



AFRICAN DEVELOPMENT BANK GROUP

Meeting of the Committee of Finance Ministers and Central Bank Governors

**CONTAINING THE IMPACT OF THE GLOBAL CRISIS AND PAVING THE WAY TO
RECOVERY IN AFRICA**

Cape Town, 21 February 2010

1. Introduction

Africa was an innocent victim of the global crisis, which disrupted a period of the continent's highest growth in decades and presented a severe setback to poverty reduction progress. Due to prudent macroeconomic policies and reforms, Africa entered the global crisis on stronger footing than the past recessions, with some countries being able to implement stimulus packages. However, many low income and especially fragile and post-conflict countries were not in the position to adopt counter-cyclical measures when the crisis hit. As there are concerns that Africa's recovery will be delayed and the longer term growth lowered, the key policy question is how to bring the continent quickly to high and sustainable growth path.

This note provides an overview of the impact of the global crisis on Africa and highlights the continent's challenges in returning rapidly to a high and sustainable growth path. It points out the key risks to timely recovery (sluggish global recovery, reduced or delayed disbursement of foreign aid) as well as growth opportunities (e.g., Africa's new partnerships with China and India, discovery of new natural resources). Key messages are:

- The crisis has underscored the importance of diversification of the economic bases. It has also created opportunities for accelerating progress with implementing structural reforms in the areas of private sector development, financial sectors, labor markets and social safety nets as well as with deepening regional integration.
- The crisis has caused significant, and possibly long-lasting collateral damage to the African economies, which needs to be resolved through a global partnership. Domestic policy initiatives in African economies need to be supplemented by measures taken by developed countries, including through adequate and timely development assistance.
- It is crucial that the African voice is adequately heard in the debate on stimulus packages and the revamp of the global financial architecture. The African Development Bank has demonstrated its capacity to assist its member countries in tackling their difficulties and lead the debate on the continent's economic development challenges.

2. The impact of the global financial and economic crisis and Africa's policy responses

Africa was among the world's fastest growing regions during 2000-mid 2008, however the growth slowed markedly at the end of 2008 due to the global financial and economic crisis. While the low integration into global financial markets protected most of the African countries from the crisis' immediate impact, the financial sector in some countries came under strain. The crisis was transmitted to Africa mostly through real channels such as declining exports and reduced FDI, remittance, and tourism-related inflows. The growth rate fell from about 6 percent in 2005–08 to 2 percent in 2009 (Figure 1), macroeconomic balances deteriorated, and unemployment and working poverty escalated.

The aggregate figures mask substantial differences across groups and countries. Since the crisis is an external shock, countries that were more open to trade and capital flows and grew rapidly prior to the crisis have suffered the sharpest growth falls in 2009. The Bank's October 2009 projections showed that two groups have taken a particularly large hit: (i) the emerging and frontier markets and (ii) the resource-rich countries. Due to their limited integration into the global economy, low income and fragile countries had the smallest declines in growth in 2009, but any decline in growth rates is a setback to these countries given high levels of poverty. .

Due to prudent macroeconomic policies and debt relief initiatives undertaken during 2000s, macroeconomic positions of African countries had markedly improved before the crisis (Figure 2). Moreover, the financial sectors were strengthened by regulatory reforms. The continent was thus much better prepared to absorb shocks in this recession than prior ones. Countries that have entered the crisis on strong footing were able to implement countering policies while others, including fragile and post conflict countries, have lacked policy space for such moves.

Where feasible, Africa has decisively implemented a range of measures to counter the crisis, including: (i) fiscal stimulus packages; (ii) expansionary monetary policies; (iii) targeted sectoral assistance; (iv) new regulations in the banking sector; and in some instances social measures such as wage increases, to stimulate the aggregate demand (Annex I). Some of the measures aim at improving the business environment, by alleviating supply-side bottlenecks.

However, there is need to deepen structural reforms to promote industrialization and development of the manufacturing sector. Africa also suffers from infrastructure bottlenecks and inadequate supply of basic services such as health and education. It has been lagging behind other developing regions in terms of institutional drivers of long term growth such as the rule of law, as well as in the areas of technology adoption, including ICT, and innovation.¹ This evidence raises concerns over African countries' ability to reach and sustain high growth rates in the long term. The note elaborates on this issue below.

3. Longer-term growth constraints and opportunities

3.1 Risk of delayed recovery and reduced longer-term growth

Fueled by the global recovery and domestic policy responses, Africa's real GDP is projected to grow by 4.1 percent in 2010, below the 6 percent annual growth rates of the pre-crisis years. The concern is whether Africa will recover more slowly than other regions, as in the past recessions.² Africa's growth outlook faces several downward risks, including the uncertainty about the speed and the size of the global recovery. Even if the global economy picks up as projected, Africa could fall even further behind if the foreign aid is cut or delayed. On the positive side, since

¹ The improvement in Africa's growth performance after 1995 was largely driven by reduction in frequency in growth declines and growth acceleration in resource-rich countries. However, improvements of structural correlates of longer-term growth, such as governance indicators, have been limited.

² In past cycles (1975, 1982, 1991), growth rates in sub-Saharan Africa stayed high during the first year of the global slowdown and generally bottomed out later than in the advanced economies.

growth prospects of both China and India have improved, the increasing trade and investment linkages between African and these Asian economies could help the continent's recovery.³

The crucial question for Africa is whether and when it will reach a high and sustainable growth path that would allow the continent to substantially reduce poverty. While the pre-crisis growth rates were high relative to Africa's past record, they were not sufficient to meet MDG 1 goal (income poverty reduction). Moreover, during growth decelerations such as the one that Africa has been experiencing as a result of the crisis, some of the economic fundamentals may be eroded because of the lack of finances. And indeed, the continent's domestic savings rates have already fallen back to the 2000 levels, with possibly negative impact on investment and growth (Figure 3). Any loss in the reform momentum would severely undermine the region's longer term growth potential.⁴

More broadly, the global crisis and the lack of resources could lead to a deterioration of the main drivers of growth, including the business environment, infrastructure and human capital. A setback in institutional reforms could undermine technology adoption, a key precondition for rapid growth. The impact of this delay could be amplified by a deterioration in other drivers of long run growth, such as human capital and R&D, due to the lack of finance.⁵ Thus in addition to pursuing strategies to minimize the impact of the crisis, policymakers need to invest in supporting the drivers of long-run growth.

3.2 Growth opportunities: Harnessing new partnerships and natural resources

On the positive side, the crisis could be an opportunity for Africa to diversify its trade and investment relationships as a means of both increasing growth and hedging against global shocks. As China's has been increasing sophistication of its production and moving up the technology ladder, it has created space for other countries in the lower value-added manufacturing. It has been recognized that this trend has created an opportunity for Africa to develop its underperforming manufacturing sector. In fact, China and the World Bank have already started discussions about setting up labor intensive manufacturing facilities in Africa, in areas such as footwear, clothing, and toys. However, to attract investment in labor intensive manufacturing, African economies need to pursue structural reforms to make their economies more attractive to investors, including those from China and other new trade partners.

Another growth opportunity stems from Africa's natural resources. A number of countries have recently discovered oil (Ghana, Tanzania, Uganda, Sierra Leone and others) and are now poised to benefit from additional export and fiscal revenues. However, they need to manage these flows

³ For example, already between 2001 and 2006, Africa's exports to China increased at an annual rate of over 40 percent, rising from US\$4.8 billion to reach US\$28.8 billion in 2006. During the same period, Africa's imports from China quadrupled to US\$26.7 billion.

⁴ Factors that could lower Africa's growth trend include: (i) worsening credit conditions on international financial markets, with spillovers to domestic markets in EMEs; (ii) slower progress with structural reforms; (iii) increased protectionism (trade barriers, capital account restrictions) in both advanced and developing countries.

⁵ The factors stemming from the crisis such as (i) worsened credit conditions on international financial markets; (ii) slower progress with structural reforms; and/or (iii) increased protectionism could amplify longstanding ones, which include higher commodity prices, demographic trends, and climate change (Annex II).

judiciously to avoid the resource curse previously experienced by many African resource-rich countries. The countries with recent oil discoveries can benefit not only from good practices established by others but also from the existing international transparency and governance frameworks. Moreover, where FDI is key in the mineral sector, the governments need to negotiate agreements that are fair and consistent with the countries' development agendas.

4. Making African economies even more resilient

As the global crisis showed through the collateral damage it caused to Africa, globalization brings about not only benefits, but also risks. Given that African economies are particularly vulnerable to external shocks, they need to increase their resilience through: (i) implementing structural reforms to diversify their economies; (ii) increasing flexibility of macroeconomic frameworks; (iii) building social safety nets; and (iv) deepening regional integration.

4.1 Accelerating structural transformation

Slow progress with structural reforms remains a long-standing issue in Africa. Although the continent gradually opened up to trade and FDI, structural transformation, and in particular industrialization, remains limited. The declining share of manufacturing in GDP over the last ten years prior to the crisis raises questions about appropriate development strategies. As this global crisis has illustrated, the lack of diversification of production and exports exposes African countries to severe adverse affects of shocks to global markets. To diversify risks and achieve broad-based growth, African countries need to supplement their export orientation with strategies to promote domestic markets through public investment, promotion of SMEs catering to local markets, and regional integration. Policies to restore high and sustainable growth will thus need to improve domestic fundamentals and encourage regional integration. More specifically:

- Encouraging private sector development to spur investment would provide a base for a more diversified growth.⁶ Improving the business climate, notably through conducive legal framework that protects property rights, is critical for enhancing Africa's competitiveness.
- Private sector development requires an adequate access to capital from a sound banking sector, well-regulated securities exchanges, venture capital or other venues. As Kenya's experience with the issuance of the infrastructure bonds showed, developing domestic markets is particular useful. Measures to improve financial deepening and encourage innovative financial instruments are critical to facilitate a private sector take off.
- Building a vibrant domestic economy also requires streamlining labor market regulations to both facilitate entry into the labor market and enhance competition. Designing and enforcing incentives for job creation while increasing the gains from growth in terms of poverty reduction are necessary steps in this area.

⁶ High-quality infrastructure is a critical factor in investors' decisions on where and how to invest. To develop such infrastructure, Africa would need additional resources. This is where the advanced countries could play vital role.

Given the variety in economic structures of the African countries, the reforms aiming at promoting long term growth will also greatly vary. Low income countries are likely to focus on productivity gains through structural transformation to manufacturing and more sophisticated services. In contrast, middle-income countries that may have already reaped the benefits of reallocative efficiency gains, will focus on “within-sector” productivity gains, through technological innovation. In countries where the private sector is particularly underdeveloped, the state can play an important role in supporting it through an industrial policy aimed at unlocking comparative advantages and increasing competitiveness.

4.2 Increasing flexibility of macroeconomic frameworks

Phasing out procyclical macroeconomic policies

Over the medium term, African countries may also want to phase out the pro-cyclicality that their macroeconomic policies exhibited in the run up to the crisis. In the post-crisis era, this would involve accumulating adequate fiscal reserves during the booms to create buffers for downturns, i.e. targeting cyclically adjusted fiscal balance. Anchoring expenditures in medium-term frameworks typically raises credibility of such fiscal rules. On the monetary policy side, countries with inflation targeting regime in place or those that aim to adopt it should keep these frameworks flexible to be able to counter exogenous shocks, so frequent in Africa. Clearly, fiscal and monetary policies need to be well coordinated to have their intended effect, rather than offsetting each other.

Mitigating volatile capital flows

Counter-cyclical macroeconomic policies alone would not offset the cyclicality of large capital flows, as experienced, for example, in Central Europe. The sudden capital outflows in these economies during the crisis have shown that emerging and frontier markets may want to liberalize their capital markets carefully and introduce protection against fast and amplified transmission of shocks from abroad. African policymakers thus need to balance attracting capital flows to fuel growth with the need to minimize their sudden stops. Country experiences suggest that liberalization of capital controls should be undertaken only after sound domestic financial supervision and cooperation on cross-border flows are in place.

The crisis has also revived the debate on restricting capital mobility through, for example, a tax on foreign exchange transactions as a precaution against large capital outflows. However, such measures are complex and difficult to implement, in addition to distorting incentives.⁷ A clear lesson from the crisis is that African countries that are just entering international financial markets should liberalize capital account cautiously, and eliminate their capital controls as the last step of the financial sector reforms.

4.3 Creating social safety nets

⁷ A particularly debated form of capital controls to discourage short term speculation has been the Tobin tax. The proponents argue that the tax would induce investors to base their decisions more on macroeconomic and structural fundamentals rather than cyclical factors. However, the Tobin tax is politically difficult to implement, since it would need to be implemented by all countries simultaneously to be effective.

As the global financial and economic crisis turned into the job crisis, the African poor have been hit hard, since they lack room for maneuver. The impact has again varied across countries. In emerging market economies, such as South Africa, the already very high unemployment has increased to new highs.⁸ While increases in unemployment in low income countries are not as striking, in these countries even small increases are damaging given the widespread poverty and the risk of social instability. Moreover, after several years of steady decline, the rise between 2008 and 2009 put the number of Africa's working poor back to the 2003 levels (Figure 2). Moreover, the pre-crisis boom did not generate a sufficient number of decent jobs in Africa. The income distribution remains highly uneven in many African countries, with a small middle class. To make growth sustainable, it needs to generate employment, be broad-based and contribute to development of a sizeable middle class.

The increase in poverty due to the crisis underscores the need for formal social safety nets. Creating new social safety nets serves to consolidate the social contract between government and the rest of the society. Moreover, through creating automatic stabilizers, social safety nets would not only provide social protection but also make domestic demand less volatile and stronger during economic downturns.

4.4 Regional Integration

The global financial and economic crisis offers an opportunity for African countries to rethink the development models they have chosen and examine options for other sources of growth than exports and FDI. In particular, they need to reduce their reliance on European and US markets by developing regional and domestic markets. So far, regional integration has played only marginal role in most of Africa's development, as evidenced by the low intra-regional trade. However, as is now widely recognized by African policymakers, regional integration could increase countries' resilience against exogenous external shocks.

The recent progress by the East African Community (EAC) with regional integration is worth noting. In an effort to enhance interactions among their markets, these countries (Burundi, Kenya, Rwanda, Tanzania and Uganda) signed a Common Market protocol on November 20, 2009, aiming at increasing regional trade. Moreover, the higher share of regional trade than in most other parts of Africa may have partly contributed to the sub-region relative resilience to the crisis (Figure 4).⁹ After the common market is established later in 2010, the sub-region aims at implementing monetary union in 2012 and political federation in 2015.

Progress with regional integration in Africa still faces serious challenges. One of these is creation of mechanism for identifying, monitoring and removing non-tariff trade barriers and achieving

⁸ According to Statistics South Africa, the job losses in the formal non-agricultural sector in the 3rd quarter of 2009 amounted to 484,000, after the loss of 67,000 jobs in the 2nd quarter and 189,000 in the 1st quarter. The official unemployment reached 24.5% of the labor force, and if discouraged workers were counted, it would exceed 30%.

⁹ East Africa can draw lessons from experiences of the Newly Industrialized Countries (NICs) in East Asia, where regional trade drove their rapid income convergence to advanced economies. The value of trade between the five current members increased by about 50 percent between 2005 and 2008.

harmonization of quality standards. At the same time, some African policymakers continue to raise doubts whether economies in the sub-regions are sufficiently synchronized and adequately flexible to undertake ambitious steps such as monetary unions in the limited time frame. Instead, some suggest that the limited resources should be spent on more realistic and still very useful steps such as raising physical connectivity of sub-regions through improved infrastructure. In particular, developing and improving Pan African corridors and networks (of transport, electricity, and other) is key to achieving the broader objective of Africa-wide integration. Over the longer term, barriers to regional labor mobility will also need to be eased.

5. External financing, African voice and the role of the Bank

External aid will be key for fast recovery and sustainable growth in Africa. So far, however, external assistance to Africa has not been adequate. At the G-20 summit in London in April 2009, countries agreed to inject \$1 trillion into the world economy; this amount included supporting recovery in emerging and developing countries. Up to now, however, the emphasis has been on containing global contagion and extending financial aid to countries in crisis. The precise amounts and timing of financial aid for Africa, especially its low-income countries, remain unclear. And the April G20 summit made no commitment to further changes to the IMF quota system, keeping Africa's voice marginalized in a key international financial institution.

Given the relatively weak African voice in the global debate, it is not surprising that the proposed solutions do not meet the continent's needs. Africa's challenges mostly emanate from the real channels of transmission of the crisis, not the financial ones. The decline in trade, both because of low commodity prices and collapsed import demand, has been amplified by the lack of market access. This constraint, which has been a contentious issue on the Doha-round agenda, will not be solved by short-term financing aimed mostly at the balance of payments support.

While the Bank has exerted major efforts to support the continent in these challenging times, its interventions have remained within the pillars of its strategic orientation: infrastructure, private sector development, governance, and higher education. Cross-cutting areas such as ICT adoption, fragile states, gender, and the environment have also received the Bank's attention. Moreover, the Bank has been examining "green growth" strategies, to support sustainable development and help Africa adapt to and mitigate changes stemming from climate change.

The effective way in which the Bank has handled the crisis has solidified its role as a partner of choice for African countries, but it also led to fast utilization of its resources. In order for the Bank to remain effective and to maintain its current and projected level of activity beyond 2010, there is an urgent need for additional funding in the form of a General Capital Increase.

6. Conclusions

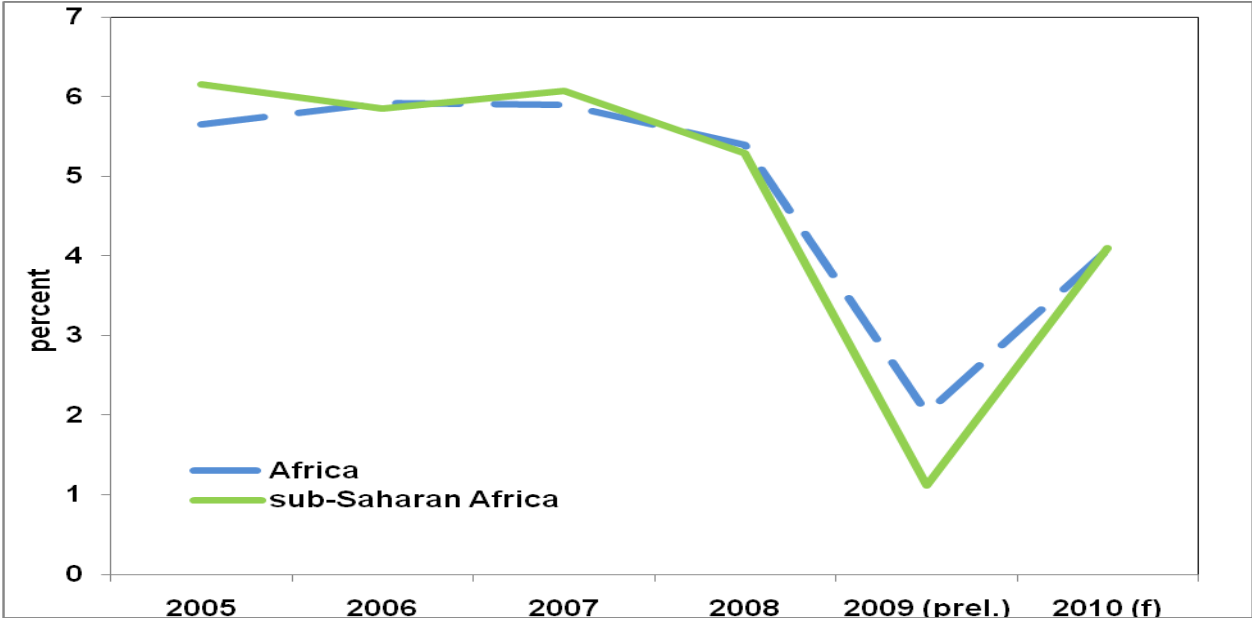
The significant and possibly long-lasting collateral damage by global crisis on African economies needs to be resolved through a global partnership. To prevent a development crisis, the international community needs to continue to work in partnership with African countries to mitigate the effects of the crisis, which threatens the achievements in terms of higher growth and some gains in poverty reduction over the past decade. On their part, African policymakers have recognized the need to make their economies even stronger and more resilient to weather similar external shocks in the future. They have also recognized the benefits of regional integration. The

actions of African countries need to be supplemented by measures taken by developed countries, including through adequate and timely development assistance. Only a true global partnership can protect Africa's poor against losing hard-won but still modest gains in their living standards. While the remaining challenges facing Africa are still numerous, the continent can surmount them— especially with continued effective support from the Bank and sister pan-African Institutions as well as other development partners.

Issues for discussion

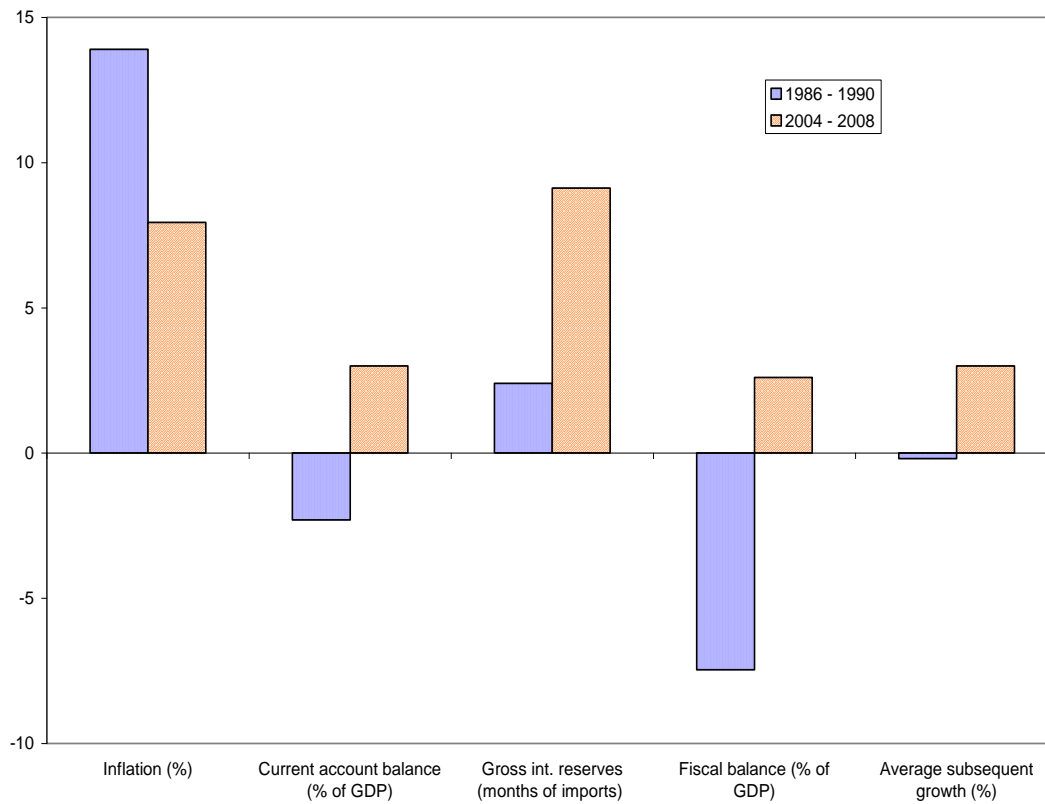
- What steps can Africa take so that its voice is heard in the global arena and in the international economic institutions? Specifically, what key points should the strategy of engagement with G-20 involve and how to increase Africa's quota in the IMF? How can Africa build mutually advantageous and durable global partnerships, including with China and India?
- What are the key obstacles that the African economies need to tackle in their effort to implement structural reforms and diversify their domestic economies? What challenges do low-income African countries face in seizing the opportunity to enter the labor-intensive manufacturing sector, notably to fill the space created by China's gradual technological upgrading?
- What measures can African countries take to accelerate progress with regional economic integration and strengthening Pan-Africa economic connectivity? How can labor movement across borders within regions be encouraged? Are there useful experiences in these areas from Africa sub-regions (East Africa) or other world regions that Africa can draw on?
- What more can the African Development Bank do to assist most effectively its member countries in tackling their constraints to long term development? In what areas is the Bank best positioned to lead the continent's debate on economic development challenges?

Figure 1. Annual real GDP growth, 2005 – 2010 (f)



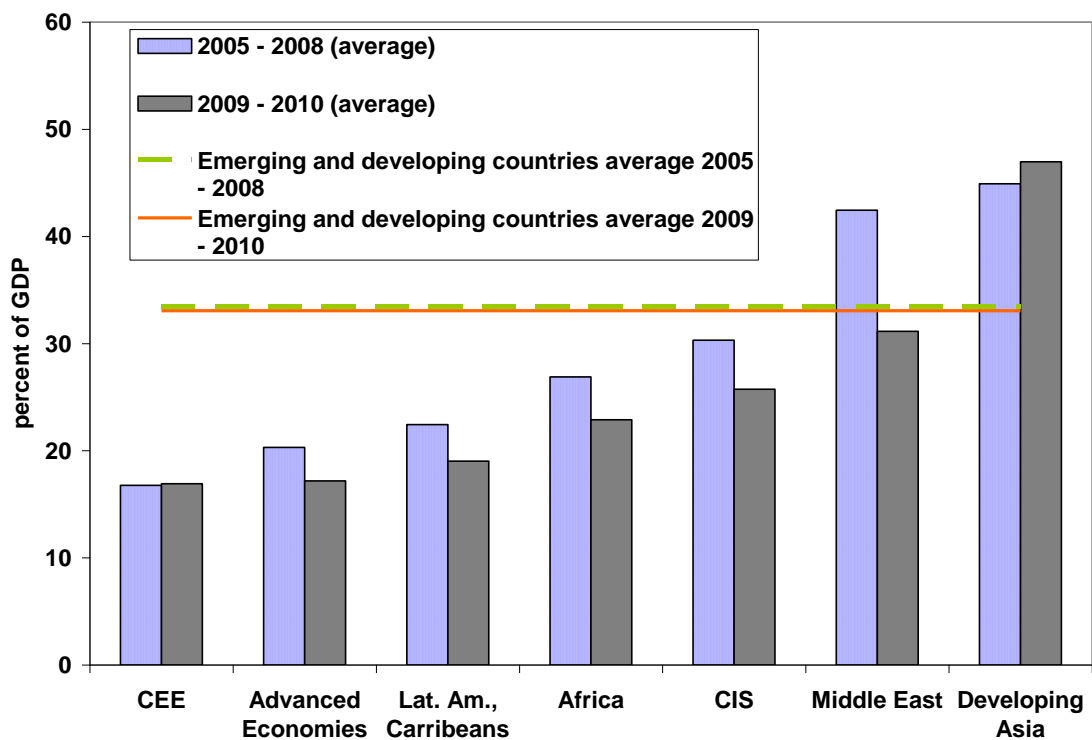
Sources: African Development Bank, African Economic Outlook database.

Figure 2. Africa's macroeconomic indicators before the two latest crises



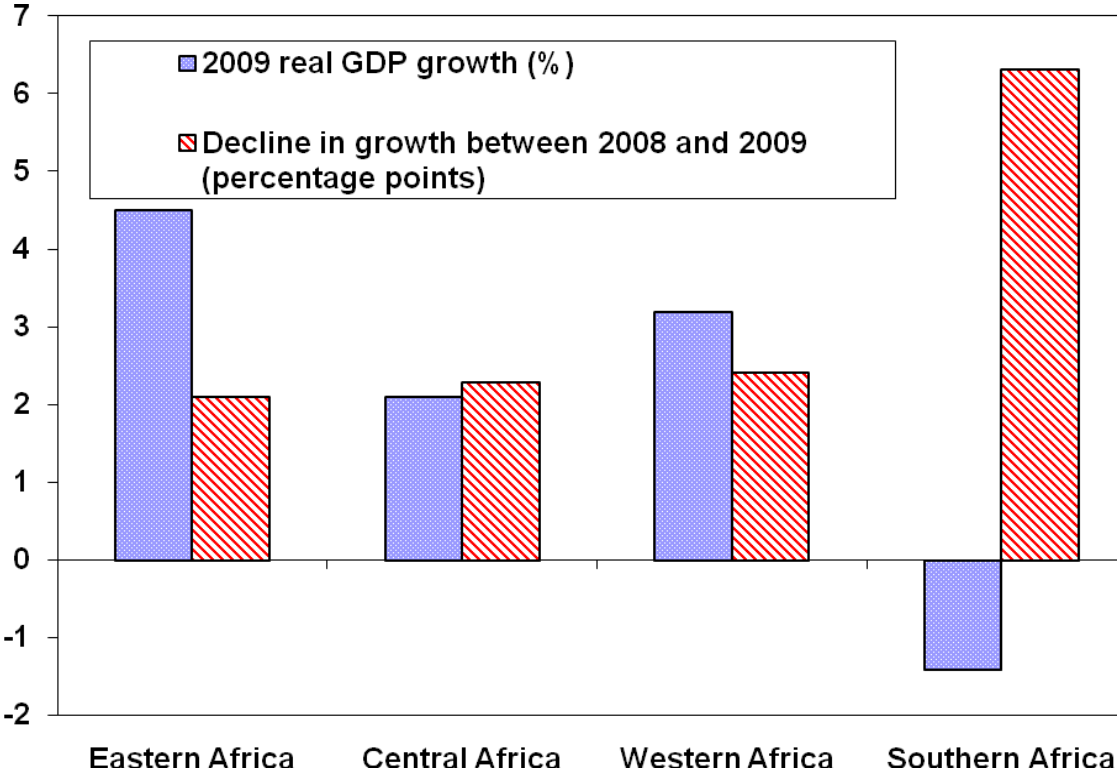
Source: African Development Bank, African Economic Outlook database (October 2009). 1/ Fiscal and current account balances include grants. 2/ Average of actual growth rates in 1991 and 1992 for the first recession and of forecasted growth rates for 2009 and 2010 for the second recession.

Figure 3. Regional comparison of savings rates, 2005 – 08 and 2009 – 2010 1/



Source: International Monetary Fund, WEO database. 1/ National saving rates.

Figure 4. Real GDP growth in Africa's sub-regions, 2009



Source: African Development Bank, African Economic Outlook database.

Annex I-- Examples of African responses to the global financial crisis

Time-frame/Objective	Policy options	Country examples	Comments
Short term			
Counteract shortages of trade finance	National governments, IFIs and others stepped in. AfDB established US\$ 1 bn Trade Finance Initiative.	Ghana, Nigeria	AfDB and partners mobilized USD 1.2 billion trade finance to support Ghana's cocoa sector; United Bank of Africa Plc (UBA) in Nigeria received \$150 mln
Liquidity support to the banking sector	Bank recapitalization	Nigeria, Tanzania	In Nigeria, government responded to the banking crisis
Monetary expansion	Lowering policy rates	South Africa, Mauritius, Egypt	
Fiscal expansion	Raising inflation targets	South Africa	
	Raising monetary targets	Tanzania, Kenya, Uganda	
	Increase spending	Tanzania, Kenya, Uganda, Mozambique, Zambia	Zambia: Increase social safety net spending (fertilizer program)
	Reduce tax rates	Zambia	Reduction in fuel excise duties
Coordinated fiscal and monetary policy	Expand tax exemptions	Sierra Leone, Zambia	
	Raise money target while increasing fiscal expenditures	Tanzania, Uganda, Kenya	
New sources of budget financing	Infrastructure bonds	Kenya	
Exchange rate policies	Minimizing ER volatility	Zambia, Sierra Leone	
Openness measures	Trade protectionism (trade and NTBs)		
	Imposing capital controls		
Longer term			
Mobilization of resources	Tax revenue mobilization	Sierra Leone	GST introduced on Jan 1, 2010
	Raising efficiency of the financial sector		
	Domestic banking supervision reforms	Increased monitoring of NPLs	Zambia, Sierra Leone
Openness measures	Introducing FDI exemptions	Sierra Leone	New tax incentives introduced to attract FDI.
Regional integration and cooperation	Progress with regional integration	East African Economic Community	Increased regional cooperation
	Coordination of banking supervisions and regulation of cross-banking financial flows	West African Economic and Monetary Union	MOU on cross-border supervision

Source: African Development Bank.

Annex II -- Changes in economic fundamentals impacting longer-term growth in Africa

Factor	Expected trends in Africa	Channels of transmission to growth	Impact on "trend" (potential) growth
Financial markets			
Credit conditions on international markets	Over the medium term, access of Africa's EMEs and FMEs will be lower than before the crisis due to investors' increased risk-averseness.	Lower investment through lower access to credit -direct impact on EMEs and spillover effects to others	negative
Development of housing markets in Africa's EMEs and FMEs	Likely to develop further in EMEs (North Africa, South Africa); start in some other countries (Ghana).	Increased domestic demand (higher demand for complements).	positive, but relatively small
Commodity prices			
Oil prices	Global demand set to rise relative to global supply.	For oil importers, higher prices for inputs (transfer, power). For oil exporters, higher revenues.	negative on balance, as costs to importers likely to exceed
Food prices	Global demand set to rise relative to global supply.	Inflationary pressures	negative
Demographics			
Population growth in Africa	High population growth likely to continue.	If growth picks up, additional labor supply is useful. Otherwise (more likely) large social pressures will arise.	ambiguous, but likely more negative after the crisis than before
Population growth in China	Slowing population growth in China.	Lower population growth in China will increase wages and create opportunities for Africa manufacturing to expand	positive, provided that Africa is ready to seize this opportunity (through enabling environment, etc.)
Other factors			
Structural reforms	They have been always lagging, and there is a risk that crisis will lower the appetite of African constituencies for structural reforms further.	Slower improvements in the business climate and governance, slower technology adoption.	negative
Regional integration	Likely to increase after the crisis as countries are looking for ways to rebalance sources of growth and demand.	Increased regional demand and diversified risks. Efficiency gains through integration (easier movement of production factors) will kick in.	positive, but significant progress will take time

Increased protectionism/slower dismantling of barriers to trade and capital flows	Likely to increase after the crisis as countries most integrated to the global economy were also the most hit by the crisis.	Lower demand for African exports among advanced economies; slower progress with regional integration	negative
Climate change (relevant over the long term)	Physical impacts of the climate change are unlikely to be substantial in the short run (before 2015), but will increase afterwards.	In the long term, yields and the area of arable land will be reduced. In shorter term, more frequent and intense natural hazards.	minimal over the shorter term and ambiguous over the longer term, depends on countries' mitigation and adaptation.

Source: African Development Bank, adapted from Asian Development Bank (2010).