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

African Development Bank

Editorial Committee

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AFRICAN DEVELOPMENT BANK GROUP

PANEL 3

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

Ministerial Round Table Discussions and High Level Seminars

2009 African Development Bank Annual Meetings

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EXECUTIVE SUMMARY

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

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

1. INTRODUCTION

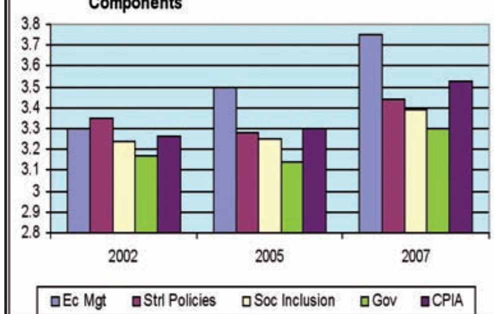
Improved policies, institutions and political leadership over the past decades have played a critical role in the continent's ability to achieve stronger macroeconomic fundamentals. The reform dividends are reflected in higher economic growth with an average of 5 percent over the past seven years. Moreover,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

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

2. AFRICA'S REFORM EFFORTS

Many African countries have intensified efforts over the last two decades to strengthen governance through the development of participatory decision-making processes that are inclusive of civil society and the private sector as well as local communities. Many have introduced decentralized governance structures as part of efforts to broaden public participation and involvement in policy processes and implementation. Reforms have also resulted in improved public service delivery, strengthened capacities, and have led to greater accountability and transparency in public administration. These have been reflected in improved country performance indicators for both policies and institutions, notably measured by the Country Policy and Institutional Assessment (CPIA) scores. The CPIA rates countries against a set of 16 criteria grouped in four clusters: (a) economic management; (b) structural policies; (c) policies for social inclusion and equity; and (d) public sector management and institutions, with 6 as the highest score and 1 as the lowest.

Fig. 1 Africa: Average Overall CPIA and its Components



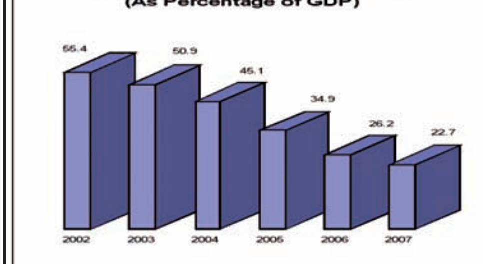
Prudent fiscal reforms have also been reflected in strengthened tax systems, including simplified and more transparent tax codes, broadened tax bases, strengthened tax administration and improved supervision to increase accountability. These have been complemented by prudent monetary and exchange rate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

In addition, since the late 1980s, African countries began to implement financial sector reforms as part of broader market oriented reforms. The financial sector has improved since the implementation of reforms; in some countries, financial depth has improved; credit ceilings and directed credit have been eliminated and interest rates liberalized; risk management has been enhanced; and the banking system has improved—stronger balance sheets and capital base.

The last decade has also seen significant improvements in transparency and accountability in management of the continent's revenues generated from oil and precious minerals. This is particularly due to the emergence of several key initiatives, standards and mechanisms, including the Extractive Industries Transparency Initiative (EITI), the Kimberley Process Certification Scheme (KPCS), and the African Peer Review Mechanism (APRM).

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

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



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

3. THE OVERALL ECONOMIC OUTLOOK IS PESSIMISTIC

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

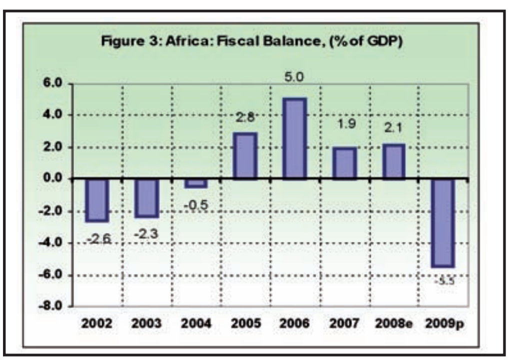


Figure 3: Africa: Fiscal Balance, (% of GDP)

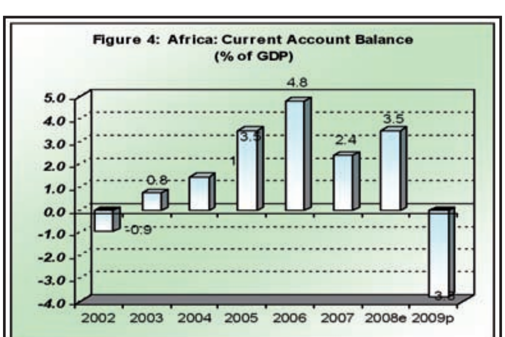


Figure 4: Africa: Current Account Balance (% of GDP)

Source: AfDB Statistics

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

4. THE WAY FORWARD

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

As the crisis hits the continent, African governments have taken a number of initiatives to mitigate the impact of financial and trade shocks, and some have set up special units to monitor the impact of the crisis and to formulate targeted responses. Some governments have responded by introducing a range of policy measures such as fiscal stimulus packages, targeted assistance to sectors, capital and exchange controls, new regulations in the banking sectors, expansionary monetary policies, and bond financing of public expenditure. However, the resources are inadequate in relation to the scale of the impact.

The following areas will require immediate attention from African governments, the continent's development partners, and the African Development Bank:

4.1 The Role of African Countries

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

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

The Role of the International Community

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

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

nationally-agreed initiatives in support of African development.

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

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

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

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

4.3 So What More Can the Bank Do?

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

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

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

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

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

DISCUSSION QUESTIONS

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

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

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

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