Global Financial Crisis: An African Perspective

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I. Introduction

The global financial system has witnessed rapid growth and substantial structural change during the last ten years leading to globalisation of financial markets. The integration of financial markets has accentuated the rapid flow of capital across borders as well as magnified the contagious effects of financial crisis with wide implications for transmission of financial policies on the domestic economy and internationally. The recent financial crisis which originated in East and South East Asia (hereafter Asia) and transformed into a global crisis is a case in point. At no time since the depths of the LDC debt crisis of the 1980s has the outlook for emerging markets appeared so bleak. Economic outlook in Asia and its financial crisis appears destined to last well into 1999, and the world faces the prospects of weaker growth. This paper reviews recent trends in global financial markets, in particular the expanding financial turmoil, which was been triggered by the Asian crisis. It examines the major factors behind financial turmoil and its impact on African countries. The paper also explores the main lessons and policy implications for African countries. Following this introduction, Section II gives a brief account of the dynamics of the crisis—its origin and channels of transmission from one region to another. Section III examines the main causes of the crisis and Section IV provides a discussion of the qualitative and quantitative impact of the crisis on African countries. The main lessons and policy implications are draw in Section V. Section VI provides the concluding remarks.

II. The Dynamics of the Crisis

The present financial crisis which originated in East Asia has been triggered by the devaluation of the Thai Currency (the baht) in July 1997, which prompted attacks on East Asian currencies and stocks. This situation was accentuated when Malaysia took a snap decision to ban short-selling— the sale of a borrowed stock in anticipation of buying it back later at a cheaper price. The ban on short-selling caused some investors to sell up all together and leave the market. Consequently, the Malaysian currency (the ringgit) plunged to a new all-time low, prompting fresh attacks on East Asian currencies. Panic selling set in, amid fears of rising interest rates and slowing economic growth, causing large capital outflows and a flight-to-quality phenomenon with investors seeking a safe haven for their funds. Some Asian stock markets have suffered worse declines than the Wall Street Crash of 1929. In Indonesia, Jakarta's composite index dropped by more than 55 percent between December 1996 and September

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1998. During the same period, South Korea stock index dropped by 42 percent from 651 to 310. Between June 1997 and August 1998 the value of national currencies in the region experienced large deterioration ranging between 500 percent for Indonesia and 55 percent for South Korea.

A direct result of the crisis is the deep economic recession in the region affecting many Asia economies, particularly Indonesia, South Korea, Thailand, and Malaysia. In Indonesia, the economic decline is threatening to erode the gains in living standards that accumulated during the last 30 years. The banking systems have been weakened considerably and there is fear that the country may default on its external debt obligations. Real GDP for this year is estimated to decline by 5 per cent, compared with an increase of a similar rate last year. In South Korea, real GDP is forecast to decline by about 1 per cent in 1998, compared with a growth rate of 5.5 per cent last year. In Malaysia, GDP growth in 1998 is expected to slow down by more than 5 percentage points from the 7.8 per cent growth rate of 1997. Economic decline in Thailand is expected to deepen, with GDP recording negative growth rates of 0.4 per cent and 3.1 per cent in 1997 and 1998, respectively.

Japan, the leading economy in the region and the world's second largest economy, is experiencing its worst recession since World War II, with real GDP expected to decline in 1998 after its stagnation in 1997. While the crisis in other Asian countries made Japan's economic recovery more difficult, the country's economic decline is deeply rooted in the fragility of its banking system, which reflects long-standing problems. Weaknesses in Japan's banking system persist in three main areas: the problem loans are not fully reflected in banks' balance sheets; the capital base of banks is weak; and the process of loan recovery continues to be slow. The recent economic decline in the country and the crisis in other Asian countries caused further deterioration in bank loan portfolio. The scale of uncovered losses remains a major source of uncertainty for investors. Concerns over the Japanese banking system and a surge in government bonds drew funds out of the stock market, with the Tokyo's benchmark Nikkei falling to a 12-year low in mid-September 1998. The Asian crisis and the recession in Japan, which are expected to persist into 1999, jolted confidence throughout the international financial system causing turmoil in world stock markets.

In Russia, political uncertainty against a background of weak domestic economic fundamentals and general economic decline in Asia precipitated a deep financial crisis in August 1998. With its hard currency reserves dwindling fast and its political crisis still festering, Russia could no longer afford to defend the currency by selling dollars (the central bank had spent $700 million in the last week of August alone defending the rouble). The crisis, although triggered by developments in the political arena, has its origin in deep structural weaknesses including large budget deficits caused by unstructured tax base and inadequate tax-collection system; mounting foreign indebtedness; weak financial and banking systems; soaring inflation and sluggish growth rate. The financial meltdown, which followed the crisis, is feared to have large human and political consequences, discouraging, thereby, the inflow of acutely needed foreign capital.

It is feared that the financial turmoil rippling through Russia may be a prelude to a similar scenario in Latin America. There are already indications that some economies in Latin America may be on the brink of becoming the next casualty. This fear was strengthened by Colombia's move to devalue its peso by 9 percent in September 1998, which is expected to exert strong downward pressure on the values of currencies in the region. Also, some investors are concerned that Brazil and Mexico could see an exodus of capital as devaluation rumours persist. Early in September 1998, Moody's Investors Service downgraded or put on review the overseas debt of Argentina, Brazil, Mexico and Venezuela, primarily because of the Asian crisis and its global repercussions. The situation in the region became even more strained when Brazil's key share index (Bovespa) plunged by 10 per cent, and the Mexican IPC Index decreased by 4 per cent in mid-September. Mainly as a result of the expanding financial

crisis, the growth rate of Latin American countries is projected to slide down from an average of 5 per cent in 1997, to an estimated 3.4 per cent in 1998. The largest economy in the region, Brazil, is projected to grow by only 1.5 per cent in 1998 — half of its growth rate last year.

Should Latin America succumb, the impact on U.S. markets would be as much psychological as financial. A currency cave-in in Latin America could drag down several U.S. sectors that rely on Latin American markets. Those industries include consumer goods, machine tools, pharmaceuticals and chemicals. US stock markets are already showing signs of strain, with the Dow Jones falling by almost 20 per cent in August 1998. Although it recovered partially in September, the market remained nervous with regard to developments in Asia, Russia and Latin America. At this point of time, with Japan, the second largest economy in the world in recession, the scenario for a global depression, seems to rest on future developments in North and South America. If the Brazilian real is devalued, growth in South America will be sharply curtailed reducing growth in the US and Canada. If North and South America go into recession, then growth will be reduced worldwide.

III. The Root Causes of the Crisis

The onset of the Asian crisis seems to have taken many by surprise. For decades, these countries had been among some of the most successful in sustaining high rates of economic growth, recording high saving and investment rates and improving the quality of life of their citizens. Asian governments had, over an extended period followed prudent economic policies that succeeded in creating a favourable macroeconomic environment. Also and more important, most macroeconomic indicators did not provide adequate warning signs of the impending crisis, leading others to suggest that the markets, reinforced by a faulty policy response of the international community simply panicked or over-reacted and that the fundamentals did not warrant such a reaction. As the crisis unfolded and spread to other regions, a number of explanations have been advanced towards explains its origins. Some have argued that Asian countries were victims of their own success in that because they had been so successful in their economic policies, foreign investors tended to ignore the underlying weaknesses of the economies. Others have put more emphasis on moral hazard problems that characterised the Asian model of development. However, a consensus view is emerging which argues that the Asian crisis exhibited a hybrid of structural and policy distortions macro-and micro-economic in the affected economies.

Macroeconomic Explanations

None of the standard fundamentals, such as GDP growth, fiscal balance and inflation gave an indication of the problems that were to come. Most of the Asian countries registered GDP growth rates of between 6 and 8 per cent per annum during the period 1990-96 (see Table1). Thailand, where the crisis began averaged growth rates 8.5 per cent per annum between 1990 and 1996. Philippines, which had performed rather poorly at the beginning of the 1990s recovered to register a 5.8 per cent growth rate in 1996. Asia countries also generally followed sound fiscal policies, which turned the low fiscal deficits at the beginning of the 1990s into surpluses. On the eve of the crisis, all the five countries most severely affected by the crisis had budget surpluses ranging between 0.3 per cent of GDP in Philippines to 1.3 per cent in Indonesia. In addition to positive fiscal balances, most Asian countries recorded single digit inflation rates between 1990 and 1996. Philippines, which had experienced double-digit inflation, reaching 18.7 per cent in 1991, had, by 1996 cut it by more than half to 8.4.

Table 1: Macroeconomic Performance in Five Asian Countries, 1990-97

Indicator	1990	1991	1992	1993	1994	1995	1996	1997
Indonesia								
Real GDP Gr.(%)	7.2	7.0	6.5	6.5	7.5	8.2	8.0	4.6
Fiscal Bal. (%GDP)	0.4	0.5	-0.4	0.6	1.0	2.4	1.3	—
Inflation (%)	7.8	9.4	7.6	9.6	12.6	8.9	6.6	11.6
Saving (%of GDP)	31.7	31.1	33.4	28.7	29.5	27.6	27.5	28.0
Investment (%GDP)	36.2	35.5	35.9	29.5	31.1	31.9	30.8	31.6
Malaysia								
Real GDP Gr.(%)	9.7	8.5	7.8	8.3	9.2	9.5	8.6	7.8
Fiscal Bal. (%GDP)	-3.1	-2.1	-0.9	0.2	2.4	0.9	0.8	2.5
Inflation (%)	2.6	4.4	4.7	3.6	3.7	5.3	3.6	2.7
Saving (%of GDP)	29.1	23.2	30.1	27.7	33.8	34.7	37.8	39.4
Investment (%GDP)	31.3	37.2	33.4	37.8	40.4	43.5	41.5	42.8
Philippines								
Real GDP Gr.(%)	3.0	-0.6	0.3	2.1	4.4	4.8	5.8	9.7
Fiscal Bal. (%GDP)	-3.5	-2.1	-1.2	-1.5	1.0	0.6	0.3	0.1
Inflation (%)	14.1	18.7	8.9	7.6	9.1	8.1	8.4	5.0
Saving (%of GDP)	17.8	17.8	18.2	17.3	20.3	17.2	19.3	18.8
Investment (%GDP)	24.2	20.2	21.3	24.0	24.1	22.2	24.0	24.8
Rep. Of Korea								
Real GDP Gr.(%)	9.5	9.1	5.1	5.7	8.6	8.9	7.1	5.5
Fiscal Bal. (%GDP)	-0.7	-1.6	-0.5	0.6	0.3	0.3	0.5	0.2
Inflation (%)	8.6	9.3	6.2	4.8	6.2	4.4	5.0	4.4
Saving (%of GDP)	35.7	35.7	34.9	34.9	34.6	35.1	33.6	33.1
Investment (%GDP)	36.9	38.8	36.6	35.1	36.1	37.1	38.4	35.0
Thailand								
Real GDP Gr.(%)	11.6	8.2	8.1	8.4	8.9	8.8	5.5	-0.4
Fiscal Bal. (%GDP)	4.6	4.8	2.9	2.1	1.9	2.9	1.0	-0.3
Inflation (%)	6.0	5.7	4.1	3.4	5.2	5.7	5.8	5.6
Saving (%of GDP)	32.3	34.8	33.7	34.3	33.9	33.2	33.2	32.6
Investment (%GDP)	41.1	42.8	40.0	39.9	40.3	41.6	41.7	35.0

Source: International Financial Statistics (various issues), IMF.

Asian nations also kept very high rates of saving and investment. With the exception of Philippines, all the other four maintained saving rates above 30 per cent of GDP. These countries invested heavily in production, infrastructure and human capital development. Investment rates were maintained at rates above 30 per cent of GDP, reaching as much as 40 per cent of GDP in Malaysia and Thailand. Also most of the countries managed to increase school enrolments and reduce illiteracy rates.

However, there are a number of macroeconomic factors that should have warned of the impending crisis. These included appreciating of exchange rates contributing to a worsening current account position, weaknesses in the financial sector, and the changing composition of capital flows.

Worsening External Balance Position

One of the major causes that triggered the Asian crisis was the widening current account deficit in a number of countries (see Table 2). Large current account deficits are generally considered unsustainable in the long run, especially in the situations of falling export performance and competitiveness. The combination of rising capital inflows and current account deficits appreciates the real exchange rate and leads to an expansion of non-tradable goods sectors *viz-avis* tradable sectors. The current account deficit in the five most affected Asian countries ranged from an annual average of 2.2 per cent of GDP in Korea between 1990 and 1997 and 6.8 per cent in Thailand. Malaysia and Thailand persistently recorded the largest current account deficits among the five countries, while Indonesia and Korea recorded the lowest. Indonesia actually shrank its deficit to 1.3 per cent of GDP, though on the eve of the crisis, it had increased to 3.4 per cent of GDP. Worsening current account balances resulted from a number of sources, including a slowdown in export performance as a result of appreciation in the exchange rate, and the easy access to capital flows, which encouraged excessive imports.

Table 2: Current Account Balances in Percent of GDP in Five Asian Countries, 1990-97

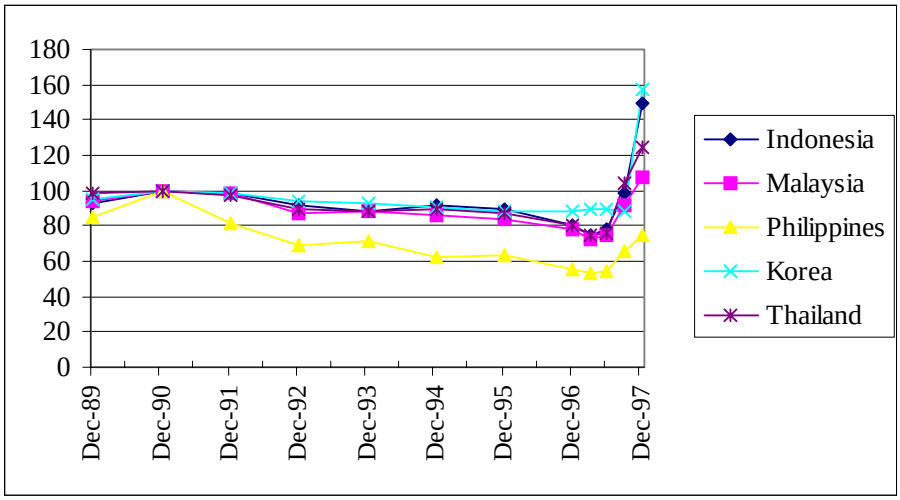
Country	1990	1991	1992	1993	1994	1995	1996	1997
Indonesia	-2.8	-3.7	-2.2	-1.3	-1.6	-3.4	-3.4	-3.6
Malaysia	-2.0	-8.9	-3.7	-4.4	-5.9	-8.5	-5.3	-5.9
Philippines	-6.1	-2.3	-1.9	-5.5	-4.4	-4.4	-5.9	-4.5
Rep. of Korea	-0.9	-3.0	-1.5	0.1	-1.2	-2.0	-4.8	-3.9
Thailand	-8.5	-7.7	-5.7	-5.6	-5.9	-8.0	-8.0	-4.6
All 5 Asian ($bn)								

Source: UNCTAD Trade and Development Report 1998.

Pegged Exchange Rates

Of all the macroeconomic indicators, the real exchange rate gave a much clear picture of the impending turmoil in Asia. Virtually all the countries followed exchange rate policies that pegged their currencies more-or-less closely to the US dollar. In happier times this had served to minimise the risk faced by foreign investors and had, therefore, encouraged capital inflows. Currency pegs are sustainable only if the economic and financial policies of the countries are harmonised, otherwise capital inflows would be potentially destabilising. Moreover, the strengthening of the US dollar after 1995 meant that these countries also experienced an appreciation in their currencies, which in turn harmed the competitiveness of their exports. With the exception of Korea, all the other four economies experienced substantial currency appreciation in 1995 and 1996 (see Fig. I). With insufficient foreign exchange reserves to defend the currencies, Asian countries were forced to devalue and increase interest rates further.

Figure 1: Real Exchange Rate Index in Five Asian Countries (1990=100)



The Changing Composition of Capital Flows

Radelet and Sachs (1998) have underscored the fact that massive capital inflows—especially short-term— played a significant part in the crisis. Having put its house in order, and with relatively well -educated but cheap labour force, Asia was seen by international investors as being more attractive, offering relatively higher returns and low risk in comparison to other emerging markets. Asian countries offered higher interest rates, which though kept high to stabilise exchange rates, also served to increase the attractiveness of the region to international investors seeking profit opportunities in emerging markets.

Net private capital inflows to East Asia and the Pacific recorded a five-fold increase from $19.3 billion in 1990 to $108.7 billion in 1996, and accounted for over 40 per cent of all net private capital flows to developing countries. Malaysia recorded the largest increase, from $1.8 billion at the beginning of the decade to $16 billion in 1996. As a proportion of GDP, net private capital flows to Malaysia increased from 4.1 per cent in 1983-91 to 10.5 per cent in 1992-96, while in Thailand they increased from 5.7 to 8.8 per cent over the same period (see IMF 1998).

The changing composition of capital flows is important in understanding the Asian crisis. At the beginning of the decade, foreign direct investment (FDI) was the primary form of private capital flows to the region, and still remains the dominant form. FDI to East Asia and the Pacific (EAP) increased from $10.2 billion in 1990 to $61.1 billion in 1996. This represented only a three percentage point increase in the share of FDI in net private capital flows to EAP between 1990 and 1996, from about 53 to 56 per cent. The largest recipients of FDI in EAP included Malaysia, Indonesia and Thailand, which between them received about $15 billion in 1996 (Table 3).

However, after 1992 portfolio flows began to increase dramatically. In 1990 portfolio investment to East Asia and the Pacific (EAP) amounted to only $2.3 billion (or 11.9 per cent of net capital flows to EAP), and by 1996 it increased by about eighteen-fold to reach $35.7 billion (32.8 per cent of net private capital flows to EAP). In 1996, portfolio investment to East Asia and the Pacific accounted for slightly over a quarter of gross portfolio flows to developing countries. Also, within portfolio flows,

Table 3: Private Capital Flows to East Asia and the Pacific, 1990-96 ***($billion)***

	1990	1991	1992	1993	1994	1995	1996
Total Net Private Capital Flows	**19.3**	**20.8**	**36.9**	**62.4**	**71.0**	**84.1**	**108.7**
Indonesia	3.2	3.4	4.6	1.1	7.7	11.6	17.0
Malaysia	1.8	4.2	6.0	11.3	8.9	11.9	16.0
Thailand	4.5	5.0	4.3	6.8	4.8	9.1	13.3
Net Foreign Direct Investment	**10.2**	**12.7**	**20.9**	**38.1**	**44.1**	**51.8**	**61.1**
Indonesia	1.1	1.5	1.8	2.0	2.1	4.3	5.8
Malaysia	2.3	4.0	5.2	5.0	4.3	4.8	6.2
Philippine	0.5	0.5	0.2	1.0	1.6	1.5	1.5
Rep. of Korea	0.8	1.2	0.7	0.6	0.8	1.8	2.3
Thailand	2.4	2.0	2.1	1.8	1.4	2.1	2.9
Gross Portfolio Flows	**2.3**	**1.5**	**4.4**	**23.6**	**25.4**	**26.9**	**35.7**
Debt	0.6	0.8	2.3	8.9	15.3	12.2	22.8
Equity	1.7	0.7	2.1	14.6	10.1	14.7	12.9

Source: Global Development Finance 1997, World Bank.

while equity flows had been relatively important, after 1992 debt instruments accounted for most portfolio flows to EAP. In 1996 portfolio debt flows amounted to $22.8 billion compared with $12.9 billion equity flows. The increase in portfolio flows increased the financial instability because unlike FDI, portfolio investors have a much shorter horizon and are after short-term financial gains. Portfolio investment flows thus tend to be more volatile and may result in disruptions of capital flows in a crisis. Thus, on the whole FDI appears not to have been affected much by the crisis. In Indonesia, Malaysia and Philippines, FDI flows fell by 12.9, 19.1 and 13.3 per cent in 1997, while in Korea they remained stagnant at $2.3 billion, and increased in Thailand from $2.3 billion in 1996 to $3.6 billion in 1997. In addition, Asian financial markets were not sufficiently developed to utilise these huge financial flows in efficient ways, and thus banks tended to lend to projects that were too risky. This is seen in the expansion of real estate investments.

Financial Liberalisation

In the 1990s, Asian countries increased the pace of financial liberalisation, which reduced credit requirements, lifted entry barriers for new banks and other financial institutions, and allowed banks to offer local citizens and firms foreign currency denominated accounts. Banks were also allowed to extend credit to domestic firms in foreign currency, while private corporations could borrow from abroad. Firms found this attractive as it allowed them to borrow abroad at low interest rates, and thus shield themselves against domestic policy shocks. Asian financial institutions also became large borrowers in international capital markets, while foreign banks were given greater freedom of entry. Asian countries thus experienced a boom in lending to the private sector, with the result that over time there was a tendency to lend to much riskier projects. Bank lending to the private sector as a proportion of GDP shot up in a number of countries. In Thailand, bank lending to the private sector increased from 64 per cent of GDP in 1990 to 101.9 per cent in 1996. In Malaysia it increased from 71.3 per cent to 93.4 per cent over the same period.

Lending by foreign banks, which had virtually disappeared following the debt crisis in the 1980s, returned to Asia in the 1990s. Foreign banks accounted for 60 per cent of the 1996 private capital flows to Indonesia, Malaysia, Philippines, Korea and Thailand, and most of these were short-term credits. Most of the debt obligations in these countries had less than a year to run. Indeed, the debt profile of Asian countries did warn of the impending crisis, especially given that most of this debt was denominated in US dollars.

Microeconomic Distortions

Moral hazard problems have featured as a prominent factor in explaining the Asian crisis, especially as it relates to the relationship between the corporate and financial sectors. Moral hazard will occur when authorities provide or are deemed to provide guarantees to public debts. In Asia, it has been argued that there was a general perception that the liabilities of most financial institutions had government guarantees, though in reality no such guarantees existed. As Krugman (1998) points out, generally "most of those who provided Thai finance companies, South Korean banks, and so on with funds believed that they would be protected from risk— an impression reinforced by the strong political connections of the owners of such institutions" (p.3). In Korea, the Chaebols were in some cases partly owned by commercial banks who in turn extended them credit.

Corsetti, et. al. (1998) have argued that the problem of moral hazard in Asia exhibited three dimensions; the corporate, financial and international levels. At the corporate level, there was a general perception that government would bail out or intervene on behalf of troubled firms, giving an impression that returns on investment were somehow insured. In Korea, though government had not actually bailed out any Chaebols in the past, it had bailed out individual chaebol affiliates. Firms with political or bureaucratic connections had easy access to credit and could borrow large sums while paying little attention to project cost, returns, or repayment obligations. Thus, favoured individuals or corporations and lenders tended to underestimate the risk. The result from this moral hazard problem was an increase in investment in low social profitability projects and an overpricing of assets. For example, Thai banks lent heavily to property markets, thereby increasing their vulnerability to variations in real estate prices.

At the financial level, the Asian model of state directed capitalism or "crony capitalism" put pressure on financial institutions to extend credit to favoured individuals or corporations. In some cases, financial institutions were themselves willing to extend credit to these corporations, perceiving these debts to have public guarantees. The problem of moral hazard in Asia was compounded by the weak system of bank regulation and inadequate disclosure of information (see Gordon, 1998). Data inadequacy and lack of transparency made it difficult for investors to keep track of the main economic fundamentals. In some countries there was incomplete disclosure on key variables such as foreign debt, the level of foreign reserves and non-performing loans.

Another source of moral hazard in Asia operated at a global level, reinforced by massive bail-outs to Mexico in 1995 and the activities of the International Monetary Fund (IMF) in providing bail-outs. International banks advanced huge sums to Asian financial institutions and corporations with relatively little regard for sound commercial principles. There was a belief on the part of international banks that Asian financial institutions were implicitly guaranteed by their governments. However, when in transpired that no such guaranteed existed, this created what Stiglitz (1998) has referred to as an "instability in beliefs". The over-optimism based on asymmetric or faulty information turned into over-pessimism, and there was an outward stampede.

IV. The Impact of the Crisis on Africa

The effects of the unfolding global crisis on African countries can be examined in terms of its direct effects emanating from Asia as well as the indirect effects emanating form the ensuing slow down in global economic activity and international trade. Both the direct and indirect effects can be traced through two main transmission channels: trade channels and financial channels.

Trade Channels

Reducing Demand for Africa's Exports

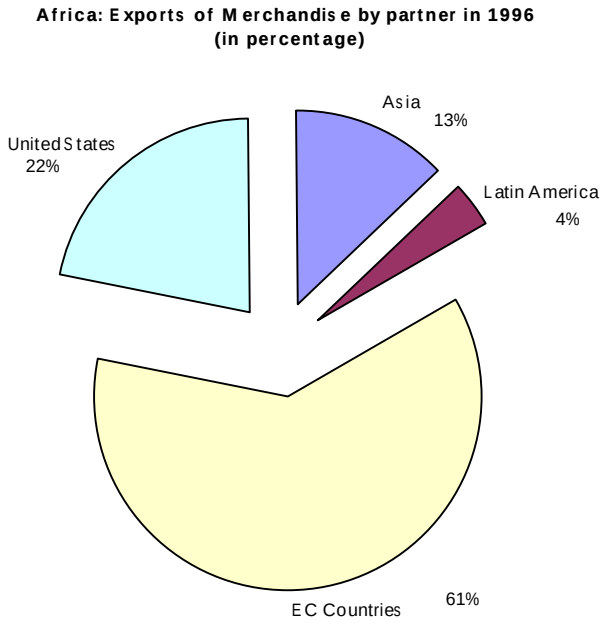
As a trading partner, the effect on the Asian crisis could be examined in terms of its effects on Africa's exports and imports. On the side of exports, the large depreciation in Asian currencies would make imports more expensive in terms of domestic currency. Table (4) shows that between June 1997 and September 1998 the exchange rate (measured as the domestic price of foreign currency) increased substantially in Asian countries affected by the crisis. This increase ranged between per 46 per cent for Republic of Korea and 525 per cent for Indonesia. The large increases in the domestic price of foreign currency had the effect of escalating domestic prices of imports. This, coupled with the austerity measures and the required realignment of the banking sector and assets markets slowed down Asia's economic activity and its GDP growth, leading to a reduction in Asia's demand for imports.

Table 4: Potential Effects of Currency Devaluation on Export and Import Prices

Country	Percentage Change in Exchange Rates	
	Domestic Price of Foreign Currency	Foreign Price of Domestic Currency
Indonesia	525.3	-84.0
Rep of Korea	46.4	-31.7
Malaysia	64.4	-39.2
Thailand	53.4	-34.8
Philippines	59.8	-37.4

The reduction of the demand for imports by East and South East Asia has a direct impact on demand for African exports and would tend to slowdown Africa's export expansion and growth rate. The magnitude of this direct effect, however, would depend on the importance of Asia as a market for Africa's exports. In 1996, Africa's exports to Asia accounted for 13 per cent of total African exports (Figure 2). The share of Japan alone is 4 per cent, the largest among the Asian countries and equal to that of Latin America. This indicates that in explaining the direct export-effect of the crisis the recession in Japan is equally important to the crisis in other Asian countries.

Figure 2: The Direction of Africa's Exports



The effect of Asian crisis on African exports is disproportionate with regard to the commodities, the regions as well as the countries that would be affected. Minerals, fuels and related material, which constitute 38 per cent of Africa's total exports to Asia, would tend to be more depressed than other categories (Table 5). This is followed by food, beverages and tobacco with a share of 19 per cent and crude materials excluding oil with a share of 18 per cent. The Southern and North Africa regions, which account for about two-thirds of Africa's total exports to Asia have been affected the most. The region likely to have been affected the least is East Africa, which accounts for only 6 per cent of Africa's exports to Asia. As for individual countries, the Republic of South Africa, which alone carried about one quarter of Africa's exports to Asia in 1996, would be the most concerned with reduction in Asia's demand for imports. The countries that will be hardest hit in Africa are the regions oil exporters, especially those that have large shares of their exports to the crisis region: Nigeria 12 per cent, Algeria 9.7 per cent, and Libya 9.5 per cent.

Table 5: Largest Exports Items from Africa to Asia (In Percentage)

	1990	1996
Total Africa Exports	100.0	100.0
Mineral fuels and related materials	44.6	38.0
Food, beverages and tobacco	16.7	18.9
Crude materials (excl. fuels), oils, fats	15.0	17.5
Chemicals	11.7	12.6
Other manufactured goods	9.2	10.4
Machinery and transport equipment	2.5	2.3

In addition to these direct effects, there is also the knock-on effect on Africa's exports.. The eight countries of East and South East Asia afflicted by the crisis accounted for 15 per cent of world trade in 1996. Between 1990 and 1995, they were responsible for 31 per cent of the increase in world imports and about 29 per cent of the increase in world exports. The contraction in Asian demand for imports would affect not only the volume of trade but also the prices of export, especially the commodities for which Asian countries are an important part of world demand. In 1996, for instance, these countries accounted for about 16 per cent of world imports of agricultural raw materials, minerals and metals and petroleum. Furthermore, their share of world imports of minerals, metals and food and beverages has been increasing rapidly. For the world at large, the contraction in Asia's demand for imports has had a large effect on world trade, which will affect, in turn global growth rates.

Intensify Price Competition with Africa Exports

Another factor that might contribute to the reduction in Africa's exports as a result of the Asian crisis is through intensified price-competition in the market for primary products. African countries encounter solid competition from Asian producers in the markets of primary exports such as cocoa beans, timber, rubber, coffee and tea. In cocoa beans for instance Africa's international market share dropped by 20 percentage points between 1970 and 1993 while Asia increased its share by virtually the same amount (Table 6). As a result of the major depreciation in the foreign price of their currencies, Asian countries could become more price-competitive, and hence increase their exports and export market shares at the expense of Africa. The improved price competitiveness is implied by the deterioration in the foreign price of their domestic currencies, which ranged between –32 per cent for the Republic of Korea and –84 percent for Indonesia. The Asian countries that might benefit from increased price competition in these markets include, Indonesia, Malaysia and Thailand. The African countries that might be most concerned about such competition include: in cocoa Côte d'Ivoire, Ghana, Benin, Cameroon, Congo, Madagascar, Nigeria Sierra Leone, Togo and Zaïre; in coffee, Benin, Burundi, Cameroon Congo, Côte d'Ivoire, Ethiopia, Gabon, Ghana, Kenya and Malawi; and, in timber Cameroon, Côte d'Ivoire, Congo, Ghana, Gabon, and Zaïre; in rubber Cameroon, Côte d'Ivoire, and Zaïre; and in tea Kenya, Malawi and Burundi. South Africa would also face increased competition with Thailand, Malaysia, S. Korea and Indonesia Asian countries, particularly in manufactured goods and mining products.

Table 6: Competition with Africa in Export Markets

	International Export Market Shares					
	Africa		Change	Asia		Change
	1970	1993	%	1970	1993	%
Cocoa	80.3	60.1	**-20.2**	0.4	20	**19.6**
Coffee	24.6	14.3	**-10.3**	4.9	10.9	**6.0**
Rubber	7.4	5.6	**-1.8**	89.1	90.8	**1.7**
Timber	13.4	7.3	**-6.1**	43.3	52.5	**9.2**
Cotton	30.7	17.2	**-13.5**	16.6	35.6	**19**

Reduce Africa's Import Costs

On the import side, the depreciation of Asian currencies and the adjustment-driven deflationary effects have resulted in a general fall in Asian prices in dollar terms which might lead to lowering the prices of Africa's imports and import bill. Such direct effects can be examined, on the aggregate, through the volume of Africa's imports from Asia (mainly vehicles, machinery and equipment). In 1996 this amounted to about 12 per cent of Africa's import bill. However, the expected reduction in import costs would tend to be disproportionately distributed among regions and countries depending on their share of trade with Asia. As in the case of exports, North and Southern Africa account for the bulk of Africa's import from Asia (70 per cent). South Africa is also the continent's leading importer, with 24 per cent of Africa's total imports from Asia in 1996, followed by Egypt (10 per cent), Algeria (9.4 per cent), Nigeria (6.8 per cent) and Morocco (6.5 per cent). This positive effect is unlikely to fully counteract the negative effects emanating from the reduction in export demand and commodity prices.

Finance Channel

Reduce Asia's Direct Investment in Africa

Another direct effect of the crisis is the likelihood of a slow-down in Asia's flows of direct investments to Africa. It is feared that the economic crisis and the consequent banking stress might cause Asia's major investors in Africa to look inward in an attempt to consolidate their financial position and, hence reduce their interest in doing business with Africa. Historically, such flows had been very small compared with those from other regions. In recent years, however, a growing number of Asian countries have taken steps to invest in Africa's telecommunication, mining and energy sectors. For instance, in Ghana, the government sold 30 per cent of its stake in Ghana telephone Company to Malaysia Telkom for US$38 million. South Africa sold a 30 per cent stake in the state-owned Telkom for $ 1.3 billion to Thintana Communications-a joint venture between SBC Communications of the United States, and Telekom Malaysia BHD of Malaysia. The crisis may limit and/or delay further progress in this area.

Apart from that of Asian origin, the crisis is feared to slow flow of FDI from other sources. This might be the case as FDI to Africa is concentrated in sectors such as oil, minerals and metals, which are hit hardly by the crisis. The large decline in world demand for these commodities, in the wake of the crisis, would reduce their prices, and hence the profitability of foreign companies in the sector. This would tend to discourage further investments, in oil and mining at least until prices recover. However, contrary to this expectation, the flow of FDI to the region, one year after the crisis, registered a marked increase, and it is not yet clear whether this increase is due to previous commitments or a shift in FDI to other sectors.

Limit access to capital markets

The widening of spreads and the decline in stock prices following the crisis has made it difficult for emerging markets issuers to tap international markets, to finance current account deficits. In addition several countries were forced to raise their interest rate to curtail capital outflows. These trends would tend to restrain the flow of direct and portfolio investment to Africa's emerging markets and reduce their ability to borrow from abroad. The countries that are most likely to be affected in this manner include Egypt, Morocco, South Africa and Tunisia.

In Morocco, for instance, the Tranche 'A' loans have suffered along with other hard currency debt in the emerging market universe. This occurred despite the fact that the country's economic fundamentals do not indicate the usual combination that would justify selling pressure. The country has a comfortable cushion of foreign reserves, the fiscal and current accounts deficits are modest, and the inflation rate is low. The country would like regular access to the international market, but is unlikely to secure the coveted investment grade status given the heightened downgrade mode of rating agencies which is driven by the perception that emerging markets are becoming increasingly risky.

In South Africa, the current climate in world markets also increased the difficulty of obtaining short-term offshore borrowing by the government. That climate was clouded by the decision of Moody's in July to put its investment grade (Baa3) rating for South Africa's foreign debt on review for possible downgrade. Some of the reasons cited by Moody's include the present international climate and following on from downgrades elsewhere. The likelihood is that South Africa may lose its investment grade rating from Moody's. This will have a knock-on effect on the government's access to offshore funding and the pricing that it can expect.

Measuring the Effect of the Crisis

While qualitatively it might be possible to delineate the different channels through which the effect of the crisis would be transmitted to African countries, quantitatively it is difficult to provide an accurate measure of the effect of the crisis. This is not only because the crisis is still unfolding, but mainly because of the traditional problem of providing a precise measure of the counterfactual situation— in this case, measuring what would have been the value of the different economic indicators in the absence of the crisis. That is, there is no single method that can accurately separate the effects of the crisis from the effects of other variables that have also been at work. In the face of this quantitative problem the simple before-and-after test could be enlightening despite its well-known limitations: it incorporates all forecast errors and it attributes the developments after the crisis to the crisis, thereby dismissing the effects of all other factors. However, intimate knowledge of the other factors at work, would reduce the possibility of misinterpreting the results of the before-and-after test.

The before and after test is used to measure the effect of the crisis on economic aggregates in 1998. To conduct this test, forecasts for 1998, which were made in 1996 before the crisis are taken to represent what would have happened in the absence of the crisis. Then, October estimates for 1998 are taken to represent the situation after the crisis and the difference between the two gives a measure of its effects. Because economic forecasts are based on certain assumptions made by the forecaster, it is important to stick to one data source to lessen discrepancies arising from different assumptions. For this purpose the forecasts and estimates prepared by WEFA Group are used. Coverage of variables and countries are therefore limited to those available from this source. The results of this test together with other findings are discussed below.

Effects on Trade

Table (7) shows the impact of the crisis on world trade as measured by key trade indicators. It is apparent that the crisis had a negative impact on export prices and trade volumes. The export price of crude oil, for instance, dropped by US $ 5.4 per barrel. As expected form the qualitative analysis, the impact of the crisis on the prices of primary commodities is more pronounced than that on manufactured goods. The average price for primary commodities dropped by about 5.3 per cent while that of manufactured goods decreased by 1.4 per cent. The slowdown in world trade as a result of the crisis

Table 7: Impact on Global Trade

		A Forecast for 1998 Before crisis	B Forecast for 1998 After crisis	Crisis Impact (B - A)
Prices				
Crude oil	($ per barrel)	18.6	13.2	**-5.4**
(% Change)				
Primary commodities		1.1	-4.2	**-5.3**
Manufactured goods		-0.3	-1.7	**-1.4**
Volume of Exports				
Total World		6.8	4.1	**-2.7**
Primary Commodities		5.3	3.0	**-2.3**
Fuel		6.3	2.6	-3.7

is measured as a 2.7 per cent decease in the volume of global trade. The decline in the volume of trade in primary commodities is estimated at 2.3 per cent. This, together with the negative impact on the prices of primary commodities, indicates that the crisis had resulted in about 7.7 per cent decline in the value of primary products traded internationally.

Effect on Commodity Prices

The before and after test could not be performed for the prices of main primary commodities because of data unavailability. However, owing to their importance in analysing the growth impacts on individual African countries, they merit an examination in terms of actual developments in the period after the crisis. While commodity prices have always suffered from a downward pressure, the Asian crisis is to a large degree responsible for their recent weakening. In the case of oil, the world's largest internationally traded commodity, the average OPEC basket price has fallen from an average of $18.8 a barrel in 1997 to an average of $12.7 per barrel in September 1998. In an attempt to check the decline in prices through curtailing supply, both OPEC and non OPEC countries have pledged to reduce production by about 3.1 million barrels per day. Despite the fact that 85 per cent of the OPEC pledged cuts were implemented, the market remained largely depressed. In real terms oil prices are at their lowest levels since 1973. For oil economies, including Angola, Algeria, Egypt, Cameroon, Congo, Gabon, Libya, Nigeria, the negative oil price shock will translate, depending on individual country's dependence on oil export, into deteriorating fiscal deficits, weak external balances and slower growth rate. The countries that would be affected the most are Algeria and Nigeria given their excessive dependence on oil proceeds.

Gold prices are also in a declining trend. The decline in prices partly due to uncertainties surrounding the Asian crisis combined with the economic slowdown in Japan, and partly the result of increasing world supply. Gold prices have declined through 1997 and most of 1998. The factors behind the

decline include low inflation in OECD countries, strong competition from bullish stock markets, and a central banks sell-off. This downward trend will affect the growth prospects of South Africa, the world's major producer. However, the attempt of South Africa to control its supply of gold and the announcement that the European Central Bank will hold some of its reserves in gold might injected some life into the bullion market.

The prices of copper, timber and rubber are mainly affected by currency devaluation in the ASEAN-4 countries. The fall in the price of copper has been large and has had adverse implications for Zambia because of the heavy dependence on copper for foreign exchange earnings. From June 1997 to January 1998 copper prices declined by 33 percent. The decline can be attributed mainly to reduced demand in Asian markets. Korea and the ASEAN-4 **(**Indonesia Malaysia, the Philippines, and Thailand) countries accounted for about 25 per cent of the growth in consumption of copper in the period 1992 1996, and the share of these countries in world consumption increased from 51.2 percent in 1992 to 81.2 percent in 1996. The price decline occurred despite the strong demand for refined copper in 1997 in the US and EC countries, where consumption increased over the 1996 levels by about 4 percent (WEFA 1998). This is probably because Indonesia, which is also a large exporter of copper ore with a 29 per cent of international market share, has experienced large currency devaluation.

Africa's timber exports amount to about 7.3 percent of the international timber market. African countries that export timber include Côte d'Ivoire and Cameroon, with international market shares of 1.5 per cent each, and Ghana, Malawi Congo (DRC) and Nigeria with share less than one per cent. The decline in the price has been uneven across types of timber and across geographic markets. While the price of the African-grown (sapele timber was modest, the price decline for Asian-grown (meranti) hardwood, which represent about 53 per cent of the market, has been greatest. The modest decline in the price for African-grown hardwood in European markets is related to the fact that in the European market because other merchants do not wish to shift from sapele hardwood timber to meranti timber unless there are firm indications that a large price differential is likely to persist. In contrast the decline in the prices of meratni timber is attributable to a long period of persistent weak demand in Japan, the principal market, and to the currency devaluation in Malaysia, Indonesia, and Thailand, which control abut 44 per cent of world market share. However, prices are expected to decline further as the cutback in construction activity in Asian countries could also release increased supplies of timber for the export market. If this trend continues there is the danger that trades will shift from sapele timber to meranti timber, which will have adverse effects on African exporters.

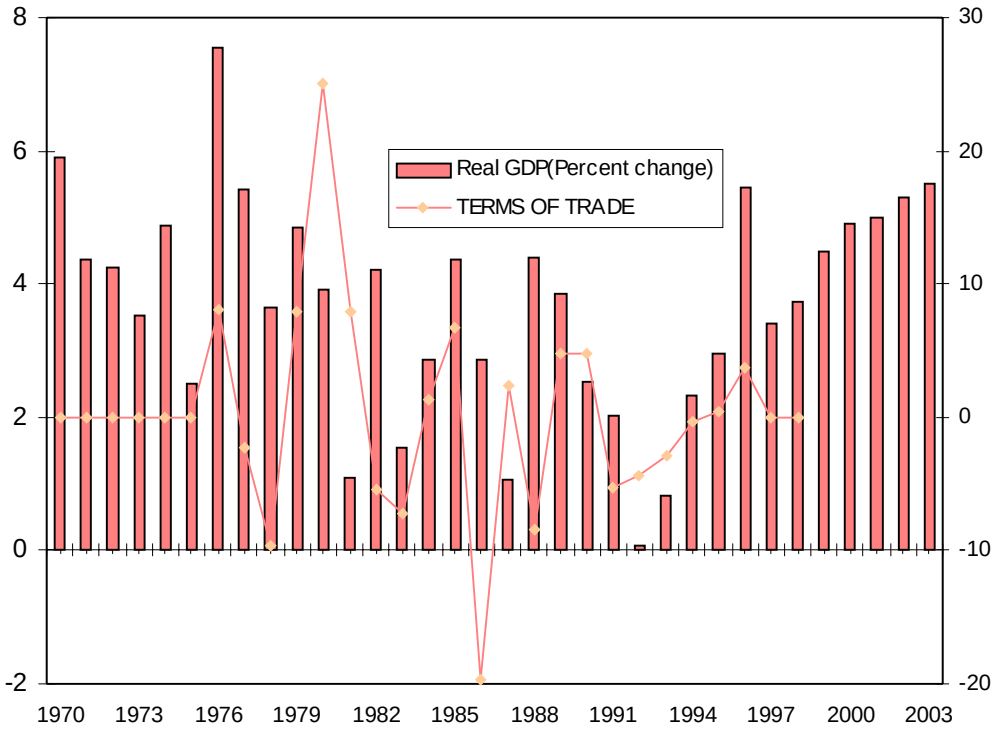
The rubber market has been suffering from price deterioration caused by excess supply since 1996. This has been further aggravated by currency depreciation in the major exporting countries, Indonesia, Malaysia and Thailand, which control about 90 per cent of the market. The price of natural rubber, thus, declined by 37 per cent over the period June 1997 to January 1998. This has adverse implications for African rubber exporting countries (Côte d'Ivoire, Cameroon, Ghana, Malawi, Congo, DRC, and Nigeria), with a combined share of 5.6 per cent of the world market. Developments in the prices of other commodities such as coffee, tea, and cocoa have been affected by market structure and weather conditions more than the Asian crisis. Coffee prices fell as a result of increased supply from Latin America and Africa and not due to reduced demand from Asia. The price of tea and cocoa actually rose and are expected to remain relatively buoyant in 1999.

In summary, low demand for primary commodities induced by the crisis and large depreciation of Asian currencies appear to have played major roles in depressing commodity prices. With only a few exceptions, the commodities suffered large price declines are those for which Asia constitutes an important market (e.g. oil) and/or those mostly supplied by Asian countries (e.g. copper, timber and rubber). Thus, the effect of exchange rate depreciation in Asia is evident on both sides of the equation.

By making imports expensive in domestic currency depreciation discouraged Asia's demand for imports, hence depressing the prices of its major imports, and by reducing export prices in foreign currency it reduced the prices of Asia's primary commodity exports.

Given their heavy dependence on primary products, the decline in commodity prices and the ensuing deterioration in the terms of trade constitute a serious impediment to the growth rate of African countries. It can be observed from Figure 3 that movements in the terms of trade are positively and closely related to real GDP growth (see Figure 3). More formally, a in study using a long-term development model for a sample of 29 African countries over the period 1970-1990 it has been estimated that the deterioration in the terms of trade of non-oil exporting countries slowed Africa's growth by an average of 0.84 percentage points per annum. The adverse terms of trade has been estimated to be large enough as to erode, on average, 42 percent of the effect of the increase in export volume on growth. Another measure of the extent to which deterioration in the terms of trade impeded Africa's growth rate is that it was large enough to erode about 34 percent of the effect of capital inflows on growth (Hussain 1995).

Figure 3: Africa: GDP and Terms of Trade 1975-2003



The measurement of the impact of the crisis on the exports of African countries for which WEFA Group projections are available is shown in Table (8). Because of data unavailability, the test is conducted in terms of export values, hence it is not possible to distinguish between volume and price effects. It can be observed that there are important differences with regard to the effect of the crisis on individual countries. The crisis had a large negative effect on the export proceeds of oil exporting countries, particularly Algeria (-32.7 per cent) and Gabon (-36.8 per cent). Proceeds in Egypt and Tunisia,

Table 8: The Effect on Exports of Individual African Countries (US $ Billion)

	A Before crisis	B After crisis	(B - A) Effect	(B - A)/A*100 Effect (per cent)
Algeria	15.388	10.351	-5.037	-32.7
Egypt	5.773	5.497	-0.276	-4.8
Libya	12.344	12.375	0.031	0.3
Morocco	6.699	8.15	1.451	21.7
Tunisia	6.095	5.757	-0.338	-5.5
Cameroon	1.415	1.962	0.547	38.7
Gabon	2.647	1.673	-0.974	-36.8
Ghana	2.021	1.665	-0.356	-17.6
Ivory Coast	3.979	5.346	1.367	34.4
Kenya	1.478	2.022	0.544	36.8
Nigeria	14.365	16.91	2.545	17.7
Zimbabwe	2.137	2.227	0.09	4.2
South Africa	29.745	28.534	-1.211	-4.1

which are less reliant on export of oil have dropped slightly. In the case of Libya exports stagnated despite reported increases in the volume of oil production. The two oil-exporting countries where the results of the test are contrary to expectations are Cameroon and Nigeria. In Cameroon the increase in export proceeds despite weak oil prices might be attributed to relatively buoyant prices for cocoa and coffee. In the case of Nigeria, the results might have been affected by pessimistic forecasts in the period before the crisis due to the country's political turmoil, and optimistic estimates in the period after as a result of the positive developments in the political arena.

The non-oil exporting countries where the test shows negative export effect include Ghana and South Africa. In Ghana, the decline in exports despite relatively buoyant cocoa prices, the country's major export earner, might be attributed to the world price of gold, the second major export, which has been in a declining trend before the Asian crisis. Drought and energy crisis also contributed to the decline in exports. In South Africa the estimated decline in exports of 4.1 per cent as a result of the crisis might be attributed to weaker commodity prices and weakened world demand. The countries whose exports were not negatively affected include Morocco, Côte d'Ivoire, Kenya and Zimbabwe. For the continent as a whole, the actual trade figures show a large decline in export proceeds amounting to 9.5 per cent between 1997 and 1998. This was the product of a 7 per cent decline in export prices and a 2.5 per cent decline in the volume of exports.

Effects on Growth

As for the effect of the crisis on growth, the test shows that there is a marked decline in global output, with world real growth rate estimated to decline by 2.4 percentage points (Table 9). The test shows a non-negative effect on the growth rates of the US and Western Europe. The growth in Latin America, excepting Mexico is negatively affected, where the growth rate is estimated to fall by 2.7 per cent. The result for Japan indicates large deterioration in growth amounting to 5.7 per cent. Japan, however, is a special case: it is both a cause and an effect. The recession in Japan is causing global slow

Table 9: Impact on Global Growth Rates

	A Forecast For 1998 Before crisis	B Forecast for 1998 After crisis	Crisis Effect (B - A)
World	4.1	1.7	**-2.4**
US	2.3	3.4	**1.1**
Japan	3.3	-2.4	**-5.7**
Western Europe	2.5	2.7	**0.2**
Latin America Excl. Mexico	4.8	2.1	**-2.7**
Mexico	5.2	4.6	**-0.6**
Africa	4.5	3.3	**-1.2**

A : August 1996
B : Fourth Quarter 1998

down in economic activity, while the round effect of the later is making it difficult for Japan to pull out of recession.

The effect of the crisis on the growth rates of individual African countries is shown in Table (10). Again the selection of countries is dictated by the availability of data from the source used. The countries covered include the 13 countries in (3.8) plus Zambia. It can be observed that in all cases, (excepting Egypt, Libya, Kenya, Nigeria and Zimbabwe), the effects of the crisis on growth rate are in the same direction as its effects on exports. That is, the countries that have negative (positive) export effects are also the ones that experience negative (positive) growth rates. In this group, the most affected are the oil exporting countries of Algeria and Gabon, together with South Africa, where the estimated decline in growth ranges between 4.3 percentage points and 2.2 percentage points. Growth rates are also negatively affected in the case of Ghana and Tunisia. The countries that show positive effect include Cameroon, Côte d'Ivoire and Morocco. Growth in these three countries seems to be the product of domestic developments rather than the crisis. The positive result in the case of Morocco is influenced by good weather conditions resulting in a large increase in agricultural output and exports. In Cameroon and Côte d'Ivoire, the outcome is influenced by buoyant cocoa prices coupled with improved competitiveness, owing to the devaluation of the CFA in 1994 and the increase in the domestic price of the dollar in 1997.

In the other group, the result of the test shows the growth rate of Egypt is not effected by the crisis, while that of Libya registers a large decline. Also both Zimbabwe and Nigeria are negatively affected. It seems however, that the large estimated deterioration in Zimbabwe's growth has to do with domestic developments as well as with the crisis, which resulted in weak tobacco and gold prices. The large negative estimate in the case of Zambia is closely related to the crisis-induced drop in copper prices, the country's major export earner.

From these results, inferences can be made for other African countries which are not in the sample. The most affected by the crisis are oil and mineral exporting countries. For the majority of non-oil exporting countries in the region, the direction and the magnitude of the effect of the crisis seem to

Table 10: Growth Effect on African Countries

	A Forecast for 1998 Before crisis	B Forecast for 1998 After crisis	Crisis Impact (B - A)
Algeria	5.3	1	**-4.3**
Cameroon	3.7	4.89	**1.19**
Côte d' Ivoire	5	6.7	**1.7**
Egypt	4.5	5	**0.5**
Gabon	3	0.55	**-2.45**
Ghana	4.8	2.95	**-1.85**
Kenya	4.3	1.5	**-2.8**
Morocco	6	7.5	**1.5**
Nigeria	3.9	2.22	**-1.68**
South Africa	3	0.77	**-2.23**
Tunisia	6.5	5.2	**-1.3**
Zambia	3	0.6	**-2.4**
Zimbabwe	5.5	2	**-3.5**

depend largely on the composition of their export baskets and its level of diversification. Countries that depend heavily on the exportation of one or two commodities such tobacco, cotton, groundnuts, livestock, whose prices declined in the wake of the crisis, would experience modest deterioration in the terms of trade and deceleration in their growth rates. The countries that would suffer smaller effects are those with more diversified exports (e.g. Egypt, Mauritius, Tunisia). There seem to be a few exceptions to this generalisation. For instance, Côte d'Ivoire, heavily dependent on the exportation of Cocoa, is not affected. This seems to have more to do with the structure of the coca market, which is dominated by Côte d'Ivoire than with the Asian crisis. South Africa, with a diversified export structure is negatively affected, probably because it is the only country in the region whose financial market is well integrated with the turbulent international capital market and whose export share to Asia is substantial compared with all other African countries.

For Africa as a whole, the test shows that growth rate is estimated to slide down by 1.2 percentage points as a result of the crisis, which indicates a reduction of US $ billion 6.2 using aggregate GDP for 1997 as the base. To put this reduction in an order of magnitude, it is about US $ 2 billion higher than the annual average flow of FDI to the continent in recent years. The result also indicates that the negative effects of the crisis in terms of reduced export proceeds outbalanced its positive effects in terms of reduced import costs, leading thereby to increased leakage and slower growth rates. It is interesting to note that the IMF Economic Outlook, October, estimated Africa's growth rate in 1998 at 3.4 per cent, which is about 1.1 percentage points lower than the estimate of the same source early in January. This tends to support the result arrived at earlier that the crisis had a net negative impact on Africa.

V. Lessons and Policy Implications

As has been outlined before, Asia's crisis was triggered by private and not sovereign debts. A feature common to all the Asian countries in financial turmoil is that the crisis was caused by private capital to private borrowers. Most of the debt was due to private companies and banks and not to the government. This distinguishes the current crisis from Mexico's in 1994-1995, or from African crisis more generally in the 1980s. Public sector debt, in those cases, accounted for a substantial proportion of debt in distress. In Asia, by contrast, public-sector debt burdens are mostly lower, and partly for that reason many local and cross-border creditors lent to Asian entities in the belief that the sovereign underpinned their credit quality. The distinction between these two crises model implies that the design of macroeconomic policies to reduce financial risks would differ according to individual country circumstances with respect to the relative importance of private capital inflows. For the majority of African countries where the inflow of private capital is small and where public debt is dominant, the traditional risk management policies, such as adopting realistic exchange rates and reducing government deficits and inflation rates, should be their major concern. However, as the role of private capital increases (as already the case in some countries such as South Africa, Egypt, Morocco and Nigeria) the design of macroeconomic policies would need to heed the lessons emerging from Asia. This section focuses on the policies that need to be adopted by African countries to prevent such crises.

The Exchange Rate Regime

The Asian crisis has demonstrated that sound macroeconomic policies should be accompanied by correct exchange rate policies. Importantly, the crisis has once again focused attention on the dilemma of exchange rate regimes in globalised capital and foreign exchange markets. While the fixed exchange rate regime adopted by the troubled Asian countries is held partly responsible for the crisis, past experiences have shown that flexible exchange rate regimes encounter equally serious problems in the face of large capital inflows. In the case of fixed exchange rates large capital inflows would need to be sterilised to prevent capital inflows from expanding the domestic monetary base, which has destabilising effects through increasing the fragility of the financial system. But sterilisation might impose high fiscal costs and reduces the independence of monetary policy. The choice for policymakers lies in the balance between the consequence of not sterilising and the cost of sterilisation (see Table 11).

In the case of flexible exchange rate sterilisation is optional, but if not adopted large capital inflows would cause exchange rate appreciation with adverse economic impacts such as loss of international competitiveness. Again the policy choice lies, in the last analysis, in the balance between the consequence of not sterilising and the cost of sterilisation. Under both exchange rate regimes the surge of capital inflows complicates macroeconomic management and increases the risk of financial crisis. Financial crises are likely to occur under flexible exchange rates as under fixed exchange rates. The policy implication for African countries where private capital inflow is assuming an increasing role, is that constant monitoring of the dynamics between the exchange rate, domestic interest rates and capital inflows is paramount. This would need to be accompanied by fine-tuning based on early warning indicators such as the ration of short-term capital to total capital inflows.

In the context of African countries, the complexity of macroeconomic management arising from large capital inflows is illustrated by the case of Egypt, which managed to keep the exchange rate virtually constant since 1991, reduce inflation and restore investors confidence. Under the Economic Reform and Structural Adjustment Program (ERSAP, 1990-1994), the Government of Egypt implemented policies aimed, among other objectives, at correcting and unifying the exchange rate and

improving the efficiency of the financial sector. Following the adoption of the unified flexible exchange rate, black market dealings in foreign exchange virtually disappeared and the foreign exchange resources of the black market were almost completely absorbed by the formal financial sector. The program has also resulted in remarkable increase in capital inflow and the consequent augmentation of the country's foreign exchange reserves. The large capital inflow into Egypt, however, created a monetary dilemma where sterilization of capital inflow were deemed necessary for exchange rate stability, but the cost of sterilization was feared to jeopardize the fiscal program and the high interest rate was feared to discourage investment. The authorities addressed this dilemma by properly sequencing its actions. Over the short-term of adjustment, where macroeconomic stability was given a higher priority, the negative effects of high interest rates were addressed by measures to improve the efficiency of investment and to enhancing investment by increasing the maturity of loanable funds. In the medium term and following the restoration of macroeconomic stability and confidence in the Egyptian pound, the interest rate was allowed to fall gradually. The authority adopted a policy of fine-tuning the domestic interest rate to a figure which is not too high to discourage investment and not too low to encourage dollarisation and capital flight. The exchange rate was kept virtually constant since 1991 and the movement of short-term capital is closely monitored (see Hussain 1997).

Financial liberalisation

There is increased evidence that financial liberalisation if not properly sequenced can lead to financial crisis. The 1994 African Development Report asserted that financial liberalisation needs to be considered within the broader context of macroeconomic adjustment and other structural reforms. The Report raises the question of "the sequencing of financial liberalisation, and how it interrelates with other aspects of liberalisation, **particularly of the foreign sector**" {emphasis added}. It concluded that financial liberalisation against a background of large budget deficits, rising inflation and the abolition of capital controls may cause as many problems as it solves. The Report also stressed the importance of restructuring and strengthening financial institutions, relieving financial distress, and improving the regulation and supervision of the financial system before full financial liberalisation. A World Bank Study which focuses on the effect of the financial crisis in Asia reached similar conclusions (see World Bank 1998). It asserts that there is strong evidence that financial crises are more likely in liberalised financial systems and that careful sequencing of domestic and external liberalisation is needed. In that, restriction on the capital account, especially on the more volatile capital flows should be lifted only after the domestic financial sector has been strengthened with adequate regulatory and supervisory institutions. This is particularly true for the Asian crisis has shown that reserves, even at very high levels, can be quickly depleted given the scale and volatility of short-term capital flows.

Structural Reforms

Public and corporate governance. Governance issues, which relate to good and transparent management of a country or corporation, have come to play a significant role in the aftermath of the Asian crisis. It has been argued that part of the problems faced by Asian countries were a reflection of the model of development followed by these countries, that of state directed capitalism, which included political patronage and nepotism. Asian companies also followed loose accounting practices. Good political and corporate governance is required to restore market confidence, attract private capital inflows and investments and promote economic growth. There is, thus, a need to make government officials accountable to the public and signal an end to excessive government intervention in the economy

and patronage in the relations between government and business. At the corporate level, it is important that government officials follow generally accepted accounting practices and to increase the accountability of directors, the transparency of corporate structure and valuation as well as financial transactions.

Legal and regulatory framework. The Asian crisis underscored the importance of a sound legal and regulatory framework. One of the most glaring weaknesses in the legal systems of some Asian countries before the crisis was the absence of bankruptcy laws. Banks found it difficult to seize the collateral on bankrupt borrowers. In Thailand's property markets, creditors could wait up to five years before they could seize on the collateral backing a loan. Bankruptcy laws would need to enacted and enforced to improve the position of creditors *viz-avis* bad borrowers and, hence avoid undue bank distress.

Bank supervision is also an issue that needs to be addressed in order to avoid bank crisis. In many of the Asian countries inflicted by the crisis, it was common to value loans as fully valued assets on the banks' balance sheets long after they had seized to become performing loans by generally accepted accounting standards. Thus not only was the regulation and supervision weak, but this also reflected a tendency not to fully disclose information. As part of reform package, Korea, for instance, enacted the Bank of Korea Act, which would give the central bank its independence, consolidate bank regulatory powers into a single supervisory agency and allow greater foreign ownership and participation in the financial sector. To restore confidence in the banking and financial system, supervision and monitoring of banks, providing timely and adequate information on key macroeconomic variables and the balance-sheets and profit and loss statements of banks and corporations are key to allowing domestic and international investors to make informed investment decisions.

International Surveillance

Global surveillance has proposed as one of the ways to prevent financial crises, especially given that as a result of the process of globalisation, major financial crises easily and quickly spill over to other regions. The issue of global surveillance, however, raises a number of questions, such as, who will play the role of "policing" the global financial system; and how far should this surveillance go. It has been suggested that multilateral organisations, especially the IMF should through surveillance warn of potential trouble spots and crises. This will require identification of factors that are likely to cause crises or heighten financial fragility and external vulnerability, and keeping watch of national policies. In addition, there is a need to monitor capital flows, especially short-term debt flows. The question of how far to go with surveillance is rather complex. For example, should Article VI of the IMF Charter, which gives countries power to control capital be amended to extend that power to the IMF and allow it to regulate controls on capital in individual countries? Or, should the IMF and other international financial institutions extend their surveillance to cover accounting practices and financial reporting in individual countries? Moreover, it is important to ensure that incentives exist to encourage individual countries to utilise the surveillance information and act quickly to prevent a crisis. However, in the meantime, and until some form of international regulations are introduced, there seem to be a case for African countries to weigh the benefits of capital account liberalisation against the costs associated with increased likelihood of financial crisis. Here, the evidence points towards the need to encourage the flow of FDI because its benefits clearly exceed its costs and restrict the more volatile short-term capital because of the opposite reasoning (World Bank, 1998).

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