

# The African Development Bank Group Chief Economist Complex



## Market Brief

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## Briefing Note on the African Economic Outlook 2010 *Africa Rebounding*

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### 1. Introduction

After a decline in growth in 2009, Africa's recovery now seems well underway. The continent has exhibited substantial resilience to the global recession, relative to most other developing regions and its own past record. While some factors driving Africa's recovery have been external, the positive outcome to date has also been due to the good policies that countries implemented before and during the crisis. Nevertheless, substantial risks remain and have been only exacerbated by the recent European turmoil, while the challenge of bringing African countries on a path of high growth and poverty reduction has become even more pressing. This note is based on the findings of the African Economic Outlook 2010 (AEO 2010). It examines how the African continent, its regions and countries, have weathered the global crisis and what the expectations are for 2010 and 2011. It also looks at trade policies and regional integration, the progress towards attaining the Millennium Development Goals and explores how public resources can be better mobilised for development through more effective, more efficient and fairer taxation. This issue is particularly important given the

uncertainties about future export revenues and unstable and unpredictable inflows of Foreign Direct Investment and Official Development Aid.

### 2. Economic recovery under way but risks remain

While the global financial crisis hit Africa later than other regions, the continent has not emerged unscathed. The global economic crisis brought to a sudden end a period of relatively high economic growth in Africa. Economic growth was slashed from an average of about 6% over the period 2006-08 to 2.5% in 2009 with per capita Gross Domestic Product (GDP) growth coming to a near standstill, while poverty and unemployment, especially among the youth, escalated. The global crisis of 2009 had its strongest effect on Southern Africa, where growth was slashed (from the average over the preceding three years) by almost 8 percentage points to negative growth of around 1%. East Africa and North Africa proved to be the most resilient regions. While in most African countries GDP continued to grow in 2009, albeit at a lower rate, in 10 of the 50 African countries covered in the AEO 2010, output declined. In half of the countries, per capita GDP stagnated or fell.

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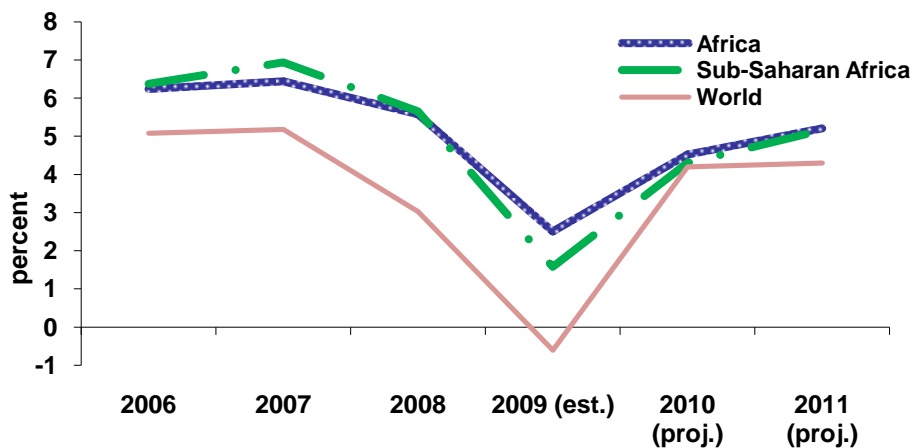
*“Due to continued weakness in remittances and possibly FDI as well as low aid inflows, several low income and fragile countries are projected to grow at relatively sluggish rates.”*

In Africa, the global crisis was mainly felt through the collapse of commodity prices and the fall of export volumes. In 2009, Africa’s export volumes declined by 2.5% and import volumes by about 8%. Due to the fall in commodity prices, Africa’s terms of trade deteriorated. Export values declined sharply, and more than import values, leading to a deterioration of trade and current account balances. The global crisis also hit through the decline of worker remittances and of foreign direct investment. The economic slowdown was most pronounced in mining, manufacturing and tourism. These sectors were particularly exposed to the fall of commodity prices and global trade in goods and services. Other sectors, notably agriculture and non-tourism services, were more resilient and mitigated the downturn. In fact, in most African countries the agricultural sector benefited from good harvests due to favourable weather, although in some countries, bad harvests exacerbated the effect of the global crisis.

While in many other regions output levels declined in 2009, growth in Africa remained positive and Africa has also emerged from the crisis faster and more robustly than in the past and than most other regions. Growth will reach 4.5 percent in 2010 and increase further to 5.2 percent in 2011 (Figure 1). As usual though, the aggregate numbers mask substantial differences across countries and regions. All African regions will achieve higher growth although the recession will leave its mark. Economies most open to trade (e.g. commodity exporters), which slowed markedly in 2009, are expected to benefit from the revived commodity prices and trade, and thus record a relatively sharp V-shaped recovery. Due to continued weakness in remittances and possibly FDI as well as low aid inflows, several low income and fragile countries are projected to grow at relatively sluggish rates. Overall, in 2010 about 60 percent of African countries are projected to grow at lower rates than on average during 2001–08.

Overall, the African continent has shown a remarkable resilience to the global

Figure 1. Real GDP growth, 2006-2011: Africa in sync with the global recovery



Sources: African Economic Outlook (May 2010) and WEO database (2010).

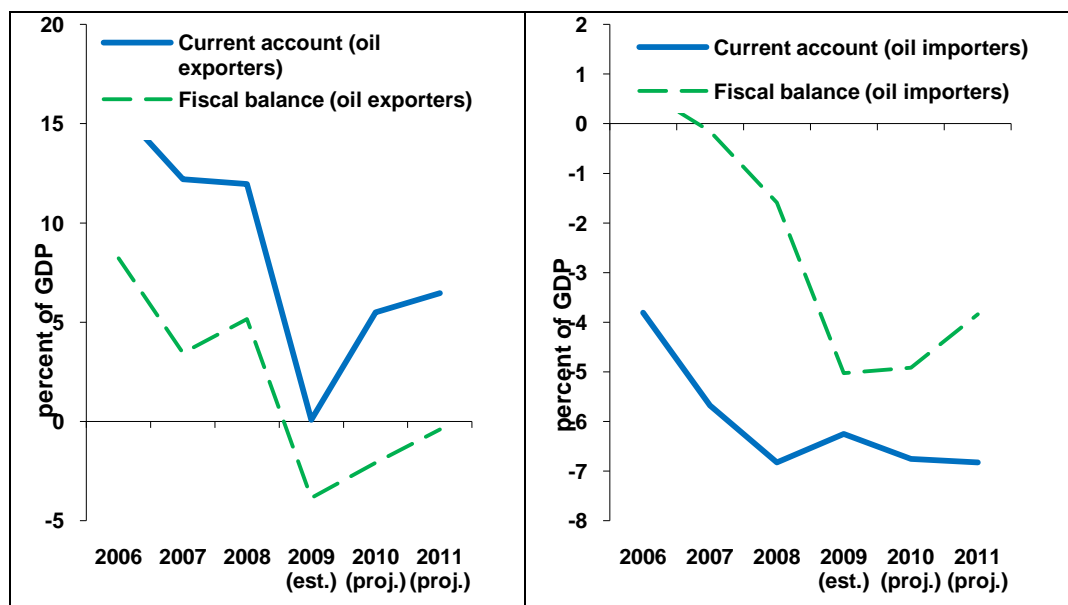
*“Africa’s inflation is expected to be gradually returning towards mid-single digits in 2010 and 2011, as the impact of high commodity prices has waned and the aggregate demand remains subdued.”*

The other key macroeconomic variables are also projected to improve. Africa’s inflation is expected to be gradually returning towards mid-single digits in 2010 and 2011, as the impact of high commodity prices has waned and the aggregate demand remains subdued. Disinflation is faster among oil importing countries, due to cheaper imports and more subdued aggregate demand. While the continent’s fiscal balance has fallen from a surplus of more than 2% of GDP in 2008 to a deficit of more than 4%, it is expected to decline to less than 2% in 2011. The fiscal and current account balances of oil exporters are projected to strengthen in 2010 and 2011 due to increased prices and demand

while oil importers will continue to post fiscal and current account deficits well above the pre-crisis levels (Figure 2). While the macroeconomic policies adopted by African countries prior to the crisis served them well overall, governments still need to maintain a healthy balance between short run stabilization and achieving high long-term growth. Now that the stimulus packages have been put in place, the key questions are for how long should these be maintained, at what speed should they be withdrawn, and how should exits across policies and countries be coordinated.

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Figure 2. Fiscal and current account balances of African oil exporters and oil importers



Source: African Economic Outlook (May 2010).

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### 3. Drivers of the continent’s recovery

Sources of the continent’s recovery have also differed across countries. In addition to the global recovery, driven by developing Asia and expansionary policies in advanced countries, strong commodity demand and prices have played a key role in the revival of the continent’s exports. Private capital flows are also projected to increase and some African frontier markets (e.g., Ghana, Kenya) will benefit from improved access to international bond markets. In a number of countries (e.g. Mauritius, South Africa, Tanzania, Uganda, and others), the rebound was helped by stimulus packages. Prudent macroeconomic policies prior to the crisis, especially fiscal consolidation, as well as improved institutions of macroeconomic management, provided space for fiscal stimulus initiatives. The financial support from IFIs, including the Bank, also played an important role in preventing large pro-cyclical fiscal cuts. In some countries improvements to business environments helped relieve structural bottlenecks. For example, Rwanda has been identified by the World Bank as the world’s top economic reformer. In several countries, government interventions stimulated agriculture and overall private domestic demand (e.g., subsidy program in Malawi, distribution of inputs in Sierra Leone, and ICT use in Kenya). In East Africa, increased regional trade in part compensated for the slump in the global demand.

### 4. Risks and policy challenges

While the outlook for Africa is generally positive, the projected growth for 2010 and 2011 remains below the trend in most countries, as increased trade and financial linkages with Asia will not compensate for subdued demand from the advanced economies and increased cost of credit. In the EU and the US, the demand for African imports will not reach its pre-recession level in the short term due to deleveraging and fiscal consolidation.

Furthermore, policymakers should also be aware of the various risks. This forecast for Africa rests on the assumption that the world economy and world trade continue to recover, and that prices of oil and other commodities will remain close to current levels. However, there are positive and negative risks for this forecast. On the upside, the global recovery may be stronger than expected. Indeed, several international indicators have improved significantly, and business confidence also has continued to increase in many countries. Stronger global growth would further boost Africa’s growth. On the downside, the global recovery could also be weaker than assumed here. Uncertainties persist in particular about remaining problems in advanced countries’ banking sectors and to what degree this will constrain investment financing and the global recovery.

There is also a risk over how worldwide fiscal and monetary policies manage the exit from highly expansionary policies into a more neutral stance during the recovery. Exiting too early could lead to a double dip or slower than expected recovery. Exiting too late could undermine credibility and nurture inflation. With the ongoing debt problems in Europe, notably the “Greek sovereign debt crisis”, the first risk seems to have become larger than the second risk. Many countries, notably in Europe are now tightening fiscal policies in order to control debt levels and to reduce sovereign risks. If this policy is not accompanied by higher private demand, global growth could be lower than assumed here which would also reduce growth in Africa.

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Besides these external factors, risks also exist within Africa. In some countries, social discontent and political tensions could rise or emerge, cutting growth. African policy makers need to be aware of these international and domestic risks. The weakening of economies and the prospect of a relatively moderate recovery has made it even more pressing to address the structural problems which existed even before the global crisis, and which reduced growth potential and led to inequalities and high poverty levels in many countries.

### **5. Raising growth potential by further improving trade policies and regional integration**

In the years before the global crisis, international trade increased rapidly and African countries benefited from this. Nonetheless, Africa’s share of world trade remained low with exports from the continent amounting to only about 3% of the global total. This poor performance partly stems from trade protection against African products, but also from constraints that inhibit trade within Africa. A rapid conclusion of the Doha Round of trade talks and outstanding issues in Economic Partnership Agreements with the European Union are crucial to Africa’s medium-term trade prospects. However, no breakthrough on the World Trade Organisation (WTO) Doha talks was made in 2009. Furthermore, a rising number of protectionist measures were adopted by advanced countries in 2009 to curb the effect of the financial crisis and often stimulus packages were geared to favour domestic sectors, such as through export support or preferences for buying, lending, hiring or investing in local goods and services. Such measures clearly discriminate against developing countries, including those in Africa.

A critical reason for Africa’s relatively poor trade performance is the weak diversification of African trade in terms of structure and destination. Most African economies depend on few primary agricultural and mining commodities for their exports and mainly import manufactured goods from advanced countries. Approximately 80% of Africa’s exports are based on oil, minerals and agricultural goods. As traditional markets in advanced countries are expected to grow less than those in emerging Asian and Middle East countries as well as markets in Africa, trade relations with these more dynamic markets need to be further enhanced.

Despite some progress, intra-African trade is still low, representing on average only about 10% of total African exports. Many factors contribute to the low trade performance, including the economic structure of African countries, such as poor institutional policies, cumbersome custom regulations and procedures, poor infrastructure, weak financial and capital markets, political instability, insecurity in several regions and other intra-African trade barriers. For instance, less than a third of the African road network is paved and its railway network is very poor. These factors contribute to high transport costs compared to the rest of world.

Various initiatives aim to improve intra-African trade and regional integration more broadly, including the gradual process to create a common market in Africa. These efforts need to be strengthened to enhance trade and regional integration.

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## 6. Challenges to attain the Millennium Development Goals

With five years left to the target date to reach the UN Millennium Development Goals (MDGs), progress on most of them has been sluggish and it seems unlikely that they will be attained. Most progress – although uneven across countries – has been made in *Achieving Universal Primary School Completion and in Promoting Gender Equality*. By contrast, the target of *Eradicating Extreme Poverty and Hunger* suffered a serious setback as Africa’s rapid growth from 2000 to 2008 came to an abrupt halt due to the global economic crisis. Although actual data is not yet available, it is likely that the trend of poverty reduction has been reversed in many African countries, knocking them seriously off track to achieving the goal of halving poverty by 2015.

The target of *Reducing Mortality of Children Under Five* is also unlikely to be met by 2015. In particular, poverty and malnutrition, HIV/AIDS, low immunization coverage, high neo-natal deaths, and malaria still factor into the stagnation and reversal of previous gains made in reducing children mortality rates in some countries. Progress is also uneven with respect to *Improving Maternal Health* as the wellbeing of mothers and that of their children is inextricably linked. When mothers are poor, uneducated and unable to access health care, the risks to them and their children multiply. Despite some improvement, the risk of dying from maternal causes remains high in many African countries.

Combating HIV/AIDS, Malaria and Other Diseases also remains a main challenge. In 2008 sub-Saharan Africa accounted for about two thirds of new HIV infections among adults worldwide, about 90% of new HIV infections among children and almost three quarters of the world’s AIDS-related deaths. Over time, some improvements were made in the worst hit countries, such as Botswana, Lesotho, Uganda and Burundi but Southern Africa remains the most affected region in Africa.

African countries also face a significant challenge in *Ensuring Environmental Sustainability*, although the continent is the lowest emitter of carbon dioxide and these emissions decreased between 1990 and 2006, except for Seychelles and Algeria. Libya and Equatorial Guinea have the highest emissions in Africa because of gas flaring in oil fields. Climate change also exacerbates water stress for many countries, which further complicates access to safe drinking water.

## 7. How to mobilise public resources for development?

The global economic and financial crisis has underscored the importance for Africa to strengthen domestic resource mobilisation to finance development and reduce aid dependence. Falling commodity prices and export revenues have resulted in a general shortfall of external finance in a context of high levels of indebtedness and uncertain future aid flows across Africa. Public resource mobilisation, in particular tax and non-tax revenues, is a precondition to Africa achieving greater economic independence and enlarging fiscal space. Over the long term, taxation will not only reduce the region’s dependence on aid, but it can also increase its ownership of the development agenda and reinforce the social contract between state, citizens and the private sector. While significant progress has been achieved in the past decade, Africa needs more effective, efficient and fairer taxation systems. In the past, donors have devoted little attention to public resource mobilisation. But if a larger share of aid were targeted at this goal, countries would become less dependent on aid in the long run, to the benefit of recipients and donors.

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*“...the average African tax revenue as a share of GDP has been increasing since the early 1990s..”*

The good news is that the 2010 African Economic Outlook (AEO) finds that the average African tax revenue as a share of GDP has been increasing since the early 1990s. The bad news is that this has been mostly due to taxes on the extraction of natural resources. Focusing exclusively on natural resource rents distracts governments away from more politically demanding forms of taxation, in particular direct forms of taxation, such as corporate income taxes on other industries, personal income taxes, as well as Value Added Taxes (VAT) and excise taxes. Indeed, income taxes (mainly personal and non-resource corporate) have stagnated over the period. Trade liberalisation and regional integration in Africa has translated into a reduction of revenue from trade taxes since the late 1990s. Further trade liberalisation will leave a critical gap in public resources if it is not purposively sequenced with domestic tax reform.

On average in the region, 440 USD of taxes were collected in 2007 per person, while 40 USD of aid was received per person (Figure 3). However, many individual countries remain highly dependent on aid. In one-quarter of countries, aid exceeds tax revenues and in half, aid is larger or equal to half of tax revenues. The challenge is for these countries to reduce dependency on aid through better public resource mobilisation. In fact, the AEO tax effort estimates confirm that some countries collect as little as half of what they would be expected, given their living standards and economic structures, while others collect two to three times what would be expected.

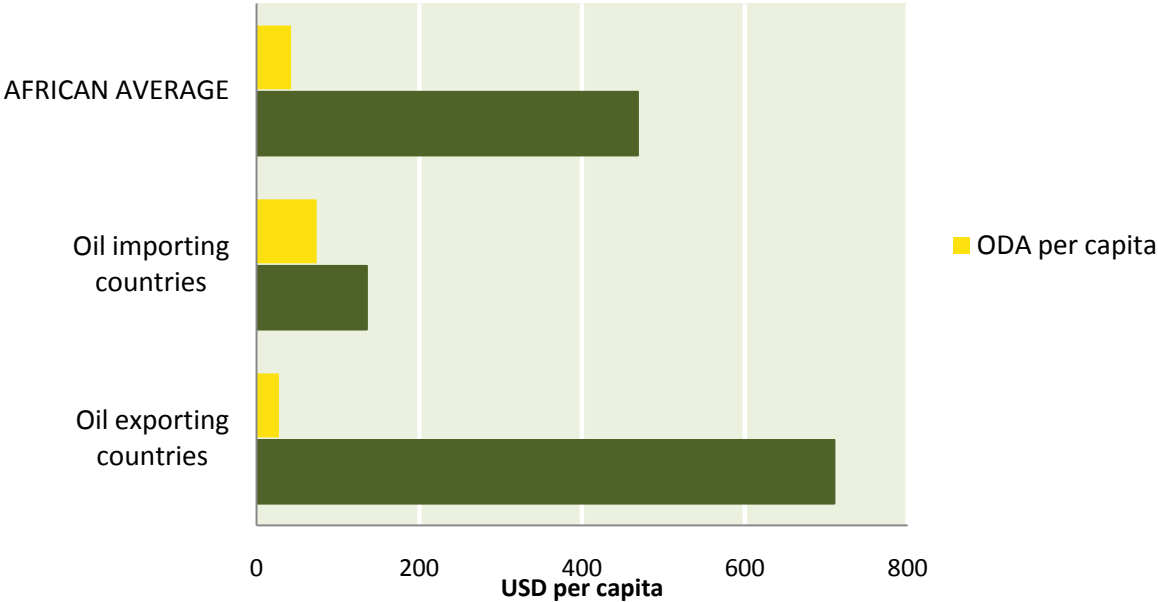
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When resource-related tax revenues are excluded from this analysis, some resource-rich African countries switch from a high tax effort to a low tax effort, which implies that these countries have made little effort to broaden their tax base.

The solution is not to simply raise existing taxes. This could undermine economic recovery without necessarily improving the quality of tax systems. Strategies towards more effective, efficient, and fair taxation in Africa typically lie with broadening the tax base in administratively feasible ways. Policy options include removing tax preferences, dealing with abuses of transfer pricing techniques by multinationals and taxing extractive industries more fairly and more transparently. The analysis also identifies urban property taxation as an instrument for mobilising public resources. This type of taxation is progressive and can be scaled up with Africa's rapid pace of urbanization and the corresponding need for financing urban infrastructure. The international community has a key role to play in enhancing administrative capacity, while African partners should provide peer-learning opportunities. At the same time the quality of public services needs to be improved which makes it easier for governments to convince citizens that they have a stake in a better-funded state.

Figure 3. Average tax revenue per capita in African countries



Source: OECD Development Centre, based on OECD/DAC data and AEO Country Survey data