted in enforcing the same policy despite its failures. Every re-evaluation of the policy suggests beyond equivocation that it is harmful, but rather than have it substituted with alternative and/or more effective policies the IMF has persisted in enforcing devaluation in its original context of maintaining the real exchange rate.

On the contrary, the policy of devaluation in Africa has benefited developed countries. This is on account of privatisation facilitating foreign acquisition of Africa's prized state assets so cheaply. Declining prices of imports from Africa also aids inflation policies in developed nations. In addition, the fact that deteriorating industry and trade liberalisation opens African markets to global enterprise also works to the advantage of their industrial nations.