THE 2009 AFRICAN DEVELOPMENT BANK GROUP ANNUAL MEETINGS

MINISTERIAL ROUND TABLE DISCUSSIONS AND HIGH LEVEL SEMINARS

CONCEPT NOTES

1. Ministerial Round Table Discussions – Africa and The Financial Crisis: An Agenda for Action.
2. High Level Seminar 1: The Global Financial Crisis and Fragile States in Africa.
3. High Level Seminar 2: The Financial Crisis, Trade and Regional Integration in Africa.
4. High Level Seminar 3: The Financial Crisis and Decades of Reforms: Options for Africa's Future.
5. High Level Seminar 4: The Financial Crisis and Access to Financing.

Dakar, Senegal – 12 May 2009
The Hôtel Méridien Président, Conference Centre
Dakar, Senegal

INTRODUTION TO THE CONCEPT NOTES

The Concept Notes for the 2009 Annual Meeting Seminars (AMS) are crafted around the theme: *"Africa and The Financial Crisis: An Agenda for Action*. They are set around the challenges posed by the current economic and financial crisis, and is divided into four specific topics to be examined in more detail during the High Level Seminars.

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. It has aggravated the risk of countries grappling with twin deficits (current account and fiscal deficits) and threatens to reverse policy reform gains and worsens poverty, 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.

The Seminars are organized into a Ministerial Round Table, which will be followed by four High Level Seminars. The Ministerial Round Table is intended to articulate the prevailing issues faced by the African continent in the current context of the financial crisis so as to contribute to the debate on an agenda for action going forward. The discussions at the Ministerial Round Table will be guided by a general Concept Note on '*Africa and the Financial Crisis: An Agenda for Action'*, which will highlight and briefly introduce the key sub-themes. The four High-Level Seminars are intended to delve further into each sub-theme each of which is informed by the concept notes on the following:

- High Level Seminar 1: The Global Financial Crisis and Fragile States in Africa.
- High Level Seminar 2: The Financial Crisis, Trade and Regional Integration in Africa.
- High Level Seminar 3: The Financial Crisis and Decades of Reforms: Options for Africa's Future.
- High Level Seminar 4: The Financial Crisis and access to Financing.

The concept notes provide general guidance to the discussion, highlight key issues under each theme and conclude with critical questions for consideration by the panelists. They are deliberately intended to be brief exposés, which set the tone for the Seminar discussions, without limiting it to issues raised in the notes. The expectation is that the Seminar will benefit from the wealth of experience and lessons to be shared by participants, drawn largely from their work in dealing with these issues and challenges in their countries.

Ministerial Round Table Discussions

AFRICA AND THE FINANCIAL CRISIS: AN AGENDA FOR ACTION

Concept Note

Date: *Tuesday, 12 May 2009*
Venue: *Plenary Hall*
The Hôtel Méridien Président, Conference Centre
Time: *9:00 am to 12:00 pm*

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 its risk bearing capacity 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.

Over the past decades, 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. With the crisis, macroeconomic convergence, which many RECs have made a core aspect of their financial integration programs, is 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

In most cases, 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 programmed 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.

Issues for Discussion:

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

ii. 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?

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

High Level Seminar I

THE GLOBAL FINANCIAL CRISIS
AND
FRAGILE STATES IN AFRICA

Concept Paper

Date: *Tuesday, 12 May 2009*
Venue: *Meeting Room B 005/006*
The Hôtel Méridien Président, Conference Centre
Time: *2:30 pm to 4:00 pm*

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. Additional resources would be required to meet the rising demands from fragile states.

The Global Financial Crisis and Fragile States in Africa

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

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.

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.

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.

Issues for Discussion:

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

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

HIGH LEVEL SEMINAR II

THE FINANCIAL CRISIS, TRADE AND REGIONAL INTEGRATION IN AFRICA

Concept Paper

Date: *Tuesday, 12 May 2009*
Venue: *Room C 005/006*
The Hôtel Méridien Président, Conference Centre
Time: *2:30 pm to 4:00 pm*

Executive Summary

Trade has been a key driver of Africa's growth surge in the last ten years. The sustainability of this trade-led growth is now threatened at a time when progress in the Doha Development Round has stalled and fears of increased trade protection are growing.

Africa's share of global trade is still low, amounting to only 3 percent in 2008. In addition, intra-African trade remains modest, representing just 8.3 percent of exports and 9.3 percent of imports. This poor performance of the continent is a result of both infrastructural constraints and poor trade facilitation such as customs and standards that make the movement of goods on the continent costly, thus reducing competitiveness in global trade.

Efforts to address the existing constraints are already underway and the crisis presents an opportunity for Africa to accelerate the pace towards deeper regional integration. Issues of multiple memberships in economic communities, harmonization and coordination of regional trade policies, and improvements in trade facilitation have recently attracted renewed donor interests. The Bank can play a critical role in supporting deeper regional integration, riding on the current wave of political support being expressed by Regional Member Countries (RMCs).

As the impact of the financial crisis continues to unfold, Africa remains challenged to think out of the box, as it seeks appropriate responses to the crisis. In particular, the efficacy of some of the suggested solutions needs further interrogation.

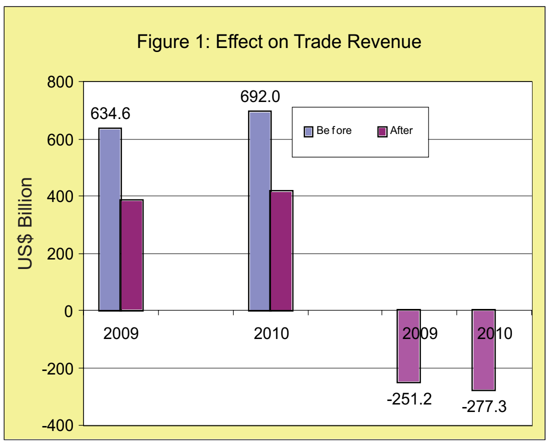
The Financial Crisis,
Trade and Regional Integration in Africa

1. Introduction

Trade has been one of the major drivers of Africa's growth surge in the last ten years. The sustainability of this trade-led growth is now threatened, due to the global financial crisis. While trade had been correctly identified as one of the channels through which the financial crisis would impact the continent, its magnitude was underestimated. The real sector effects, emerging largely through the trade and investment channels are proving to be more damaging than had previously been expected. Weakening global demand for Africa's exports and the resulting decline in commodity prices, projected to reach about 45 percent in 2009, will have far reaching implications for the continent's growth prospects.

Furthermore, many countries in Africa are heavily dependent on mineral and oil exports, which contribute up to 90 percent of total export earnings and over 50 percent of government revenue in some countries. Consequently, both social and infrastructure expenditures face possible drastic cuts unless alternative financing resources are found.

Given the limited linkages of export-oriented sectors with the rest of the economy, substantial job losses in these sectors affect other sectors through the income channel. As a result reduced demand for exports and a slowdown in private sector activity, the continent's growth prospects are bleak: a meager 2.8 percent real GDP growth rate is expected for 2009, down from 6 percent in 2007 and 5.7 percent in 2008.



Source: AfDB, March 2009

Africa's low share of global trade (only 3 percent in 2008), up to 50 percent of which is accounted for by South Africa, makes the situation even more dire. Intra-African trade remains modest, representing just 8.3 percent of exports and 9.3 percent of imports. Low intra-African trade is a result of both the lack of diversity in production and infrastructural constraints that limit the movement of goods on the continent. Notwithstanding improvements in the business environments in Africa, increased inflows of foreign capital and participation by local investors may now not be realized, especially as increasing protectionist measures in response to the financial crisis limit access to international markets. Support to continental growth drivers, therefore, will be critical in building the resilience of African economies.

The African Development Bank has already been engaged in efforts that can promote intra-African and South-South trade. In particular, accelerating processes towards deeper regional integration, including addressing constraints such as overlapping membership, infrastructure development and harmonization of economic, trade and financial policies, is now imperative. The Bank continues to support efforts aimed at breaking the impasse in the Doha Development Round and scaling up resources for the Aid-for-Trade initiatives.

There are also opportunities for the African Development Bank, mainly in its role as the premier development institution and voice on the continent. The Bank's experience and capacity will be critical assets in addressing some of the challenges, as the continent responds to the financial crisis.

2. Impact on Africa's Trade Prospects

As the developed world goes through the worst recession since the 1930s, African exports face a contracting market. Trade revenue in Africa is projected to decline by US$ 251 billion in 2009 from an expected level of US$ 634 billion and another US$ 277 billion in 2010 (Figure 1). The loss in export revenue will have serious implications for Africa's current account position. These projections may turn out to be underestimations of the impact of the crisis, as some countries resort to protectionist responses. Already, developed countries are providing subsidies (industry support schemes) while some developing countries are increasing tariffs (India and South Korea) and restricting import (Indonesia and Argentina). These measures will have an effect on the direction of trade flows.

African trade will be further squeezed through lack of trade credit. The World Bank estimates a financing gap of up to US$ 700 billion for all developing countries. The impact of tightening credit markets will have dire consequences on trade performance, further exacerbating the effects of the crisis. Small-to-medium enterprises (SMEs) that are key agents in the diversification of African production and job creation are particularly at risk. Export-oriented SMEs have difficulty accessing low-cost foreign currency denominated working capital, leading to low capacity utilization. The financial crisis reinforces existing market failures that result in sub-optimal allocation of credit to SMEs, while the current regulatory frameworks also contribute to this difficulty as banks respond in a pro-cyclical manner.

At the regional level, the crisis has dampened prospects for increased intra-Africa trade by worsening financing constraints for the RECs. African governments have not been able to fully provide for the financial requirements of RECs during the growth period. The financial crisis will compound the inability of these countries to meet their financial obligations to RECs, undermining their ability to effectively carry out their mandates.

The rationalization of the RECs, notably to reduce multiple memberships by African countries may partly reduce the burden that countries face in meeting their obligations to different regional bodies.

The poor state of infrastructure and inadequate trade facilitation in Africa are among the major factors contributing to lower intra-African trade. The rolling out of regional infrastructure projects and trade facilitation programs, especially within the context of the Enhanced Integrated Framework and Aid-for-Trade, is critically dependent on effective delivery of aid commitments. It is especially critical to prevent a retreat from infrastructure development and trade facilitation which would further weaken the continent's ability to absorb the impact of the crisis and further increase its marginalization in the global economy. Furthermore, deepening regional integration requires adequate infrastructure and trade facilitation, both of which will need to be funded through scaled up external assistance.

3. Opportunities for African Countries

South-South trade – Trade barriers in Africa remain, with an average tariff rate of about 19 percent compared to global tariff peaks at 15 percent. Currently, only 40 percent of exports from developing countries go to other developing countries. Thus, concerted efforts are required to reduce trade barriers in developing countries, to promote South-South trade.

Fostering regional integration – The Bank's medium-term strategy, underlines the growing importance of regional economic integration and infrastructure development, under NEPAD's development agenda. The Bank is ready to join forces with other partners whose resources can be leveraged. Deeper political support as indicated by the adoption of the *Plan of Action for Acceleration of Industrialization* by African Ministers of Trade, Mining and Industry in 2008 must be followed by concrete actions. The continent can take advantage of the current donor interests in the Spatial Development Initiatives (SDIs)[2]. SDI encourages integrated development within a given space, defined by its economic potential rather than by political exigencies.

Regional infrastructure development – Financing for infrastructure has declined significantly, particularly from bilateral donors. The Bank is willing to contribute to filling this gap through a careful selection criterion that maximizes the economic value of projects through stimulating a diverse range of economic activities in a regional context. But the Bank resources alone will not close the financing gap. Other donors and multilateral institutions will have to complement the efforts of the Bank. In this regard, the bank will continue supporting the efforts of the Infrastructure Consortium for

2 The term SDI refers to a multi-national development in infrastructure that links more than one country and it also includes all the necessary government policies (tax breaks, investments incentives, government support, etc.). An SDI can include a development corridor but it can also be a development such as trans-frontier Game Park of which there are several examples in Southern Africa.

Africa (ICA) in implementing the NEPAD action plan. RECs should move quickly with programs that enable the Bank to use its integrated structure as a source of advantage; by building synergies across public/private sectors and foster Public-Private Partnerships (PPPs). For instance, the development corridors under the SDI could generate significant economic value through the configuration, prioritization and promotion of inter-related infrastructure and large-scale economic sectoral investments in defined geographic areas. This will optimize the use of infrastructure, encourage value-added processing, enhance the competitiveness of African economies, and stimulate investment-led growth.

Implementing comprehensive policy reforms – There is evidence that the global economic landscape has its own challenges but offers opportunities as well. The Bank continues to strengthen its support to RMCs for comprehensive policy reforms, including strategies for deepening regional integration efforts. This support is critical especially in this period of economic crisis where countries face a real risk of policy reversal.

4. The Role of The African Development Bank

Counter-cyclical role – There is need for prompt action to mitigate the impact of the financial crisis and avoid a "*reverse development*" in RMCs. The Bank has quickly moved to implement short-term targeted interventions to mitigate procyclicality in the current financial environment. Two important objectives in this regard are: offsetting the decline in government revenues linked to falling trade volume, and compensating the decline in credit availability. On the trade front, the Bank will address the short-term trade credit shortage through the *Trade Finance Initiative* that seeks to make available trade financing through existing regional and private banking institutions. Furthermore, the *Emergency Lending Facility*, a multifaceted revolving credit facility that is disbursed in Euro or US$, has flexible utilization requirements and quick disbursing. These two measures compliment existing instrument, namely *budget support* to governments and *credit lines* to commercial and development banks. Efforts are also underway to scale up the Bank's financing from about US$ 5.2 billion per annum projected before the crisis to between US$ 8.8 billion and US$ 10.5 billion per annum.

Bank's support to regional integration – Deeper regional integration within Africa is imperative to build markets and new opportunities for growth, job creation and improved living standards; to create more robust, competitive and diversified economies; and, to attract and reward new sources of investment finance. With the Bank's RMCs having identified regional integration as a key strategic objective for the institution, an increasing amount of resources allocated in support of regional integration is required. However, the Bank faces resource constraints, and an increase in its resource envelop will be required to allow it to effectively support the regional integration agenda.

Strengthening financial integration – Deeper regional trade integration will require strengthening financial integration. This in turn will require a comprehensive program aimed at strengthening and streamlining *financial sector policies* and *financial* *infrastructure* (regulatory framework, payments systems). This will help in the development of strong *financial institutions* (banks, non-bank financial institutions bond and capital markets) and enhance the financial system's ability to mobilize and allocate resources, especially medium and long-term resources for development financing. This is critical for supporting private sector development, regional and international trade and, ultimately, growth and poverty reduction. While some actions have been taken in this area, both financial and human resources limit the Bank's reach and impact. Coordination and collaboration with other players should be pursued.

Voice for and within Africa – The Bank has committed itself to be an effective and credible voice for and within Africa. While there is substantial knowledge of the impact of the financial crisis, the impact is differential and is continuing to unfold. To effectively project Africa's voice as well as meaningfully influence RMCs' policy directions, the Bank has to possess superior information and demonstrate a deeper understanding of the continent and the challenges it is facing. This is possible through:

- An intensive information gathering process that allows critical analysis and drawing conclusions to inform country responses. The establishment of a network of information sources in selected parts of the continent, as recently implemented by the Financial Crisis Monitoring Group need to be strengthened and expanded.
- Using its convening power, the Bank continues to facilitate the process of developing a common African position, especially at the G-20 level and the Breton Woods Institutions. In addition, through its participation at various international forums, the Bank continues to project Africa's voice to ensure its effective participation and representation at the international level.
- In a similar vein, the Bank has added its voice in calling for a speedy conclusion of the Doha Development Agenda, which remains critical to stimulating the global economy. Successful conclusion of the Doha Round would help to better integrate developing countries, including those in sub-Saharan Africa, into the global trading system, which would spur global and regional growth and facilitate African attainment of the MDGs. Recent developments have shown that, instead of forging ahead with greater trade liberalization, developed and emerging economies are sliding back into a protectionist mode. Africa and other developing countries may emerge as the worst victims of a rise in protectionism.

Attendant risks can be avoided if Africa can realize its full potential in regional trade. Yet it has become very clear that though the Bank has a strategy to address major trade constraints on the continent, its implementation will be limited by inadequacy of resources, thereby requiring a longer time span to unlock existing potential. Securing a General Capital Increase (GCI) may help the Bank to mobilize more resources to help move the development agenda forward in a quicker and more effective manner.

Issues for Discussion:

i. What preferential arrangements should be put in place to help the integration of Africa into the global trading environment?

ii. How best should national governments respond to the crisis without jeopardizing progress on the regional integration agenda in Africa?

iii. What additional arrangements are needed to boost south-south trade?

HIGH LEVEL SEMINAR III

THE FINANCIAL CRISIS AND DECADES OF REFORM: OPTIONS FOR AFRICA'S FUTURE

Concept Paper

Date: *Tuesday, 12 May 2009*
Venue: *Meeting Room B 001*
The Hôtel Méridien Président, Conference Centre
Time: *4:30 pm to 6:00 pm*

Executive Summary

Improved policies, institutions and political leadership in Africa over the past decades have played a critical role in helping the continent achieve stronger macroeconomic fundamentals. The reform dividends have resulted in better economic performance as reflected in higher economic growth, fiscal surpluses, lower and more stable inflation, low and declining external debt burden. These gains, achieved through painful reforms, are threatened by the current economic crisis. In particular, the crisis is causing a deterioration of macroeconomic balances in most African countries. For example, Africa's growth is expected to slow down to 2.8% in 2009, down from 5.7% in 2008 and 6.1% in 2007. From an overall current account surplus position of 3.5% of GDP in 2008, the continent will face a deficit of 3.8% of GDP in 2009. The budget deficit is forecasted at about 5.5% of GDP in 2009.

While the current crisis has affected all the countries, it appears that countries that had stronger economic fundamentals before the crisis have weathered the storm better so far. These are typically the ones that successfully implemented comprehensive economic reforms. The lesson is that reforms are not only important for achieving higher economic performance, but they are also essential for cushioning the effects of external shocks. Thus, while focusing on mitigating the impact of the crisis, it is important that African countries do not backslide in their reform programs. To sustain the reform efforts, African countries will need strong and targeted assistance from development partners, including the African Development Bank. In particular, it is necessary to scale up the resource envelope at the disposal of regional and sub-regional banks to enable them to effectively respond to the crisis. The AfDB, as a knowledge bank, is complementing this effort with policy advocacy. In addition to scaling up resources, the crisis and post-crisis situation calls for more policy flexibility in order to optimize resource utilization. It also calls for differential application of instruments and measures to country groups given that the speed and nature of the impact of the crisis in Africa vary very significantly across countries depending on economic structure, policy constraints, natural resource endowments, and other specificities.

The Financial Crisis and Decades of Reform: Options for Africa's Future

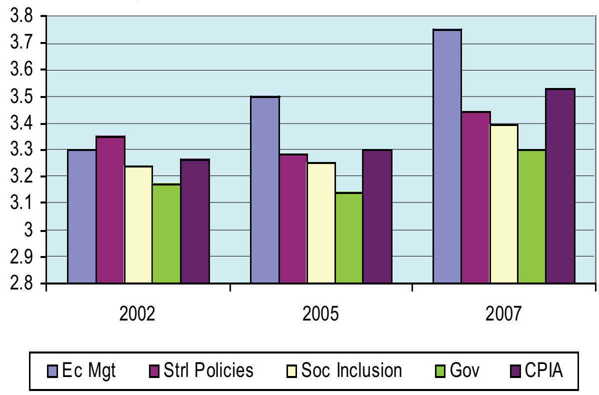
1. Introduction

Improved policies, institutions and political leadership over the past decades have played a critical role in the continent's ability to achieve stronger macroeconomic fundamentals. The reform dividends are reflected in higher economic growth with an average of 5 percent during the past seven years. Moreover, the continent recorded a fiscal surplus since 2005; average inflation dropped to single digits since 2002; the current account had been positive since 2003; the debt service to exports ratio declined to 10.6 percent in 2005, the lowest in two decades; and the debt to GDP ratio declined to 22.7 percent in 2007 compared to 76 percent in 1994. These gains are now threatened by the financial crisis.

This note discusses the implications of the current financial crisis for the continent's reform efforts, and especially highlights the risk of policy reversal. The note proposes a way forward and concludes with discussion questions to guide the deliberation of the panel discussions.

2. Africa's Reform Efforts

Fig. 1 Africa: Average Overall CPIA and its Components



Many African countries have intensified efforts in the last two decades to strengthen governance through the development of participatory decision-making processes that are inclusive of civil society and the private sector as well as local communities. Many have introduced decentralized governance structures as part of the efforts to broaden public participation and involvement in policy processes and implementation. Reforms have also resulted in improved public service delivery, strengthened capacities, and led to greater accountability and transparency in public administration. These have been reflected in improved country performance indicators for both policies and institutions, notably measured by the Country Policy and Institutional Assessment (CPIA) scores. The CPIA rates countries against a set of 16 criteria grouped in four clusters: (a) economic management;

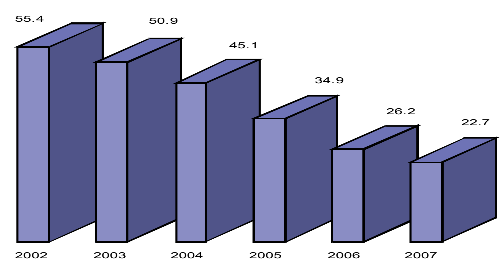
(b) structural policies; (c) policies for social inclusion and equity; and (d) public sector management and institutions, with 6 as the highest score and 1 the lowest.

Prudent fiscal reforms have also been reflected in strengthened tax systems, including simplified and more transparent tax codes, broadened tax bases, strengthened tax administration and improved supervision to increase accountability. These have been complemented by prudent monetary and exchange rate policies as well as improved regulatory frameworks.

In addition, since late 1980s, African countries began to implement financial sector reforms as part of broader market oriented reforms. The financial sector has improved since the implementation of reforms; in some countries, financial depth has improved; credit ceilings and directed credit have been eliminated and interest rates liberalized; risk management has been enhanced; and the banking system has improved—stronger balance sheets and capital base.
The last decade has also seen significant improvements in transparency and accountability in managing the continent's revenues generated by oil and precious minerals. This is particularly due to the emergence of several key initiatives, standards and mechanisms, including the Extractive Industries Transparency Initiative (EITI), the Kimberley Process Certification Scheme (KPCS), and the African Peer Review Mechanism (APRM).

The Highly Indebted Poor Countries (HIPC) initiative and the enhanced HIPC also provided additional incentives for deepening economic reforms. The HIPC initiative, along with the Multilateral Debt Relief Initiative (MDRI) encouraged countries to establish a track record of reforms and sound policies. By the end of 2008, 19 out of 33 eligible countries had reached completion point, while others are at various stages of the program.

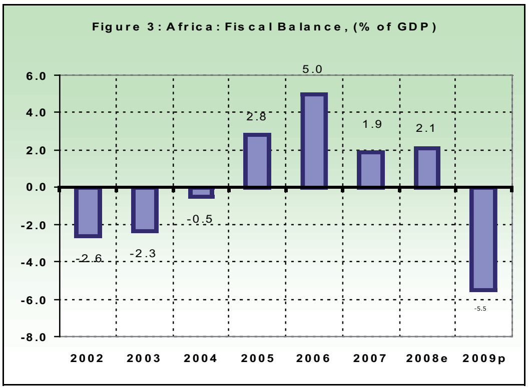
Figure 2: Africa: Debt Outstanding
(As Percentage of GDP)

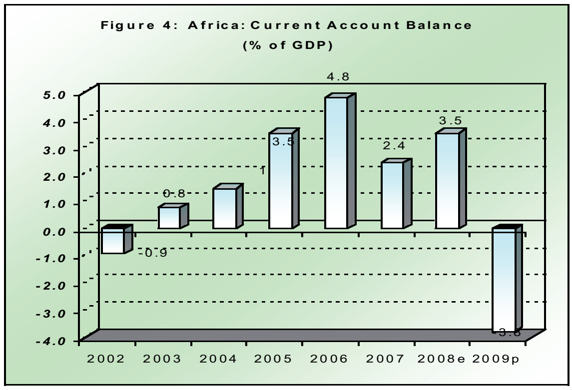


The critical challenge faced by the continent now is how to avoid reversing these reforms and sliding back into stagnation and deepening poverty.

3. The Overall Economic Outlook is Pessimistic

The gains achieved through the reforms of the past decades are threatened by the current economic crisis. Fiscal and current account balances are deteriorating in most African countries. The continent's growth is expected to slump, projected at 2.8% in 2009, down from 5.7% in 2008 and 6.1% in 2007. Overall, Africa will move from a budgetary surplus of about 2.1% of GDP in 2008 to a budget deficit of 5.5% of GDP in 2009 (Figure 3). Furthermore, African countries face rapidly deteriorating external conditions. The current account balance for the continent is projected to move from overall surplus position of 3.5% of GDP in 2008 to a deficit of 3.8% of GDP in 2009 (Figure 4). This situation has a potential of dragging the economies into a protracted recession.





Source: AfDB Statistics

Also, the crisis is hitting countries whose initial conditions were already weak, especially low-income countries and fragile states. In those countries, the poor are especially exposed to the effects due to lack of safety nets. The ability of governments to respond is also severely hindered by the erosion of their fiscal space in the face of declining revenues. Government's resources and attention may thus be diverted from pressing reforms and social programs to the exigencies of the crisis.

4. The Way Forward

Going forward, the key message is that even as African countries attempt to mitigate the impact of the crisis, it is important that they do not backslide in their reform programs. It is by preserving the gains of the reforms that the continent can position itself to take advantage of the global economic recovery of the crisis. Therefore, a comprehensive response agenda at both national and international levels is needed to keep countries on the growth track.

As the crisis hit the continent, African governments have taken a number of initiatives to mitigate the impact of financial and trade shocks, and some have set up special units to monitor the impact of the crisis and to formulate targeted responses. Some governments have responded by introducing a range of policy measures such as fiscal stimulus packages, targeted assistance to sectors, capital and exchange controls, new regulations in the banking sectors, expansionary monetary policies, and bond financing of public expenditure. However, the resources are inadequate in relation to the scale of the impact.
The following areas will require immediate attention from African governments, the continent's development partners, and the African Development Bank:

4.1 The Role of African Countries

To speed up recovery, move back to a path of high growth and accelerate progress in poverty reduction, actions required by **African countries** to deepen reforms include the following:

- Promote trade within the continent by improving the regulatory environment and transport infrastructure;
- persist with macroeconomic reforms;
- Setting up safety nets to protect the poor and marginalized groups; and
- Deepen the financial sector and strengthen financial sector regulation to ensure stability and sustain domestic drivers of growth. These should be embedded within a strategy for boosting domestic resource mobilization to support investment and growth, and reduce reliance on external financing.

The Role of the International Community

Africa's **development partners** need to:

- Increase resource allocations into crisis-response initiatives to support lending to Africa, especially for trade financing, and infrastructure development;
- Honor commitments to increase aid to Africa as agreed at Gleneagles and as reiterated at the April G20 meeting;
- Scale up support for African and international reform initiatives, including those related to Enhanced HIPCs, MDRI, EITI, the Kimberly Process, and the APRM;
- Adhere to and support the principles imbedded in the Paris Declaration and other global conventions towards higher aid effectiveness;
- Promote a stronger African voice in the multilateral organizations; and
- Put in place effective independent mechanisms to monitor and report on progress on implementation of internationally-agreed initiatives in support of African development.

4.2 The Role of the African Development Bank (AfDB) Group

In response to the financial crisis, he Bank has established targeted initiatives for an effective response, notably the *Emergency Liquidity Facility (ELF)*, the *Trade Financing Initiative (TFI)* and accelerated transfers to *ADF* countries. These initiatives need to be supported by the injection of new resources into the Bank's envelope to ensure successful implementation. Traditional instruments such as budget support and balance of payment support are needed as short-term instruments in addressing resource constraints faced by African Countries. Although such initiatives are useful in mitigating negative shocks, more resources and instruments will be needed to meet the needs of African countries.

Through partnership with its international development stakeholders, the Bank will continue to leverage its capabilities as the leading development finance institution in Africa so as to promote greater coherence and harmonization with the international development community and build new synergies for resource mobilization as well as enhance greater development effectiveness.

The Bank also seeks to strengthen and scale up its advocacy role by: strengthening its analytical capacity; intensifying detailed information gathering at the country, sector and regional levels on a consistent basis; strengthening collaboration and partnerships with other MDBs and other organizations; and generating suggestions for policies tailored to country-specific circumstances and needs. The Bank will draw upon the resources from this exercise to inform clients (RMCs) so they can equip themselves to weather the crisis, adapt their development strategies, sustain economic growth and alleviate poverty.

4.3 So What More Can the Bank Do?

However, the speed and nature of the impact of the crisis in Africa vary very significantly across countries depending on economic structure, policy constraints, resource endowments, and other specificities. 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 have limited fiscal and policy space to counter the effects of such shocks. Indeed, a number of **low-income African countries (LICs)** are highly vulnerable and have a more constrained fiscal policy space due to their high current account deficits and fiscal deficits. **Middle-income countries (MICs)** have been hit severely due to their relatively higher integration into the global economy. Although **non-resource-rich countries**, especially non-oil exporters, are benefiting from the decline in oil prices, their populations are severely affected by the crisis due to their already relatively lower pre-crisis living standards. **Natural resource-rich countries**, especially those with low levels of international reserves, are particularly at risk due to falling export revenues and dwindling investments in the natural resource sector. Special instruments and measures would therefore be needed to help each group of countries weather the crisis.

A critical area of intervention in **fragile states** is for the Bank help their governments build legitimacy and effectiveness by promoting transparent management of resources and provision of security, notably by assisting them to build and pay for their own reliable police and armed forces. Other areas of the Bank's operational intervention involve mainstreaming, capacity development for good governance in every operation; using the private sector window to crowd in the private sector through the provision of investment and advisory services, investment climate assessments, developing basic financial services and micro-credit, and encouraging better corporate governance; greater coordination and integration of activities with other development partners through joint assessments, joint benchmarks, greater divisions of labor, leveraging synergies, and sharing best practices; and greater use of Trust Funds to pool resources with other donors so as to reduce the administrative burden on already weak governments of having to deal with multiple donor procedures.

The Bank could therefore establish a new **Vulnerability Financing Facility or** a **Rapid Social Response Fund** to help mobilize more funding to protect the poorest and the most vulnerable in all country groups through the provision of urgent help in the form of maternal and infant health care, targeted micro-credit schemes, public works schemes that provide employment and a living wage, nutrition programs, and school meals. In addition, efforts should be made to encourage particularly low-income African countries to improve the targeting of their spending on social safety nets.

The member countries need to develop an effective early-warning system, with a focus on poverty through a **country poverty alert**. The country alert will help the country and development partners capture real-time information on how many children are being pulled out of school due to the crisis, how many people are unable to have access to health care, how many people have lost their jobs, how many people are dying of hunger and starvation, among others – information on which the Bank can act in time to make a real difference.

In **natural resource-rich countries**, the Bank intends to scale up its technical assistance and advisory services to member countries through its Legal Support Facility (LSF) while using its guarantee facility to help secure foreign direct investment (FDI) not only to the natural resources sector but also to other sectors of the African economy. These would be complemented by mobilizing the Bank's knowledge resources to identify additional country needs.

Issues for Discussion

i. What can we learn from Africa's reform successes and how can these reforms be preserved and deepened even further?

ii. How should African governments handle the domestic fallout of the ongoing economic crisis (loss of jobs, growing poverty, declining fiscal revenues, vulnerable groups, etc), and at the same time push forward with economic and trade reforms?

iii. What is the role of the State vis-à-vis the private sector in weathering the storm of the crisis?

High Level Seminar IV

THE FINANCIAL CRISIS
AND
ACCESS TO FINANCING

Concept Paper

Date: *Tuesday, 12 May 2009*
Venue: *Meeting Room Chef delegation – A 001*
The Hôtel Méridien Président, Conference Centre
Time: *4:30 pm to 6:00 pm*

Executive Summary

Africa's access to international capital has been substantially reduced as a result of the financial crisis. Foreign lines of credit have virtually closed. Local African 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 the African Development Bank. Private capital flows, which have recently overtaken 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. Similarly, remittances have already started to decline significantly due to the economic down turn in developed and emerging economies.

The situation calls for increased efforts to improve domestic resource mobilization. This will require deepening domestic financial intermediation to mobilize savings, introduce instruments with longer maturity to meet long-term investment needs, and provide adequate incentives and capacities to banks to lend to traditionally credit rationed sectors. To channel resources more efficiently, it is important to explore the use of innovative mechanisms for reducing risks, such as loan guarantees, which have proven to be effective in developed countries and several African countries. Moreover, developing national and regional bond markets can help channel excess banking sector liquidity into productive sectors. MDBs, and especially the African Development Bank have an important role to play in this process.

While posing serious challenges for the development of the African economies, the financial crisis presents some opportunities that need to be seized. Some proposals have been advanced on how the continent can forge ahead with these challenges but some questions still remain. Thus, the Concept Note seeks to articulate these issues and develop key questions that will guide the panel discussions.

The Financial Crisis and Access to Financing

1. Introduction

As developed countries intensify their response to the economic crisis, there is renewed commitment globally to assist Africa and developing countries in general to minimize the impact of the crisis. Access to finance has become the most critical challenge faced by African countries. The continent faces a fall in foreign capital inflows, at a time when export earnings are declining due to weakening export demand and declining commodity prices, combined with drastically falling tourism receipts. Therefore the challenges that the continent now faces include safeguarding the gains from decades of reforms, avoiding a deep recession and recovering its growth momentum, securing alternative sources of development financing, including domestic resource mobilization and revitalizing efforts to meet the MDGs.

After an average growth rate of 5.6 percent during 2003-07, the continent's economic growth is projected to decline to around 2.8 percent in 2009. While evidence of the impact of crisis on African countries is increasing, their capacity to respond effectively is limited, given the weak fiscal space. For most countries, macroeconomic balances have weakened further in 2008, as a result of the crisis.

The key challenges faced by Africa in this context are the shortage of financing for public investment, private investment, and trade. These are critical not only for minimizing the impact of the crisis but also for positioning the continent to take advantage of global recovery after the crisis.

2. Increasing Scarcity of Financial Resources

Credit crunch – While African banks survived the initial impact of the financial crisis due to lack of direct exposure to the American mortgage related bad debts, their access to international capital has been severely curtailed. In particular, short-term trade credit has almost dried up as international correspondent banks raise thresholds for African banks, effectively cutting them off from accessing credit. This situation threatens trade in Africa, with little light at the end of the tunnel. This leaves the continent with a tremendous challenge of seeking alternative sources of trade finance, if Africa is to recover from the gloomy economic malaise.

Capital inflows – The crisis is reversing the recent upward trend in capital flows. Bank credit and other private foreign capital flows are declining.

The G20 has given renewed hope to Africa for increased development assistance, with several pledges for new initiatives. The challenge will be to ensure that these pledges are followed by effective aid delivery.

Remittances to sub-Saharan Africa amounted to US$19 billion in 2007, an equivalent of 2.5 percent of GDP. The World Bank estimated Nigeria to have received US$ 3.3 billion in 2007, followed by Kenya with US$ 1.3 billion, and Senegal with US$ 0.9 billion. Remittances to developing countries peaked at around US$ 283 billion in 2008 but are expected to fall by between 1 and 6 percent in 2009. Remittances account for more than 15 percent of GDP in several African countries

Unfortunately, remittances are declining as a result of the crisis. According to the World Bank, remittances to sub-Saharan Africa will decline by between 4.4% and 7.9% in 2009, after a 6.3% increase in 2008. A fall in remittances will undermine access of small and medium enterprises to a once reliable source of financing. Beyond subsistence, remittances are instrumental in the education and healthcare sectors.

Shortage of infrastructure financing – The continent is facing severe infrastructure constraints; it is trailing behind other developing regions in access to infrastructure services, especially for rural areas. The Bank estimates that US$80 billion per year is needed to finance the infrastructure gap. This calls for scaling up and targeting development assistance to infrastructure investment.

Access to finance for SMEs – Sectors such as the SMEs are the worst affected, given that domestic and international credit flows are primarily to large established firms. The SME sector is considered risky either because of a lack of credit history of the enterprise or lack of adequate collateral. Further, SMEs tend to have a higher rate of failure, which can be as high as 40 percent in some countries. However, SMEs have been observed to be more innovative and more labor intensive. Therefore the worsening credit constraints faced by SMEs will have severe impacts on employment and living standards.

3. Strategies for Domestic Resource Mobilization

Since the 2002 Monterrey Consensus on financing for development, an increased attention has been paid to domestic resource mobilization as a source of finance for PRSP implementation. This attention is now being renewed as the global financial crisis is likely to lead to reduced aid and private capital flows into Africa. In this context, African countries need to strengthen domestic resource mobilization, more than ever, to supplement aid and pursue their development efforts.

The development of the domestic financial sector is a critical factor for improving domestic resource mobilization. The focus must be on promoting efficiency and deepening the financial system. Currently, access to financial services on the continent is very limited, with exclusion ratios as high as 54 percent in countries such as Tanzania. The lowest ratio is about 25 percent in South Africa. While financial education remains necessary to raise awareness among the populations, it is crucial to provide incentives for financial sector institutions to develop low cost services and products, and to expand coverage especially in the rural sector. The use of modern technology can improve access by reducing transactions costs.

Domestic resource mobilization is severely constrained by the lack of depth of most African financial systems. The bank deposits/GDP ratio is 29 percent on average for the continent compared to 65 percent for rest of world. In spite of commendable strides in mobilizing insurance savings, such savings only constitute a small proportion of domestic resources, at a meager 0.03 percent of GDP. Africa also has poorly developed stock and bond markets. The sum of public and private bond market capitalization to GDP amounts to only 42 percent, compared to 76 percent average for the rest of the world. Moreover, the lack of innovative mechanisms to increase the participation rates in these markets has excluded potential players that could contribute to a greater mobilization of domestic savings.

Recent evidence in Kenya reaffirms that some flexibility in setting the rules in the ***bond market*** can yield significant benefits. Following a downward adjustment in the thresholds for public participation Kenya's infrastructure bond was oversubscribed by 152 percent in January 2009. This experience in Kenya refutes the notion that low participation in the financial sector in Africa is due to low per capita income. It is clear from this experience that the full potential of Africa's domestic bond markets to contribute to the raising of financial resources for development needs is under-utilized. Domestic savings may turn out to be significant and possibly a cheaper alternative to external sources of financing.

In most African countries, the ***tax base*** is narrow. Fiscal reforms are needed to expand the tax base and improve the efficiency of tax collections. In most countries, ***private pension schemes*** are of limited coverage, dysfunctional or absent altogether while social security schemes remain underdeveloped. In the face of declining foreign capital inflows and the mounting pressure for governments to finance infrastructure development, revitalizing domestic sources of revenue should be a priority. Also, given projected decline in ODA, it is imperative to enhance revenue earning capacities of governments, while also exploring mechanisms for greater private sector involvement notably through public-private financing arrangements.

Finally better mobilization and maximization of the development impact of remittances is crucial in Africa as it can promote business opportunities and stimulate job creation. More importantly, remittances can become a reliable and predictable source of financing for small and medium enterprises, respond to social needs in the health and education sectors, and provide safety nets for augmenting subsistence for the poor.
Stabilization funds – African countries need to examine the role of stabilization funds

as a source of countercyclical resources. An example is the Nigerian Excess Crude Oil Account that collects revenue accruing above a pre-determined level. Such resources would only be drawn upon for financing development projects or when the price falls below a certain threshold. This can provide additional comfort in adverse times.

4. The Role of The African Development Bank

New financing initiatives – The Bank has responded to the crisis by setting up special initiatives to alleviate the credit constraints faced by the private sector and African governments. In this context, it has launched an *Emergency Liquidity Facility* (ELF) and a *Trade Finance Initiative* (TFI). The ELF is an exceptional multi-purpose facility (US$ 1.5 billion) providing financial support to AfDB eligible countries and non sovereign operations in all RMCs facing financial constraints due to the global financial crisis. This objective is achieved through the flexibility of the instruments to adapt to the changing environment. The instrument also covers a broad range of beneficiaries including Medium Income Countries (MICs) and/or their Central Banks, public and private finance institutions and corporations in all RMCs. The facility provides bridging finance, with a fast track disbursement, but with strict eligibility criteria.

In addition, the US$ 1 billion Trade Finance Initiative is initially meant to provide lines of credit that will allow African commercial banks and Development finance Institutions (DFIs) to use Bank resources to support trade finance operations. Ultimately, the Bank intends to make trade financing part of its financial instruments along the lines of the programs developed by the IFC and other regional MDBs. The focus of these interventions will be on providing guarantees in support of weak banking institutions to access trade financing for African exporters.

Similar initiatives have been put in place by the International Monetary Fund and the World Bank. The World Bank has even called for the allocation of at least 0.7 percent of any stimulus package in the developed countries, to a *Vulnerability Fund* for Africa. The G20 April meeting reiterated the need for scaling up crisis response initiatives and commitments have been made in this regard. The basic objectives of these initiatives are to ensure macroeconomic stability and to provide countercyclical finance to mitigate the impact of the crisis. It is imperative to ensure that these commitments are met in a timely fashion.

Leveraging funds for SMEs – The Strategy Update for the Bank's Private Sector Operations listed supporting SMEs as one of the private sector development strategic priorities. While the Bank has been supporting SMEs by availing credit through lines of credit, Partial Credit Guarantees (PCGs) have been identified as one of the core financial instruments to mobilize financial resources for economic and social development of regional member countries (RMCs). In 2008, the Bank approved five PCGs worth US$ 60 million to ease SME access to finance in Cameroon, Ghana, Kenya, Tanzania and Zambia. Given that SMEs face a greater challenge in accessing finance, especially in the context of the current financial crisis, this raises the urgency for timely interventions to avoid enterprise closures. However, it has also been recognized that that the Bank needs to minimize moral hazards. Thus, the risk sharing requirement of approved PCG schemes guarantee of 50 percent of the principal of investment loans, with guarantees delivered through a portfolio model to maximize on the number of SMEs that access bank credit.

Bond market development and infrastructure financing – There is an urgent need to develop domestic capital markets in Africa as a complementary source of development financing. Well-functioning, deep and liquid bond markets can help countries access long-term debt in local currency thereby providing much-needed financing for the constantly growing housing and infrastructure needs. This is particularly important, as countries are unable to access international capital markets and are faced with a likely decrease in aid financing in the face of the global financial crisis.

Indeed, it is estimated that Africa will need an estimated US$ 80 billion of infrastructure investment per year, in order to narrow the gap with its developing country peers and show faster progress toward the Millennium Development Goals. Moreover, in Africa, corporate bond markets are either nonexistent or in their infancy, with the public sector dominating debt issuance, mainly with debt instruments of very short tenor and activities focused on the domestic primary market with limited secondary trading. Although several countries have listed the bonds on the stock exchange, secondary market trading remains virtually non existent due to the “buy and hold” strategy of domestic banks that hold about 70 percent of bonds issued. This outcome is a result of the limited lending opportunities and prudential requirements.

Several stakeholders have made some efforts to develop bond markets in Africa but with limited success, due to the fragmented nature of these efforts. The Bank is now leading efforts to harness the potential of national and regional bond markets, paying particular attention to identifying and lowering market risks, volatilities, and uncertainties. Under the African Financial Markets Initiative (AFMI), which falls within the framework of Making Finance Work for Africa (MFW4A) Partnership, a study covering five regions on the continent has just been completed.

Further initiatives for resource mobilization – The Bank is currently preparing a strategy to support remittance mobilization through the *migration and development initiative*, which aims at maximizing the development impact of remittances by reducing their cost, increasing their productive use, and promoting business opportunities and job creation at the grassroots level. A trust fund for this initiative is being created to which France has already committed Euro 6 million. Furthermore, the Bank in cooperation with the World Bank has undertaken a study on migration and remittances which will improve our understanding of the dynamics of remittance flows and migration, and strengthen the capacity of policy makers, researchers, banks, financial institutions and donor agencies to enhance the development impact of migration and remittances in Africa.

Finally the Bank is also supporting *fiscal reforms* for improved domestic resource mobilization. The Bank is a founding member of the *African Tax Administration Forum*, envisaged as a focal point for sharing good practices and setting strategic direction for African Tax Administration.

Supporting financial sector reforms – The African Financial Markets Initiative (AFMI) complements the Bank's advisory role, through its continued support in financial sector reforms, and indeed policy reforms in general, to ensure financial stability and increase the resilience of African economies. This involves institutional capacity building and strengthening to ensure efficient management of the transformative process.

Prudential regulation and supervision – One of the pillars in the Bank's Medium-Term Strategy involves institutional and human resource capacity building. Regulatory institutions in many African countries lack the capacity to adequately regulate and supervise financial institutions. The Bank, together with other international institutions involved in this area, can play an important role in helping to develop an appropriate regulatory and supervision framework best suited to the needs and conditions of the continent.

The way forward – While these initiatives of the Bank are timely and critical for minimizing the impact of the crisis, they remain insufficient for responding to the increasing resource requirements. The continent will need up to USD 50 billion in 2009 just to sustain the pre-crisis growth rates. To achieve the growth rates needed to reach the MDGs, the continent would require as much as USD 117 billion. Clearly the G20 commitments for increased resources could not have come at a more opportune time. The challenge is now to deliver on these commitments.

Issues for Discussion

i. Is the international response well tailored to the different requirements of the African countries?

ii. Is the response commensurate to the challenges faced by the countries?

iii. What additional measures should be considered by the MDBs to increase access to finance?