## *AFRICAN DEVELOPMENT BANK GROUP*

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Ministerial Round Table Discussions

# PANEL 1: The Global Financial Crisis and Fragile States in Africa

**The 2009 African Development Bank Annual Meetings**

Ministerial Round Table Discussions and High level Seminars

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# Executive Summary

Fragile states have been hard hit by the global economic crisis. Falling export prices and volumes, and declining capital flows, are causing balance of payments and fiscal difficulties, exchange rate depreciation, job losses and declining growth. With little room to maneuver, fragile states need additional donor resources to deal with the crisis. The AfDB is well placed to channel those additional resources to them, having institutionalized a framework – the Fragile States Facility – for addressing the special needs of fragile states. Priority areas for additional financial resources include capacity building, employment creation, support for arrears clearance, and support to vulnerable groups – women, children, the elderly and the disabled. The Bank would also require additional capital to meet the rising demands from fragile states.

## 1. INTRODUCTION

Fragile states typically have weak governance institutions, undermining their capacity to provide basic services. Many fragile states have been embroiled in years of violent conflict, or face the threat of such conflicts. Others are emerging from such conflicts[1]. Net food and fuel importers like Burundi, Liberia, Sierra Leone and Zimbabwe, have had to cope with the food and fuel price hikes that preceded the global financial crisis. Thus, fragile states were typically in precarious circumstances even prior to the global financial crisis. This constitutes a distinguishing feature of fragile states: they have relatively little room to maneuver in response to domestic or external shocks. They have a narrow revenue base and weak fiscal positions, resulting in aid dependence. Their economies are undiversified, with a low level of industrialization, increasing their vulnerability to external shocks.

As with most other low income African countries, the first round effects of the global financial crisis on fragile states was relatively modest, due to their weak integration into the global financial system. The financial system in these countries is typically rudimentary. Unsurprisingly, there have been no known cases of collapse of banks or other financial institutions as a result of the crisis. However, accruing evidence points to much stronger subsequent adverse effects on fiscal and external balances, exchange rates, and the real economy. The objective of this concept note is to articulate these issues and to generate questions for panel discussion.

## 2. IMPACTS INTENSIFIED IN FRAGILE STATES

The immediate effects of the global financial crisis and the ensuing economic meltdown are on trade and capital flows including foreign aid and remittances. These effects in turn, have an impact on the balance of payments, the financial sector and the exchange rate.

***Trade-related effects* –** The economies of many fragile states rely strongly on exports of primary commodities which account for well over 95% of total exports in most fragile states. Oil exporters like Angola, Chad, the Republic of Congo, and Sudan, have been hard hit by the collapse of commodity prices from the global economic slowdown. The result has been the severe decline in foreign exchange earning, government revenues and households incomes. In Chad, and Equatorial Guinea, for instance, oil export revenues fell by 59% and 43%, respectively, between July 2007 and July 2008. In the Sudan, oil revenues are expected to be 43 % lower in 2009 compared to 2008.

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[1] Development partners have defined fragile states in different ways, leading them to focus on varying groups of countries. For instance, some characterize fragile states as those with poor policies, institutions and governance structures. Others use poor socio-economic indicators as a criterion for determining state fragility, including security, stability of political environment or inability to make progress towards the Millennium Development Goals (MDGs). Whatever the definition, the continent hosts the largest number of fragile states, which constitutes a formidable development challenge.

The story has been no different with mineral exporters, many of which are now threatened with the closure of revenue generating and job creating mining companies. In the Democratic Republic of Congo, for example, about 350,000 jobs in the mining sector have been lost in the Katanga Province. Reduced tourist arrivals are also threatening tourism-dependent economies like Djibouti and the Gambia. This has further negative implications for employment, given the importance of the tourism sector in creating local jobs.

The decline in foreign exchange earnings has caused a drastic deterioration of balance of payments position in many fragile states. The current account deficit deteriorated from about 19% of GDP in 2007 to about 66% of GDP in 2008 in Liberia, from about 25% to 34% of GDP in Djibouti, and from 16% to 22% of GDP in Burundi. These developments are a cause for concern; they raise the prospects of a reversal of reform gains, and have adverse implications for poverty and political stability.

A second area of serious concern for fragile states is the impact on government revenues. In the Sudan for example, the fiscal deficit is expected to widen from 2.6% of GDP in 2008 to 6.2% in 2009, despite measures to cut expenditures and boost non-oil revenues. Given that oil accounts for about 65% of government revenue and 90% of exports, the decline in oil exports will exert pressure on the investment budget and jeopardize the financing of pro-poor expenditures on health, education and other social services.

Even though oil importers stand to benefit from falling oil prices, these gains are largely offset by falling prices of the primary commodities and declining earnings from tourism.

Growth for 2009 has been revised downwards by half the original estimates. The effects of growth deceleration on poverty and social indicators like child and maternal mortality in fragile states would be considerable due to poorer initial conditions and weaker institutions. This could exacerbate the overall impact of the crisis in fragile states and increase the risk of drifting away from the attainment of the Millennium Development Goals (MDGs).

***Development aid*** **–** Most fragile states are highly aid-dependent, which raises their vulnerability to shocks. For instance, the Democratic Republic of Congo’s aid to Gross National Income (GNI) ratio was as high as 98% in 2003, and has averaged around 27% between 2004 and 2006; Burundi’s aid to GNI ratio averaged around 50% between 2004 and 2006, compared to an average of about 6% for Africa. Since 2000, foreign aid has financed around 40% of Sierra Leone’s fiscal budget. While donors have pledged to maintain aid levels in the face of the recession, fragile states would be hard hit should donors fail to deliver on commitments. The recession in the advanced economies is already affecting aid flows indirectly. For instance, in Sierra Leone which is dependent on British aid, the depreciation of the pound sterling against most major currencies (and the domestic currency) has resulted in a significant decrease in budgetary support, measured in domestic currency terms.

Fragile states that are facing or emerging from violent conflict require massive aid inflows to fund conflict resolution and peace-building initiatives. Governments in developed countries are urged to provide financial and logistical support to conflict resolution or peace-building efforts in the continent. Such support is critical for reducing the risk of violent conflict in fragile states.

***Remittances*** – Remittances are an important source of financing for consumption and investment in fragile states. In 2007, remittances as a share of GDP were as high as 10% in Sierra Leone, 8% in Guinea-Bissau, and 7% in the Gambia. Remittances by Africans living in Europe and North America – where the bulk of remittances to Africa originate – are projected to decline, with adverse implications for poverty reduction in fragile states.

***Foreign direct investment*** –Some fragile states with high levels of foreign direct investment are already feeling the pinch. These include the Gambia and Guinea Bissau where net foreign direct investment was 16% and 14% of GDP respectively in 2006. However, this channel is weak in other fragile states with relatively low levels of foreign direct investment (e.g. 0% of GDP in Burundi in 2006).

***The financial sector*** – The global financial crisis is making external credit harder to secure for banks operating in fragile states. Lines of credit have shrunk; the cost of credit is rising as risk premia widen; and fund-raising for new initiatives is in jeopardy. The high degree of foreign ownership of banks in fragile states poses potential additional risks of capital withdrawals to finance dwindling portfolios in home countries, or meet capital adequacy requirements. Foreign ownership of total banking assets is close to 100% in Djibouti and Guinea. It is about 80% in the Gambia and Togo, over 60% in Cote d'Ivoire, and between 40% and 60% in Angola, the Republic of Congo and Zimbabwe.

***Exchange rate effects*** – The crisis has led to increased exchange rate volatility which hurts trade and growth by increasing uncertainty and the costs of international trade. For fragile states in the CFA zone which has a pegged exchange rate to the Euro – Central African Republic, Chad, Comoros, Côte d'Ivoire, Guinea-Bissau, Republic of Congo, and Togo – the depreciation of the Euro against the Dollar induces a real exchange rate depreciation. Some other countries have also experienced a depreciation of their currency. For instance, the Congolese Franc depreciated by 20% between September 2008 and January 2009. As in the case of the CFA countries, the nominal exchange rate depreciation also induces real exchange rate depreciation and serves to improve external competitiveness. This, to an extent, constitutes an appropriate adjustment to the falling demand for exports: exports would be relatively cheaper from these countries (in dollar terms). However, these countries have little capacities to increase exports to enable them realize the gains from this opportunity.

In contrast, exchange rate depreciation has inflationary consequences as import prices are mainly dollar-denominated. Moreover, debt service burden increases in domestic currency terms, raising the prospect of additional fiscal difficulties.

On the other hand, for countries with a currency peg to the US dollar such as Djibouti, the appreciation of the dollar induces real exchange rate appreciation, undermining external competitiveness. This requires policy action to restore external competitiveness, and to counter the effects of the appreciation of the dollar.

## 3. BANK RESPONSES

The African Development Fund (ADF) is the Bank's main window of support to low-income countries, including fragile states. Access to ADF resources is determined by the performance-based allocation (PBA) system which, however, has the major drawback of prioritizing performance over needs, thereby penalizing poor-performing fragile states with chronically weak policies, institutions and governance.

Recognizing the difficulties faced by fragile states in accessing ADF resources, the Bank has responded with a Fragile State Facility (FSF) and Fragile State Unit to provide additional resources to fragile states especially those emerging from conflict or crisis. The support is intended to consolidate peace, stabilize the economy and lay the foundation for sustainable poverty-reduction and long-term economic growth. The FSF has three grant support windows:

- The **Supplemental Support Window** to enhance support, over and above the PBA-determined country allocation to eligible fragile states. This window is open to post-conflict countries that meet criteria aimed at assessing progress made in peace consolidation; improvement in macroeconomic stability, and transparency and accountability. Currently, only 9 countries have access to this window.

- The **Arrears Clearance Window** offers a one-off support for the clearance of arrears. Countries accessing this window should be eligible for HIPC debt relief.

- The **Targeted Support Window** provides supplemental funding for technical assistance and knowledge management that cannot be provided through the Bank's existing programs. This window is open to all fragile states.

The Bank has proposed an ADF guarantee instrument to leverage infrastructure financing in low-income countries by backstopping government obligations to commercial banks under specific circumstances. It has also established a Framework of Accelerated Resource Transfer to ADF Countries.

Funding for fragile states under the above facilities remains insufficient relative to their needs. The total ADF portfolio for all twenty fragile states for 2008 was less than US$ 1 billion. As at January 2009, total resources available for the Fragile States Facility were approximately US$ 890 million. On the other hand, as Table 1 shows, projected export revenue shortfalls for 2009 induced by the global economic meltdown runs into billions of dollars for some countries like Angola (US$38 billion), Sudan (US$ 5.5 billion), Republic of Congo (US$ 7.3 billion) and the Democratic Republic of Congo (US$ 2.9 billion). Total export revenue shortfalls for 2009 for the 13 countries in Table 1 amount to US$61 billion. Thus, fragile states would require substantial additional funding to compensate for the large export revenue shortfalls and other adverse effects of the crisis.

**Table 1: Export Revenue Shortfalls (Billion US$)**

| Country | 2009 | 2010 |
|---|---|---|
| Angola | 38.2 | 45 |
| Burundi | 0.01 | 0.01 |
| Central African Republic | 0.15 | 0.15 |
| Chad | 2.5 | 2.1 |
| Congo, Democratic Rep. | 2.9 | 4.5 |
| Congo, Republic | 7.3 | 8.6 |
| Cote d'Ivoire | 3.6 | 3.8 |
| Djibouti | 0.02 | 0.04 |
| Gambia, the | 0.03 | 0.04 |
| Guinea | 0.45 | 0.51 |
| Liberia | 0.36 | 0.77 |
| Sudan | 5.5 | 6.4 |
| Togo | 0.2 | 0.25 |

The Bank has also launched new initiatives to help Regional Member Countries weather the effects of the global economic meltdown. A US$ 1 billion Trade Finance Initiative (TFI) will be implemented in phases as the Bank develops the necessary capacity. This, however, is intended for countries experiencing difficulties in accessing trade finance as a result of the global financial crisis. Another initiative is a US$ 1.5 billion Emergency Liquidity Facility (ELF), designed to alleviate the current liquidity crunch faced by Regional Member Countries. The Facility will provide bridge financing to Regional Member Countries facing short-term and unexpected funding shortfalls resulting from the financial crisis, with a fast track approval process. Being short-term with relatively high interest rates, this facility is intended for middle-income countries (MICs) and not helpful for fragile states.

Thus, the need for channeling additional resources to fragile states in the context of the financial crisis remains critical. This is particularly so in view of the growing *capacity building* needs to augment their weak human and institutional capacity, the need to revitalize their economies to *create employment* to reduce poverty, consolidate peace and security, and create *social safety nets* to support to weaker social groups, including women, children, the disabled and the elderly.

Accumulation of *debt arrears* prevents fragile states from accessing valuable donor resources, to which the Bank has responded through it *Arrears Clearance Window* as an instrument under the Fragile States Facility (FSF). Additional resources to the FSF would permit an expansion of this window to countries constrained by arrears from accessing donor resources.

Indeed, the Bank is well placed to serve as a channel for the additional resources that fragile states require to deal with the effects of the global financial meltdown, having institutionalized a framework for addressing the special needs of fragile states. This institutional framework now needs to be expanded to accommodate additional resources. In this context, the Bank has set up the Fragile States Unit (FSU) to administer the Facility States Facility, but there is need for additional resources for the FSF to diversify instruments and increase its field presence to improve operational effectiveness in fragile states.

## QUESTIONS FOR DISCUSSION

1. How best can additional resources be channeled to assist fragile states to weather the global economic meltdown?

2. What are the effective strategies for setting up, financing, and managing safety net programs in fragile states?