Ministerial Conference on the Financial Crisis

BRIEFING NOTE 1:

The Current Financial Crisis: Impact on African Economies

Ramada Plaza Hotel, Tunis, Tunisia
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1. Introduction

The financial crisis has taken a global dimension, spreading from the US, Europe and the emerging markets. This rapid contagion of global bank failures poses a serious threat to growth worldwide. This has been referred to as the “Globalized Synchronized Slowdown”. Africa’s relative insulation from the global economy, plus residual controls on the capital account, have initially worked in its favor; the banking contagion in the US, Europe and such emerging markets as Korea, has not affected Africa to the same degree. However, spillover from the developed-markets’ financial crisis and economic slowdown threatens the remarkable growth enjoyed since the mid-1990s. Real GDP in the region grew at an average rate of 5 percent between 2003 and 2007 for the region as a whole, the most persistent and diversified period of growth in the post-war era. This growth has not been limited to one type of country (e.g. oil exporters) nor has it been entirely attributable to higher commodity prices. Rather success is attributable to the implementation of sound macroeconomic policies combined with improved governance. This has revived domestic investment and attracted a wide range of financing from external sources including portfolio flows, remittances, FDI, and trade credits. While in the developed markets a financial crisis is leading into economic slowdown, for Africa, the first-order impact is likely to stem from the global economic slowdown, which may lead to a second-order financial meltdown if appropriate actions are not taken. The severity of the impact of the crisis on different African countries will depend on the level of integration into global trade and financial markets. We have therefore to consider strategic decisions now to minimize the impact of the current crisis on the continent and also to position itself to withstand the severe effects of any future crisis and to increase its voice in multilateral discussions. Designing appropriate policy responses will require a clear understanding of:

- The nature of the effects of the crisis on the continent, and
- The channels of transmission of the financial crisis onto African economies,
- Policy options and tools available to minimize the impact of the crisis.

Equally important is the development of a common framework for monitoring the impact of the crisis at the national and regional levels. The **purpose** of this **Briefing Note** is to articulate these issues and raise broad questions, so as to guide discussion at this Ministerial Conference.

2. Africa and the Global Financial Crisis

Financial Linkages

The financial sector of Africa remains shallow and thin, capital markets are illiquid and the system is weakly linked to the global international financial system. The share of stock market capitalization, public debt securities and bank assets in the global totals is equal to 1.81%, 0.31% and 0.15% respectively. Only 17 countries have accessible stock exchanges. Banks are not active in the derivative markets, rely mainly on domestic resource mobilization to support operations, and foreign ownership is rather limited. Indeed, banks in Africa were not exposed to the sub-prime market. As a result of this low level of integration, as well as the residual controls on capital account, Africa has been largely insulated from the severe contagion effects witnessed in the developed and emerging markets.

However, Africa is vulnerable through a number of financial linkages to the global financial markets. The continent received close to US$35 billion in FDI in 2007 and about US $ 15.73 billion in portfolio flows. Trade credit lines have played a critical role in financing imports and investments. Similarly, entry into the sovereign bond market as a source of finance for infrastructure development was growing. In addition, remittances from the African diaspora are estimated at US$15 billion for 2007 alone. Remittances represent 3.9% of GDP for North African countries and about 2% for the rest of the continent. The recent investor interest in African debt and equity markets from the traditional and emerging sources (China and India), makes Africa vulnerable to reversal of flows as investor sentiments change. Given the small size of African markets, even limited withdrawals would be a source of high volatility in market prices. A credit squeeze in the international markets would restrict lending to emerging markets, which would adversely affect trade credits and planned sovereign bond issues.

As developed and emerging markets slow down, the investment flows that have supported growth are going to decline. Risk averse foreign direct investors, hedge funds, private equity, and international companies, are already pulling funds out of Africa to deal with redemptions, slower fundraising, and lower profits. International banks will be tempted to cut-off trade lines (both import and export) to preserve capital. There is already evidence that the crisis is making external credit harder to secure for African banks. Commercial banks have seen their lines of credit shrink while fund-raising for new initiatives appear to be in jeopardy. Also, countries that were planning to issue sovereign bond for long-term financing for infrastructure development may have to put it off for some time. As a result, African governments will face major macroeconomic adjustments not of their making and not in their control.

In the course of 2008, as global liquidity tightened, portfolio flows to Africa are estimated to have declined to US$ 5.9 billion compared to US$ 15.7 billion in 2007. Furthermore, African *stock market indices* have moved in the same direction as those of the United States, Europe and the rest of the world .This is contrary to earlier expectation that the crisis may divert capital flows in favor of Africa, as investors in the US and Europe seek to diversify risk. In addition, African countries have experienced volatility in the foreign exchange markets, as investors opted for safer heavens.

Uncertainty concerning the depth and intensity of the crisis, the future dynamics of financial and economic systems, and the effectiveness of the policy responses undertaken by industrial economies, are likely to affect banks and business behavior. This will distort their lending and investment decisions to the disadvantage of long-term investment. Uncertainty will also have negative effects on foreign exchange markets. This will further result in larger exchange rate volatility, with damaging effects on trade and capital flows.

The magnitude of the downward adjustment on growth rates and real exchange rates as a result of declining financing will vary by country as a function of fiscal imbalances, size of foreign exchange reserves, exposure to dollar denominated debt and structure of the real economy. African governments will have to carefully modulate monetary and fiscal policies to manage the de-leveraging of their economies to avoid falling back into a slow growth equilibrium trap. The predictable losers are the poor. This process must be supported by higher, rather than lower ODA, in spite of the tighter fiscal situation in the donor countries. Thus, the multilateral and Regional Development banks have to act with swift and targeted countercyclical interventions without compromising their own financial soundness.

Global slowdown and Trade Linkages

While Africa's global trade share is only about 2.8 %, increasing trade integration has been a crtical driver of recent growth performance. The openness indicator, measured by the sum total of exports and imports as a ratio of GDP, has improved from 60.8 per cent as of 2000 to 75.2 % in 2007. Both oil exporters and importers have benefited from the high commodity and metal prices. The recent strengthening of trade links with China and India have further boosted trade. As the financial crisis dampens growth prospects in developed and emerging markets in 2009, African exports are likely to decline. The prices of coffee arabica and cocoa have dropped by 24% and 27%, respectively since July 2008. Similarly, oil and copper prices have dropped by over 50 % since June 2008. Projections for commodity prices for 2009 point downwards for all commodities. This would imply deterioration in terms of trade for commodity exporters and a marked fall in export receipts, with implied adverse effects on growth. However, the downward correction in commodity prices, especially for oil prices will benefit oil importers and will ease inflation pressures affecting many countries in the region.

Effects on Tourism – The tourism sector is also likely to suffer a contraction as a result of the financial crisis. Some countries, especially South Africa, Mauritius, Egypt, Kenya, Tunisia, and Morocco have seen substantial increases in tourism activity in recent years. The success of these countries in diversifying their sources of exports earnings may be severely undermined by a global recession.

Global slowdown and Real Sector Activity in Africa - The global financial crisis will have a very significant impact on the real sector of the economy in Africa. Erosion in demand for Africa's exports and the squeeze on financing trade and investments will depress private sector activity and adversely affect the growth momentum enjoyed during the past five years. Our current projections reveal that Africa will record slower growth of 5.5 % in 2008 compared to earlier estimate of 5.9% and the estimate for 2009 is 4.9% compared to the earlier projection of 5.9%. .
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Inflationary Pressure – Inflationary pressures in Africa have been rising as a result of high oil and food prices, excess liquidity in oil-exporting countries and supply-side bottlenecks. The slow-down in global growth will result in lower commodity prices, thus reducing inflationary pressure. However, the observed depreciation of national currencies will add upward pressure on domestic prices.

Effects on Poverty – Should the financial turmoil induce a recession, it would have a dramatic impact on the poor. While the recent increase in GDP growth in Africa is yet to translate into commensurate reduction in poverty, it is clear that African countries cannot achieve poverty reduction without growth. Thus, a reduction in growth will reverse the modest gains achieved in poverty reduction in recent years and reduce the prospects of achieving the MDGs.

3. Policy Responses

The current crisis highlights a number of weaknesses and vulnerabilities that African economies ought to address with targeted structural policy interventions and reforms. In particular, the crisis highlights the need for strengthening financial sector regulation to ensure stability. African countries need to recognize and prioritize the regulation of financial sector institutions. In the

short run, recovery in Africa will depend on domestic drivers of growth. The continent needs to boost domestic resource mobilization to support growth and investment. Addressing these issues require strategic interventions at various levels:

Possible coping strategies for Regional Member Countries (RMCs)

- The RMCs need to continue to consolidate economic reforms to build resilience to emerging external crisis;
- Undertake a proper sequencing in trade and financial liberalization towards a balanced integration into the global economy;
- Recognize the importance to proceed with the reforms in a coordinated fashion at the regional and continental levels;
- Reserves holdings by countries have helped them mitigate against the effects of the rapid withdraw of foreign investors. Monetary authorities could revisit the level of reserves cover.
- There is a need to undertake reforms to improve the efficiency in domestic resource mobilization through financial and fiscal instruments;
- Pursue financial sector reforms that enhance competition, while enforcing mechanisms that minimize exposure to risky foreign-currency borrowing;
- Revamp capital requirements for banks ;
- Strengthen the regulation of the non-bank segment of the financial sector;
- Accelerate pension reform to unlock medium and long term finance;
- Consider sovereign guarantees to restore investor confidence;
- Design a troubled bank resolution strategy including the nature of resources (specialist consultants, accountants, lawyers) required, and identification of the organization responsible for issuing bailout bonds;
- Respond to the urgency of reducing dependency on primary commodities; i.e., accelerate structural transformation of the economies to achieve a more diversified production and export structure;
- Better strategies for natural resource management and prudent use of export revenues to enhance diversification and resilience to hedge against external shocks;
- Consider supra-national bodies to regulate cross border banking;

The African Development Bank (AfDB)

- As credit dries up, it becomes more difficult for countries to access finance from the international markets through traditional channels; the Bank can play a role to help countries access long-term finance, particularly for essential economic infrastructure. When liquidity returns to the banking sector, the Bank can help countries access funding from alternative sources by providing guarantees;
- As the Bank plays these counter-cyclical roles, it will intensify its collaboration with other development partners including regional DFIs to ensure more effective and efficient outreach on the continent;

- Use the Making Finance Work for Africa project to promote improved transparency and disclosure by banks;
- The Bank can help RMCs to support commercial and development banks by expanding lines of credits and offering other liquidity and risk capital enhancing support to the financial sector, targeted at clear development objectives while ensuring prudent institutional risk management;
- The Bank should intensify its financing and advisory role of helping countries harness potential natural resource revenues, and prudently using such resources for sustainable growth;
- The Bank can provide technical assistance in negotiating and structuring difficult contracts especially in cross border investments and banking;

DISCUSSION QUESTIONS

1. Do Ministers and Governors share this analysis and the lessons drawn and the priorities articulated?

2. Specifically, do Ministers and governors agree that innovations and reforms of the financial sector have been critical to promoting economic growth in Africa? If so, what additional measures should be implemented to promote innovation in the financial sector while mitigating the risks?

3. Is there a need to go further; for instance for the AfDB to develop a crisis response instrument? What additional support would the countries require from the AfDB and Sister Institutions?