Policy Briefs on the Financial Crisis

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Impact of the Financial Crisis on African Economies - An Interim Assessment

African Development Bank

The Policy Briefs on the Financial Crisis (PBFC) are produced by the Complex of the Chief Economist with contribution from other departments of the African Development Bank. The PBFC are intended to present analyses of experiences and lessons emerging from the Financial Crisis, so as to encourage policy debate that guides the search for sustainable solutions to the crisis.

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AFRICAN DEVELOPMENT BANK GROUP

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Meeting of the Committee of Finance Ministers and Central Bank Governors

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1. Introduction

Last year at this time, Africa was looking at a bright growth outlook, with many arguing that the continent had turned the corner from decades of economic stagnation and structural macroeconomic imbalances. Indeed in 2007, the continent recorded a growth rate of over 5 percent for the sixth consecutive year, which was an unprecedented achievement. Today, the picture is, unfortunately, drastically different. The continent is faced with severe uncertainties about its growth prospects and its chances of reaching its development goals. The main drivers of recent growth performance are threatened by the current financial and economic crisis. The demand and price of African primary commodities are declining, the recent upward trend of capital inflows appears to be losing steam, and promised increases in aid have not materialized.
Furthermore, inflationary pressures have increased in many countries, and the service sector is facing pressures with declining demand, especially for tourism. Already, growth forecasts have been revised downward as a result of these risks. While immediate effects of the crisis may have been limited, medium term effects are likely to be larger.

This paper is an interim assessment of the impact of the financial crisis on African economies as of to date. It also discusses risks and channels of further effects of the crisis in the medium term. It concludes with a discussion of policy responses to address the impact of the crisis.

2. Risk, vulnerability and country-specific factors

African countries are facing four main risks as a result of the financial crisis and global recession. The first is capital outflow risk, namely private capital reversal and amplified volatility of private capital flows with the resulting impact on the exchange rate and ability to finance the current account deficit. The second is fiscal risk, arising from declining revenue (especially international trade taxes) as well as rising expenditure occasioned by the need to support financial institutions and to meet public debt service commitments. The third risk is export risk, related to slowing demand and declining prices of export commodities. The fourth risk is a liquidity risk affecting the domestic banking sector and the government due to the weakening of global financial markets.

The degree of exposure to these risks and, consequently, the magnitude and speed of the impact of the financial crisis and the global economic downturn vary greatly across countries depending on each country's economic structure and particular circumstances. Some countries are, therefore, more vulnerable than others. Two key determining factors of vulnerability are (1) the country's initial macroeconomic fundamentals and (2) the degree of its integration into the global financial system.

With regard to macroeconomic fundamentals, a number of African countries exhibit a high level of vulnerability due to poor macroeconomic balances, namely high current account deficits, high debt levels, and budget account deficits. For these countries, a decline in exports, capital inflows, and government revenues expose them to high fiscal risk with the threat of insolvency. Many African countries can be classified as high risk countries on the basis of these macroeconomic balances considerations (Table 2). In 2007, eleven countries had current account deficits above 10 percent of GDP and 8 countries had debt service to export ratios above 20 percent, which are considered high by conventional standards.

The degree of financial integration varies widely across African countries. The ratio of liquid assets and liabilities to GDP exceeds 20 percent for 9 countries in 2007, but it is generally low for most African countries. Another measure of integration is the degree of foreign bank presence, which is a potential channel of contagion of financial distress. Foreign bank assets represent over 70 percent of total bank assets in 7 countries; and over 70 percent of banks are foreign in 11 African countries (Figures 1a and 1b).

3. Assessing the Impact of the Crisis

In the early days of the crisis, the effects were mostly observed on the financial markets, with stock indexes losing substantially due to outflow of funds. Among African stock markets, only the Tunisian stock exchange ended the year higher than its closing value in 2007, gaining 2.2% in the year. In contrast, the Egyptian CASE-30 lost 56.4 percent of its value, followed by the Nigeria Stock Exchange (NSE) with a 45.9%, the All Share Indices for Mauritius (36.2%), Nairobi stock exchange (34.1%), the Johannesburg Stock Exchange (25.7%), Morocco's Casa All Share (12.9%) and the BVRM Composite Index (10.7%).

The crisis was also accompanied by widespread currency depreciations on the continent, on the expectation of lower export revenues due to declining commodity prices, lower inflows of capital and short-term capital outflows. By the end of the year, all African currencies except for the Angolan New Kwanza were at values below their levels at the end of 2007 in USD terms. Although many have appreciated recently, this has not been enough to fully offset the losses incurred earlier in the year.

For the continent as a whole, inflation ended at higher levels in 2008 relative to 2007, at 8.8%, compared to 7.4%. The 8.8% was 1.3 percentage point higher than anticipated before the financial crisis. In contrast, inflation is expected to be lower in 2009 (6.2%). This is attributable to the decline in oil prices which will ease pressure in oil importing countries. However, despite the decline in oil prices, inflationary pressures persist in many countries. This is due to persistent high food prices and supply-side bottlenecks. Inflation has increased faster among non-resource-rich countries, compared to oil and mineral exporters (Figure 2).

As anticipated, the crisis has caused a slowdown in capital inflows to the continent and substantial outflows of short-term capital. For example, Egypt experienced a decline in net FDI by 44 percent in December 2008 on a year-on-year basis. Meanwhile, due to massive outflows from the Treasury bill market, total *portfolio outflows* amounted to US$3.5 billion in 2008, compared US$1.4 billion in 2007.

Remittances, which have become an important source of external financing for African countries, have been affected by the economic downturn in developed countries. Total remittance inflows to Africa stood at USD38 billion in 2007 and, in some countries, they exceed ODA as a source of external financing. Intra-African remittances are declining as well due to job losses following the decline in the mining sector. The decline in remittances has direct negative effects on household welfare given that, unlike other transfers, remittances are directly used to meet basic needs such as food, education, and health.

Public finances are being affected by the financial and economic crisis through lower revenue, which is making it difficult for countries to maintain planned levels of public expenditure, including long-term infrastructure investment as well as social expenditure. The decline in revenues has been manifest, especially among oil and mineral resource exporters due to the decline in prices. Between 2007 and 2008, many primary commodities experienced drastic declines in prices. However, the prices of some commodities increased on a year-on-year basis, notably phosphate, iron, and tea (Table 1).

The biggest concern with regard to the impact of the financial crisis on African economies is its negative impact on growth and the resulting consequences on living standards. The crisis will reverse achievements made by African countries in raising growth rates, a key condition for poverty reduction. Real GDP growth is expected to decline to 4.6 percent in 2009 from 6.2 percent in 2007 as a result of the global financial crisis (Figure 3). The 2009 4.6 percent growth forecast was revised downward by 1.3 percentage point from 5.9 percent. Compared to the 2007 benchmark, Southern Africa will be the hardest hit, with forecasted growth rate falling to 4.0 percent in 2009, which is a full percentage point lower than projected before the crisis (5% and down from 7.4% in 2007). This reflects Angola's growth declining from 20.9% in 2007 to 7.6% in 2009. The second most hit sub-region relatively to 2007 is East Africa, with a projected growth rate of 6% in 2009 down from 8.4% in 2007.

The financial crisis has worsened macroeconomic balances in many African countries as exhibited by rising current account deficits, budget deficits, and inflation. The current account deficit has worsened between 2007 and 2008 in 32 countries, some experiencing deep declines (Figure 4). This is especially true for Liberia (from 18.7% of GDP to -65.9% of GDP), Madagascar (from -13.9 to -23.1%), Djibouti (from -24.8% to -33.5%), Malawi (from -2.1% to -8.2%) and Burundi (from -16% to -21.9%). These countries will experience difficulties financing these widening current account deficits within the context of declining capital inflows.

The crisis is hitting some of the key sectors that have driven growth over the past years, especially those that are predominantly export-oriented. This is especially true for the mining sector, tourism, and sections of the manufacturing sector. Mining companies have been forced to scale back production and lay off workers due to a decline in demand. For example, in the Democratic Republic of Congo (DRC), most of the 61 foreign mining companies have been forced to scale back, postpone or abandon their investment plans. Affected mining firms have taken various actions, including the suspension of operations (copper and cobalt) and the withdrawal of exploration agreements (diamond). Similar difficulties are observed in other countries where mining activities constitute large shares of economic activity, such as South Africa, Botswana, and Zambia. The slowdown in the mining sector is causing job losses. For example, by December 2008, the DRC Ministry of Mines had reported that more than 200,000 jobs had been lost in the mining sector. A further 200,000 were expected to lose their jobs in the early months of 2009.

The manufacturing sector has been affected by both declining global demand and increase in the cost of imported inputs due, in part, to currency depreciations. Factories are therefore running at lower capacity and employment is seriously threatened. For example, in Uganda, the Manufacturers Associations (UMA) reported that 15 factories closed in 2008 due to the high cost of doing business. Most of these firms were in fish, leather processing, grain and tobacco sectors. Lesotho is also experiencing a decline in clothing and textile exports after a recovery at the end of the MFA in 2005.

Tourism has suffered substantially from the crisis as well, with substantial declines in tourism arrivals and receipts, hotel bookings, and air travel. Kenya Airways reported a decline in profits by 62.7% for the six months ending September 2008. The decline in tourism activity will reverse recent gains made by the service sector which is becoming an important driver of growth. This calls for efforts toward more diversification within the service sector, in particular, and the economy, in general.

The impact of the crisis on the private sector has been worsened by the tightening of credit markets due to a shortage of bank liquidity as well as a rise in uncertainty. African banks are therefore having difficulties securing lines of credit on international markets. Similarly, governments that had planned to raise long-term finance through sovereign bond issues have had to hold back their plans due to the rise in risk and costs. The shortage of financing is particularly affecting *trade financing* and financing for large infrastructure investment, both of which will have drastic effects on the continent's growth prospects.

4. Summing up

While the immediate effects of the crisis have been mitigated, African economies are faced with severe threats of growth deceleration, which would undermine the progress made in reducing poverty. Substantial negative effects have already been observed in terms of losses on stock markets, currency depreciation, and worsening macroeconomic balances (current account deficits, budget deficits). The crisis is hitting the very same sectors that have been driving growth over the past years, namely; natural resources and services. Growth prospects are therefore, much less optimistic than before the crisis.

The development impacts of the financial and economic crisis will be large and will outlast the crisis. In particular, the deceleration of income growth will undermine the modest poverty reduction gains that many countries have registered over the past few years. Efforts to sustain these gains will involve a combination of strategies at the national and sub-regional levels and support from Africa's development partners in terms committed aid delivery as well as incentives to encourage private banks and companies in developed and emerging countries to invest in Africa.

In the short term, Africa's recovery from the current global downturn will depend on the ability to mitigate effects of procyclicality, revitalize domestic drivers of growth and boost domestic resource mobilization to support investment and trade. However, long-term strategies must be oriented toward building more resilience to crisis and sustaining growth.

The following areas will require immediate attention from African policy-makers and the continent's development partners.

- Strengthening the *financial regulatory framework* at the national and regional levels: The reform of the regulatory frameworks should focus, in particular, on issues of financial supervision, *risk management, and systematic disclosure* of information by financial institutions. The key is to ensure *transparency and comprehensiveness* in the regulation of financial institutions and transactions. While preserving the special role of banks, regulators need to ensure that adequate regulation and supervision is established for banks as well as non-banks, on-balance sheet as well as *off-balance sheet financial operations*. Regulation also needs to establish mechanisms for *mitigating procyclicality* of bank lending.

- Supporting domestic growth drivers: Economic policy at the macroeconomic and sectoral level needs to target support for *domestic growth drivers* depending on each country's circumstances. It is encouraging to know that some African countries have already undertaken initiatives – such as cuts in tourism levy on hotel (Egypt) to support sectors that have been exposed to the crisis. Similar measures should be investigated for the mining sector and other export-oriented activities.

- Increasing investment in infrastructure: It is critically important that African countries keep an adequate level of infrastructure investment to support private sector activity, in general, and enhance *competitiveness* and *diversification*, in particular. Hence, financing for infrastructure must be considered a priority by governments, donors and other financiers, including the MDBs.

- Preparedness and targeted responses by MDBs: MDBs will play a critical role in assisting African countries to devise strategies for preventing and mitigating the impact of financial crises. In particular, it is important to evaluate the *resource requirements* for assisting countries affected by the crisis, including *recapitalization of banks* and the provision of targeted finance such as *trade financing*.

- Ensuring adequate flows of development aid: Despite the economic downturn in developed and emerging countries, it is important that donors honor their aid commitments. Any reduction in aid will amplify the negative impact of the crisis, which will, in turn, delay global economic recovery by depressing demand.

Table 1: **Change in some commodity prices between January 2007 and December 2008**

	Brent (US. Dollars Per Barrel)	Gold $/g	Phos-phate $/ton	Iron $/ton	Alumi-num $/ton	Manga-nese $/ton	Cocoa beans, US$ per metric ton	Tea, US cents per Kilo-gram	Coffee, Ara-bica, US cents per pound	Coffee, Robus-te, US cents per pound	Cotton, $/ton
Jan-07	53.7	22.3	45.5	84.7	2809.3	158.8	1702.0	249.7	124.5	80.6	1302.1
Dec-07	92.1	28.3	135.0	84.7	2382.0	202.4	2113.1	206.0	136.5	91.4	1535.0
Dec 08 (or latest)	40.3	28.5	350.0	140.6	1852.0	107.2	2067.7	282.0	116.9	84.0	1020.0
% change Jan 07 to Dec 07	71.6 %	27.3 %	196.7 %	0.0 %	-15.2 %	27.5 %	24.2 %	-17.5 %	9.6 %	13.4 %	17.9 %
% change Dec 07 to Dec 08	-56.2 %	0.4 %	159.3 %	66.0 %	-22.3 %	-47.0 %	-2.1 %	36.9	-14.4 %	-8.1 %	-33.6 %

Note: *latest data are for November for phosphate, iron, aluminum, and cocoa beans; and October for gold, manganese and tea*.

Figure 1a:

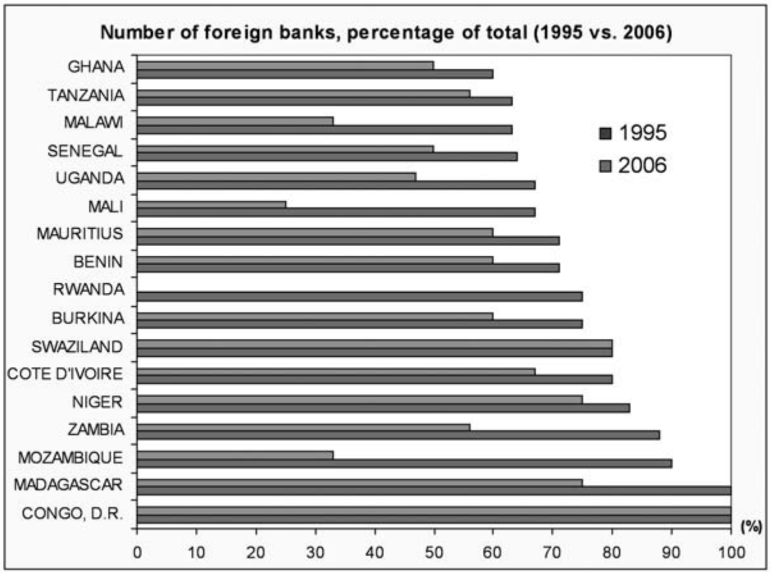
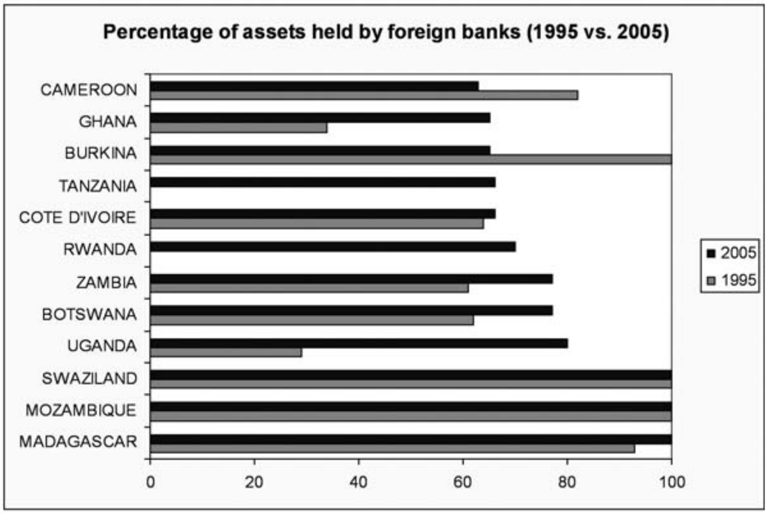


Figure 1a:



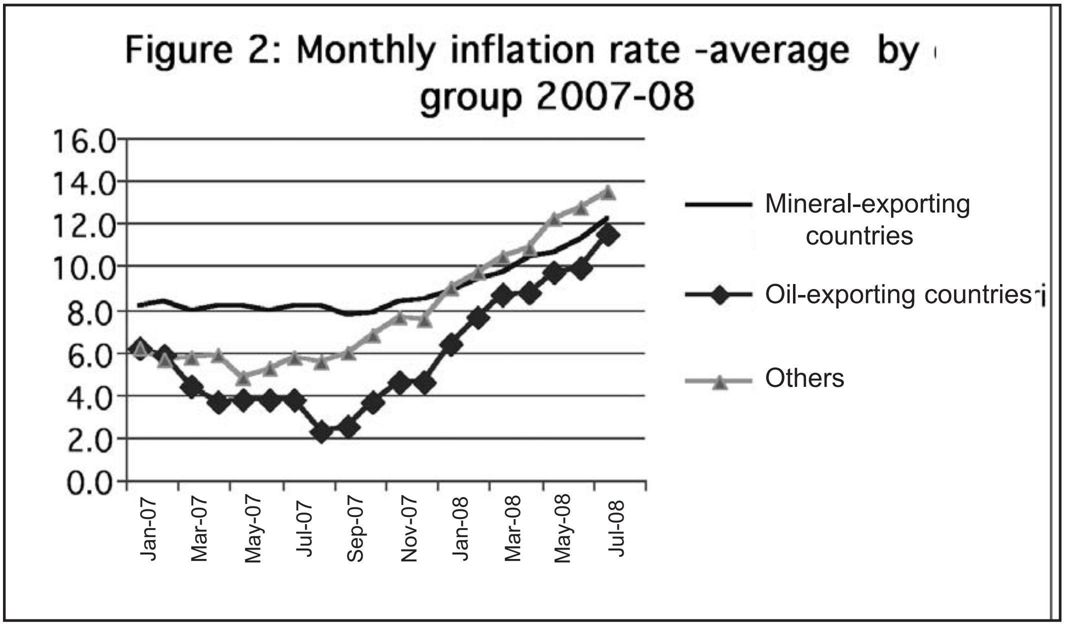
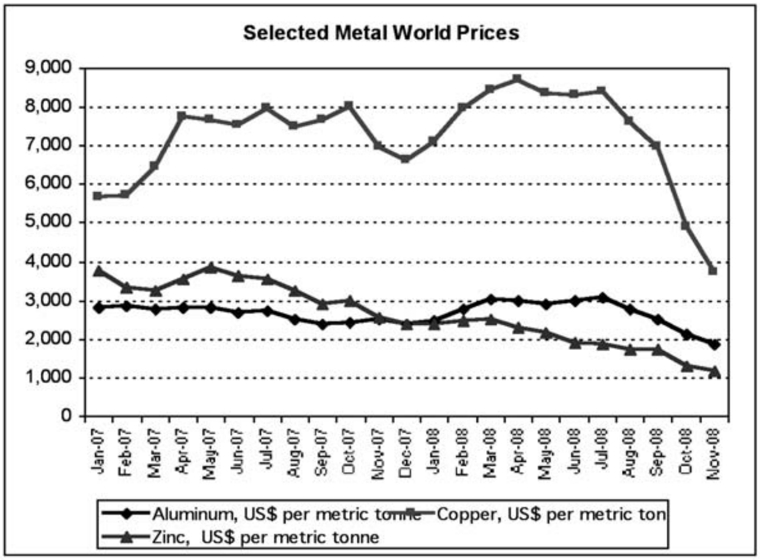
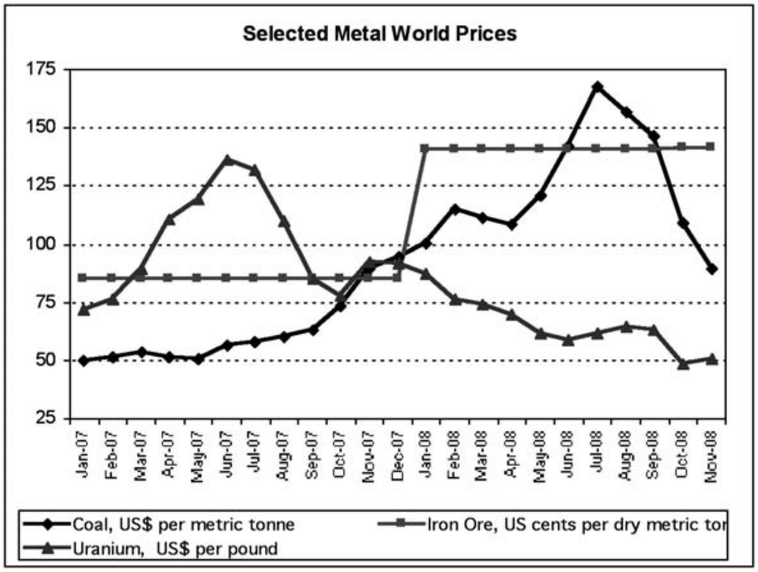
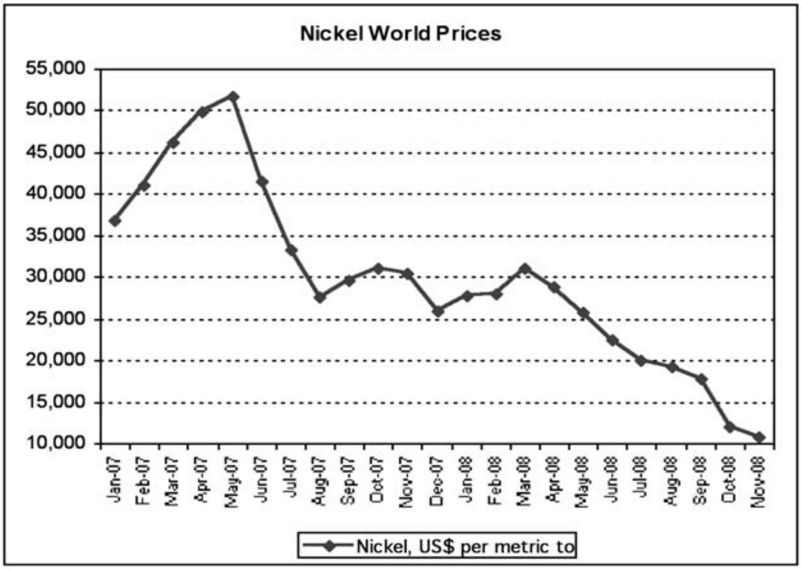


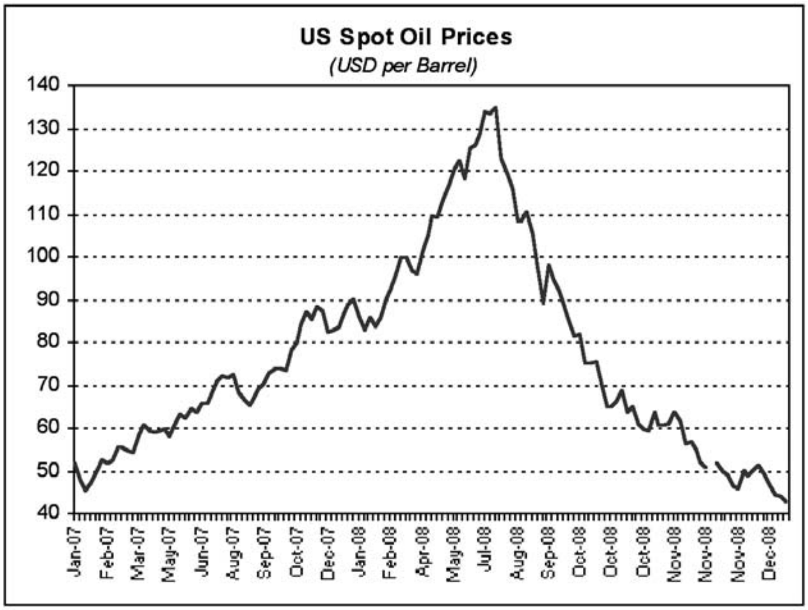
Figure 2: Monthly inflation rate -average by
group 2007-08
16.0
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
Jan-07
Mar-07
May-07
Jul-07
Sep-07
Nov-07
Jan-08
Mar-08
May-08
Jul-08
Mineral-exporting countries
Oil-exporting countries
Others

Figure 3: **Commodity prices Jan 2007-Nov 2008**






Nickel World Prices
55,000
50,000
45,000
40,000
35,000
30,000
25,000
20,000
15,000
10,000
Jan-07
Feb-07
Mar-07
Apr-07
May-07
Jun-07
Jul-07
Aug-07
Sep-07
Oct-07
Nov-07
Dec-07
Jan-08
Feb-08
Mar-08
Apr-08
May-08
Jun-08
Jul-08
Aug-08
Sep-08
Oct-08
Nov-08
Nickel, US$ per metric to


US Spot Oil Prices
(USD per Barrel)
140
130
120
110
100
90
80
70
60
50
40
Jan-07
Feb-07
Mar-07
May-07
Jun-07
Aug-07
Sep-07
Oct-07
Dec-07
Jan-08
Feb-08
Apr-08
May-08
Jul-08
Aug-08
Sep-08
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Nov-08
Nov-08
Nov-08
Dec-08

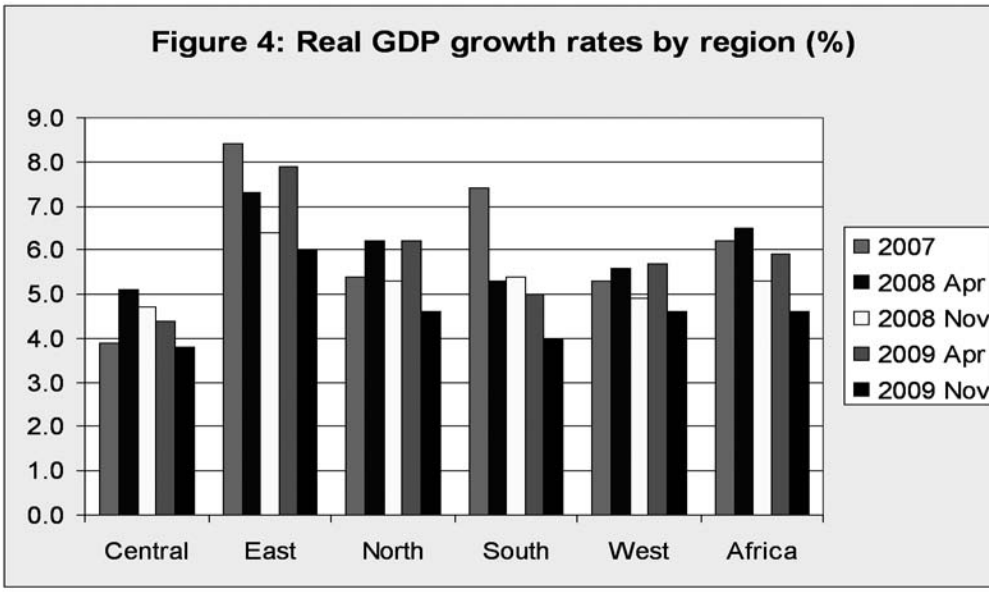

Figure 4: Real GDP growth rates by region (%)

Figure 5: **Worsening current account balance**

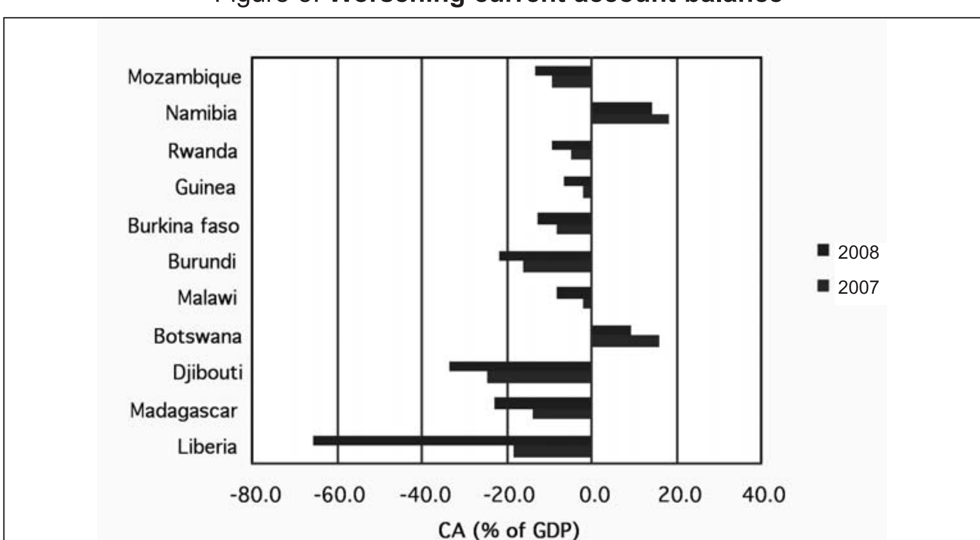

Table 2 : **Some indicators of vulnerability (2007 values)**

Current account (%GDP		**TDS% exports**	**FL&FA (%GDP)**	**Reserves months of import cover**	**% of foreign bank assets**
Seychelles	-38.7	10.04	90.4	0.39	36
São Tomé & Príncipe	-35.5	114.66	43.0	3.81	NA
Liberia	-30.7	0	660.0	2.2	NA
Djibouti	-25.2	8.1	69.3	NA	NA
Congo, Republic of	-19.5	5.0	4.9	7.34	NA
Madagascar	-15.1	1.3	4.7	2.94	100
Ghana	-12.8	3.3	NA	NA	65
Burundi	-12.4	69.1	11.3	4.52	36
Sudan	-11.8	4.5	2.9	1.54	20
Gambia, The	-10.7	198.8	12.2	4.86	NA
Cape Verde	-10.1	9.3	14.4	4.43	NA
Burkina Faso	-9.9	5.8	8.8	7.34	65
Mozambique	-9.4	17.2	0.0	4.79	100
Tanzania	-9.2	132.8	5.5	6.42	66
Guinea	-9.2	8.1	NA	NA	NA
Senegal	-8.1	7.4	9.4	3.89	48
Mauritius	-7.9	3.9	335.4	4.54	37
Niger	-7.7	2.2	5.0	4.22	59
South Africa	-7.3	9.0	28.9	3.94	0
Mauritania	-6.7	2.4	NA	NA	5
Zambia	-6.7	1.3	7.6	3.53	77
Mali	-6.6	3.9	10.0	5.62	57
Togo	-6.4	0.5	10.9	3.9	0
Benin	-5.7	6.3	12.1	12.19	40
Rwanda	-4.8	1.4	NA	NA	70
Eritrea	-4.7	30.3	11.9	NA	NA
Ethiopia	-4.5	5.7	5.0	2.6	0

Table 2 : **Continued**

Current account (%GDP		TDS% exports	FL&FA (%GDP)	Reserves months of import cover	% of foreign bank assets
Central African Rep.	-4.5	0.0	3.4	4.49	NA
Chad	-4.3	2.1	3.5	4.29	NA
Congo, Dem. Rep. of	-4.0	8.1	5.1	NA	47
Sierra Leone	-3.8	4.1	7.0	4.5	NA
Kenya	-3.5	5.8	5.6	3.9	41
Malawi	-3.2	5.6	2.3	1.95	22
Tunisia	-2.5	13.3	12.8	4.91	NA
Uganda	-2.0	6.5	5.1	8.46	80
Guinea-Bissau	-1.7	8.0	7.8	7.16	NA
Zimbabwe	-1.0	8.2	22.9	NA	51
Morocco	-0.1	9.3	5.0	9.12	NA
Cameroon	0.4	9.7	4.7	4.83	63
Nigeria	0.7	3.7	5.1	12.56	5
Swaziland	1.2	0.0	4.1	3.56	100
Côte d'Ivoire	1.4	9.9	4.5	3.38	66
Egypt	1.5	6.6	23.4	8.38	NA
Equatorial Guinea	1.8	0.4	3.0	7.41	NA
Comoros	1.9	70.0	4.2	8.3	NA
Lesotho	4.8	4.4	21.4	6.27	NA
Angola	11.0	8.0	6.2	5.58	53
Gabon	12.8	10.2	13.9	4.25	NA
Botswana	16.8	15.4	7.0	31.75	77
Namibia	18.4	3.6	5.2	3.34	50
Algeria	23.2	3.1	0.9	34.66	NA
Libya	42.5	NA	3.1	37.35	NA

Red: High risk: CA< -7.7%; TDS>15%; FL&FA >20%; Reserves <4 ; % of foreign bank assets (FBA)>60%
Yellow: Moderate Risk: -7.7%<CA< -2%; 5%<TDS<15%; 10%<FL&FA<20%; 4<Reserves<6 ; 30%<FBA<60%
Green: Low Risk: CA > -2%; TDS<5%; FL&FA <10%; Reserves>6 ; FBA<30%

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