AFRICAN DEVELOPMENT BANK GROUP

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Africa and the Financial Crisis: An Agenda for Action

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Executive Summary

The current economic and financial crisis affects all the drivers of African growth: prices and demand for primary commodities, capital flows and foreign direct investment and regional integration, especially in low-income countries and fragile states. Many countries face the risk of twin deficits (current account and fiscal deficits) and the crisis threatens the gains achieved in the last decade in the fight against poverty.

The African Development Bank responded quickly to support the continent by stretching all resources already at its disposal, through front-loading, fast-tracked disbursements and portfolio restructuring; stepping in several projects to provide additional funding and mobilizing existing programmatic instruments to support all countries, especially fragile states. Beyond these mainstream measures using existing resources and instruments, the Bank has developed a new set of crisis instruments, including an emergency liquidity facility and a trade finance initiative, of USD 1.5 and 1 billion respectively. By working directly with Ministers of Finance and Central Bank Governors, collaborating with the AU and ECA, the Bank has also played a catalytic role in enhancing Africa's voice and effective participation in international regulation and by articulating its interests in the G-20 and the other regulatory institutions. The Bank is therefore actively preparing to initiate an early General Capital Increase to boost the risk bearing capacity of the bank and to better position it to support member countries to face the negative effects of the crisis.

Africa and the Financial Crisis: An Agenda for Action

1. Introduction

The current economic and financial crisis affects all the drivers of Africa's economic growth: prices and demand for primary commodities, capital flows and foreign direct investment (FDI) and regional integration. Many countries are grappling with twin deficits, with widening current account and fiscal deficits. The crisis threatens to reverse policy reform gains and undermines efforts for poverty reduction, especially in low-income countries and fragile states. Responding to this crisis requires comprehensive and coordinated actions at various levels to prevent African countries from sliding back into economic stagnation and deepening poverty.

Given the diversity of social and economic circumstances of African countries, it is crucial that responses to the crisis are tailored and targeted to country specific circumstances. Fragile states, landlocked countries and middle-income countries require country-specific instruments to contain the negative impacts of the crisis. The objective of this concept note is to articulate the different issues faced by the continent in the current context so as to contribute to the debate on an agenda for action going forward. The second section of this concept note explores how the crisis is affecting the continent. The third section discusses the role of the Bank in assisting African economies while the last section concludes with what can be done to further promote growth and development in the RMCs.

2. Challenges Posed by the Crisis

The crisis has specifically aggravated the continent's development challenges. Since late 2008, growth forecasts for 2009 have been drastically revised downwards, from 5.9% in November 2008 to 2.8% in February 2009. In 2009, export growth is expected to drop by 7% while import growth will decline by 4.7%, resulting in a deterioration of trade balance for most countries. The shortage of liquidity and increased risk are causing a decline in badly needed capital inflows and curtailing the availability of trade finance. This further undermines trade, economic growth and the financing of infrastructure programs. Thus, while responding to the immediate challenge of revitalizing capital flows, the long-term challenge of economic diversification to reduce dependence on primary commodities remains key for improving Africa's resilience to external shocks.

The crisis also raises the risk of return of structural and macroeconomic imbalances, characterized by deepening fiscal and current account deficits, and accumulation of debt arrears. Overall, it is projected that the continent's surplus budgetary position amounting to 1.8% of GDP in 2008 will change to a deficit of 5% of GDP in 2009. Already, oil exporters (Angola, Congo Republic, Equatorial Guinea, Gabon, etc.) registered a deficit of 7% of GDP 2008, down from a surplus of 4% of GDP in 2008. This fiscal deficit will equally deepen for net oil importers. Moreover, from an overall current account surplus position of 2.9% of GDP in 2008, the continent will face a deficit of 4.4% of GDP in 2009. The large surplus of 8.8% of GDP for the group of oil exporters will also turn into a deficit of about 4% of GDP, making the continent's growth prospects even gloomier. These deficits coupled with reduced resources to close the financing gaps, weaken the continent's capacity to sustain macroeconomic stability and undermine growth recovery.

2.1 Investment and Access to Financing

Through its linkages to the real economy, the financial crisis is expected to significantly reduce private investment and private sector activity, a critical engine of economic growth. Private capital flows, which have recently outpaced Official Development Assistance (ODA) in Africa, increasing from US$ 29 billion in 2000 to US$ 52.98 billion in 2007, are now severely at risk of drying up as a result of the financial crisis. Foreign Direct Investment (FDI) is projected to decline by about 18% in 2009, from US$62 billion to about US$50.8 billion, with severe implications on private sector activity. At the same time, portfolio flows have already dropped by about 62%, from US$15.7 billion in 2007 to US$5.9 billion in 2008. All of these declines point to an important financing gap that will further slow down the continent's recovery prospects, given the strong reliance on FDI and portfolio flows to cover current account deficits. Governments' ability to mobilize capital on the international markets has been severely affected by the crisis. Since October 2008, sovereign debt spreads have been on the increase. Thus, several African countries, including Tunisia, Kenya, Uganda and Tanzania, decided to postpone bond issue in international financial markets to mobilize resources for financing growth, turning instead to local markets.

On the trade front, foreign lines of credit for trade financing have virtually closed. Local banks that have relied on credit lines from the international capital markets have had to scale back operations or have turned to alternative sources of financing from regional development banks, such as African Development Bank.

Similarly, remittances have already started to decline due to the economic down turn in developed and emerging economies. For countries such as Lesotho and Comoros where remittances represent over 20% of GDP, the effect of the crisis could be more devastating if the trends continue.

2.2 Adverse Impact on Regional Integration

The drying up of external financing is impacting negatively on the implementation of large projects, including large infrastructure projects that are crucial for regional integration. The crisis has aggravated the cost and shortage of financing infrastructure projects, causing project delays and even cancellations. In Sub-Saharan African, infrastructure projects that have been delayed or cancelled amount to US$1.35 billion.

Further, financial integration programs in the various African RECs have been underpinned by the progress in macroeconomic and financial sector reforms, leading to sustainable fiscal balances, stable exchange rate, reductions in inflation rates as well as strengthening of the banking systems. Macroeconomic convergence, which many RECs have made a core aspect of their financial integration programs, is also threatened by weakening national economies. Yet regional integration is critically important for the continent's ability to withstand the shocks and integrate into the global economy notably through market expansion, gains for economies of scale and improved competitiveness.

2.3 Low-Income Countries and Fragile States

The crisis is hitting countries whose conditions were already weak, especially low-income countries and fragile states. Fragile states are particularly vulnerable to external shocks due to the limited foreign reserves and thus limited fiscal and policy space to counter the effects of such shocks. Growth deceleration, cuts in aid flows and reduced export revenues will exacerbate existing balance of payments and budgetary constraints, which may force African governments to make costly macroeconomic adjustments.

Fragile states, are especially ill-prepared to make such adjustment because of their weak institutions or poor economic performance. Thus, there is a danger that such states currently implementing market reforms may reverse such policies to respond to the emergency of the crisis. The negative effects of such a scenario will be far reaching; the poor will be disproportionately affected due to lack of safety nets. Also, the existence of weak institutions undermines the effectiveness of social safety nets. The ability of weak governments to respond is severely constrained by the erosion of their fiscal space in the face of declining revenues. Scaling up of international support to these specific countries is critically important to protect the poor and preserve the modest gains in poverty reduction recorded before the crises.

3. The Role of the African Governments and the Development Community

We welcome the initiatives undertaken by the G-20 to help developing countries address the impact of the crisis. Indeed, responding effectively to the crisis places a shared responsibility on both African governments and their development partners. For African governments, the situation calls for strong commitment to pursue the reform agenda, improve macroeconomic management as well as concerted efforts for domestic resource mobilization. For its part, the international community should make a genuine effort to meet the G-20 commitment for scaling up aid, support Africa's reform agenda, avoid trade distorting policies and effectively include Africa in policy making and in debates and decisions on international financial regulation. Countries should have the ownership of their development policies and programs, and should be supported to make strategic choices and prioritize actions in accordance with country-specific circumstances, with adequate fiscal and policy space. The international community has an important role to play in this process, especially in supporting targeted interventions for mitigating the impact of the crises, such as those developed by the Multilateral Development Banks (MDBs) to improve Africa's access to finance. In April 2009, the G-20 agreed on an additional US$1.1 trillion programme to restore credit, growth and jobs in the world economy. At least US$100 billion will support additional lending by the MDBs.

4. The Role of the African Development Bank

The Bank will continue to play a catalytic role by mobilizing resources towards meeting Africa's financing needs and will enhance the continent's co-financing role. The Bank has introduced innovative instruments, and intends to use its own resources to leverage funds from other sources, including the private sector. In this regard, the Bank will scale up its financing from US$5.2 billion per annum projected before the crisis, to between US$8.8 billion and US$10.5 billion per annum in response to increased needs for financing by RMCs.

Counter-cyclical role - Traditional financing instruments such as budget support and balance of payment support are needed as short-term measures to address resource constraints for African Countries. In addition, the Bank is now exploring possibilities of providing guarantee instruments for access to international finance and lines of credit to the banking sector. In particular, 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, as well as a *Framework of Accelerated Resource Transfer to ADF Countries*. Based on a portfolio restructuring and reprogramming, the Bank will be able to leverage additional resources for ADF countries in 2009.

The Bank is also intensifying its role in mobilizing private sector resources for regional infrastructure, and supporting the involvement of local and regional private sector groupings in regional infrastructure projects. In this context, lending through its Private Sector window is projected to reach between US$2.4 and US$4.0 billion in the medium-term.

The Bank will capitalize on the *Making Finance Work for Africa* (MFW4A) project to improve transparency and disclosure by banks. The Bank is hosting the MFW4A Secretariat, a G8 initiative whose aim is to bring together African governments, development partners and the private sector to coordinate financial sector development efforts across the continent. Coordination leverages individual contributions to unleash the potential of the financial sector as an engine of shared growth.

Exploring the potential of African bond markets - The magnitude of the crisis and the sharp reduction in capital flows call for scaling up efforts to harness the potential of domestic resource mobilization. Concrete steps in this regard range from tax reforms to boost revenue collection, prudent use of natural resource wealth such as long-term investment reserve funds, and development of domestic bonds markets. Indeed, evidence points to large unused potential for domestic resource mobilization. For example, the Central Bank of Kenya successfully issued an infrastructure bond of 18.5 billion shillings (US$232.6 million) locally after reducing the threshold for local participation. The Bank is therefore developing an initiative to help maximize the potential of African bond markets, in collaboration with the African Financial Markets Initiative (AFMI). Domestic bond markets are an important means of mobilizing resources to support growth and investment.

Enhanced Policy Advisory Support - The Bank has also used its development knowledge and experience towards the search for solutions to the crisis, and in supporting governments and partners to alleviate the constraints.

4.1 Increasing the Voice and Representation of Africa

The November 2008 Conference of Finance Ministers and Central Bank Governors in Tunis, organized by the Bank, the African Union Commission (AUC) and the United Nations Economic Commission for Africa (ECA), discussed the early impacts of the crisis and possible solutions for Africa, and provided valuable inputs into the G-20 meeting in Washington in the same month. It also gave birth to the Committee of Ten Finance Ministers and Central Bank Governors (the C-10), which has been tasked with sustaining the debate on appropriate responses to the crisis and promoting Africa's voice in the global arena. The Bank has played a leading role in providing technical assistance to the Committee, notably through the preparation of analytical input for the meetings and in helping articulate an African position in the G-20 deliberations.

4.2 Supporting Trade-Related Initiatives

The crisis has increased the urgency of supporting the Doha Development Round to come to a successful conclusion to promote Africa's access to the markets of developed countries. However, given the multiplicity of trade-related constraints, opening access to markets alone will not be enough without removing constraints to Africa's competitiveness, notably poor infrastructure and lack of diversification. Thus, the Aid-for-Trade initiative must be supported in order to address internal supply side constraints to support the trade liberalization agenda. Beyond liberalization, there is a strong need for support in the areas of trade policy and regulation, trade-related infrastructure, trade-related adjustment and capacity building.

The G-20 ensured US$250 billion of support for trade finance and pledged to promote global trade and investment and reject protectionism. Many MDBs have already proposed emergency facilities and trade facilitation programs, including the IMF Short-Term Liquidity Facility (SLF) and the Bank's Trade Finance Initiative (TFI), which are promising responses to the drying up of trade finance. The USD 1 billion TFI will be implemented in phases as the Bank develops the necessary capacity: (i) African commercial banks and DFIs can use new trade finance line of credit (TF LOC) to support trade finance operations; (ii) The Bank will examine the feasibility of introducing products and services that provide more comprehensive assistance for trade finance and facilitation. The challenge is to finance these initiatives at a level that adequately addresses Africa's trade finance needs and to ensure that they are accessible to low income countries and fragile states.

4.3 Establishing Emergency Initiatives

The Bank has introduced two emergency facilities to close financing gaps resulting from the crisis: Emergency Liquidity Facility (ELF) and the Trade Finance Initiative (TFI). The USD 1.5 billion ELF is designed to alleviate the current liquidity crunch faced by RMCs. We believe these proposals reflect real needs and true demand. The crisis has highlighted the need to enhance the flexibility of the Bank's instruments to adapt to the changing environment. Ideally, the ELF will bridge funding gaps until normal funding conditions are restored. The Facility will provide bridge financing to RMCs facing short-term and unexpected funding shortfalls resulting from the financial crisis, with a fast track approval process. A lesson from the Bank's response to the food crisis is that innovation, flexibility and speed have been effective and appreciated by the recipient countries. Implementing these initiatives to a scale that will improve RMCs' resilience to the crisis will depend on the support from donors and stakeholders through approval and contribution to increasing the Bank's resource envelope, including a general capital increase.

5. What more Can the African Development Bank do?

The Global Plan for Recovery and Reform adopted by the G-20 in April 2009 will help bridge the financing gap faced by African countries. We hold it to the G20 to ensure that the pledges result in fast disbursements to the emerging and developing countries. However, RMCs will face the challenge of managing scaled up resources so as to minimize any adverse impact on macroeconomic stability.

The case of Low-Income Countries (LICs) and fragile states deserves particular attention, as these countries will not benefit from the ELF and the TFI. In April 2009, the G-20 decided that the additional resources from agreed IMF gold sales will be used for concessional finance for the poorest countries. However, attention should be given to services that most effectively enable human capital development and growth among the poor. Responding to the crisis should not in any way divert attention or resources from financing social programs that address structural problems, specifically those that target the poor and the marginalized groups. Protection of social spending (especially on education and health) is important in this context. Well-targeted safety nets, including cash transfers to poor households, can go a long way to addressing the negative effects on human development outcomes and avoiding sliding back on the MDGs. The MDBs have supported the idea of establishing a global vulnerability fund to help developing countries finance investments in three key areas: (i) Infrastructure projects; (ii) Safety net programs, and (iii) Financing for small and medium-sized businesses and microfinance institutions.

Unlike LICs, the African Middle-countries would meet the allocation criteria of the ELF and TFI and would also benefit from improved actions. Given the current trends of responses by the IMF and the World Bank, the AfDB will focus its actions in MICs, both in the area of financial and non-financial interventions especially in three main areas: (i) Financing of infrastructure development (ii) Making the Paris Declaration work and (iii) Establishing knowledge as a public good. The Bank could also offer loan guarantees to support partnerships for private investment as well as regional integration and trade.

To some member countries, these measures are not comprehensive. We have been challenged to design measures that directly benefit enterprises and banks in difficulty. Without doubt, there will be areas that may not be covered by the current response by the Bank or its sister institutions. But the Bank is prepared to periodically assessing the financing requirements as the crisis develops and tailoring the instruments to identified needs.

DISCUSSION QUESTIONS

- What has worked and what has not worked at country levels in addressing the different challenges of the global crisis?

- What additional roles can the AfDB play in promoting sound financial sectors in Africa and in helping countries better respond to the challenges of the crisis?

- Do the proposed measures by the Bank respond sufficiently to the development challenges faced by member countries as a result of the crisis?