Policy Briefs on the Financial Crisis

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Trade, Investment and Domestic Resource Mobilization

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

Trade, Investment and Domestic Resource Mobilization

Meeting of the Committee of Finance Ministers and Central Bank Governors

Cape Town, South Africa,
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1. Introduction

A dedicated G20 macroeconomic work stream has been established to conduct thorough analysis of the roots of the crisis and lessons to be learnt to lay down sound foundations for economic recovery and avoid crises of this scale in the future. Its scope is also to identify policy responses required to deal with the fallout of the real economy, address national needs while enabling an open global economy and international cooperation, and to lay the foundations for sustainable recovery.

This briefing note speaks directly to the work of the macroeconomic work stream. Its scope also covers issues of relevance to another G20 working group that deals with Multilateral Development Banks. The issues pertain to the leveraging of international development resources to meet poverty and growth challenges, especially for low-income countries.

Most African banks and other financial activities were not affected directly by the first round effects of the financial crisis due to lack of exposure to international credit markets. However, most countries, including Ghana, Nigeria, Egypt, South Africa and other members of the Common Monetary Area (Lesotho, Swaziland and Namibia) experienced real currency depreciation as investors moved their positions from emerging markets. In addition, another immediate visible impact of the crisis on African countries, which is likely to have a long-term impact, is the decline in prices of commodities such as oil, copper, gold, platinum as well as wheat and maize. This decline in commodity prices has already been felt in many countries through widening of current account deficits and a drop in reserves.

In terms of the second round effects, the spill over of the crisis to the real economy in developed countries has pushed many countries into a recession, which is having a visible impact on Africa through demand for African exports and investment. Trade performance is affected further by lack of financing due to liquidity shortage in the financial sector as investors move away from Africa and other emerging markets. The International Monetary Fund (IMF) forecasts show a fall in global trade volumes amounting to 4.1 percent in 2009 and Africa is expected to be seriously affected.

All these factors will have serious implications on African countries through employment and growth, which undermines the fight against poverty and progress towards meeting the Millennium Development Goals (MDGs) by 2015. However, recent developments in the global economy present some opportunities to African countries in terms of lower oil and food prices, which have had a huge impact on current account deficits, inflation as well as humanitarian effects such as hunger.

The aim of this briefing note is to highlight major effects of the crisis on African countries with emphasis on trade financing. The analysis provides input for ministers and governors to deliberate on the ability of African countries to withstand potential effects from the financial crisis through targeted policy responses, including innovative instruments to mobilize domestic resources to meet the growing financing gap.

2. Managing First Round Effects

In the early days of the banking crisis, a lot of reference was made to “decoupling”, that Africa would not be directly impacted by the current banking crisis due to its weak integration into the global economy. African capital markets are the smallest in the world and account for less than two percent of the global stock market capitalization and less than one percent of global debt securities and bank assets. Besides South Africa, Nigeria and Egypt, most African economies are marginal recipients of portfolio flows which, compared to foreign direct investment, are subject to high volatility. For countries like South Africa, the main concern is the financing of the large current account deficit which has largely depended on short-tem capital flows.

Prior to the financial crisis, Africa was experiencing a substantial *increase* in financial flows driven by higher yield and improved risk assessments. However, the crisis has prompted the withdrawal of international investors from domestic debt and capital markets in Africa, resulting in a downturn in African stock exchanges. Already, stock markets in Egypt, South Africa and East Africa have experienced high volatility, and stock values have fallen. In South Africa, for example, the stock exchange lost 27 percent between January 2007 and December 2008, while Egypt and Mauritius lost about 37 percent and 59 percent of their market values, respectively, in the same period.

Similarly, many currencies experienced steep depreciation, which will increase the burden of debt for countries servicing debt in local currency. All African currencies depreciated, against the United States dollar, except those of Angola, Liberia and Sao Tome and Principe from the end of

July to the end of November 2008[1] . The worst affected currencies during this period were those of Seychelles (110 percent), followed by the D.R. Congo, South Africa and rand-linked currencies of Lesotho, Namibia and Swaziland (about 34 percent each). Zambia and Ghana also experienced some significant depreciation of their currencies, at 28 percent and 26 percent, respectively. More recently, some countries have recorded a recovery in currency values against the hard currencies. Most of the appreciations took place during the last week of November 2008, with South Africa leading at 6.5 percent. The Euro linked currencies of the CFA Zone appreciated by about 3 percent during the same period while the Zambian kwacha and Kenya shilling appreciated by 2.1 percent and 1.8 percent, respectively.

More pronounced has been the impact of the crisis on the prices of commodities such as oil, copper, nickel, coal, platinum, gold, coffee, cocoa and others. From a peak of US$140 per barrel in July 2008, the price of oil declined to about US$40 in December 2008, less than half the price of nearly US$100 per barrel in November 2007 (Figure 1). For most commodity exporting countries such as Nigeria (Box 1), this translates into a large loss in revenue, while for net oil-importing countries, the gains are reflected in the easing of inflationary pressure and lower current account deficits.

Overall, currencies and stock prices continue to be volatile though there are signs that markets may be stabilizing. Similarly, commodity prices remain volatile and unpredictable and this is likely to affect African countries that are heavily dependant on commodity exports. Thus the issue of diversification of African economies remains crucial for growth.

3. Impact on the Real Sector

As the problems in the financial sector in the United States and Europe spread to the real economy, concerns are mounting regarding the adverse impact on developing economies, in general, and African countries, in particular. The critical challenge is to restore confidence in the financial system – a key ingredient to proper functioning of the financial system – and liquidity to keep an adequate level of private sector lending for investment and consumption.

The effects of the financial crisis on Africa are not one-dimensional. They interact with each country's prevailing macro-eco-

[1]Analysis excludes Zimbabwe which has been experiencing economic problems not related to the financial crisis.

Box 1:
Nigeria government undertakes vigorous response to the financial crisis

Nigerian financial markets are already feeling the hit of the global financial crisis in many respects. International hedge funds managers had taken as much as USD 10 billion out of the country by mid October; Nigerian banks saw their credit lines shrink rapidly (e.g., letters of credit); and for new initiatives such as the Nigeria Infrastructure Fund prospects for funding have faded away.

The stock market has suffered a major setback, with the all-share index declining from 52,916 in July 2008 to 28,986 as of December 9, 2008. This reverses a trend where the index had nearly doubled during the period of January 2007 (at 33163) to March 2008. Market capitalization has declined by 6 percent from January to October 2008.

In response to the crisis the Nigerian Government has undertaken a series of measures to address the adverse impact of the crisis on the financial markets. A Presidential Advisory Panel was set up to monitor the events and advise the government on appropriate responses. The Stock Exchange Commission stepped in by setting up two expert panels to deal with issues of governance and operations. The Central Bank introduced major innovations in its instruments including: a reduction of the policy rate from 10.25 percent to 9.27 percent; a reduction of the cash reserve ratio from 4 percent to 2 percent and the liquidity ratio from 40 percent to 30 percent; it injected an equivalent of $1.27 billion in the system in October 2008 to shore up liquidity. These measures have been instrumental in maintaining confidence in the financial system and sustain private lending.

Meanwhile the decline in the price of oil created serious problems for public finances. In October 2008, the Government was forced to adjust the benchmark oil price to US$45 per barrel, down from $62.5 for the purpose of the 2009 Appropriation Bill. Now even the US$45 per barrel seems optimistic. This drop in oil revenue will continue to force substantial tightening in many areas of government spending in the coming year.

nomic context. The briefing note sketches generic real sector impact of the crisis for a typology of countries according to their common characteristics with some evidence drawn from different sources, including AfDB financial crisis monitoring reports, country briefs as well as IMF research, the World Bank and other institutions. However, one can identify five distinct real economy transmission channels.

First, access to ***international and domestics capital markets***, through bond issues, become more costly as liquidity tightens. This has a direct impact on the costs of large *infrastructure investment projects* such as dams, roads, railroads and electricity generating plants, among others. Countries that had planned to issue sovereign bonds, such as Uganda and Kenya, have been forced to delay these plans due to unfavourable pricing in the international capital markets. Similarly, banks that have relied on *credit lines from* the international capital markets may have to scale back operations and seek alternative sources of financing, such as regional development banks like the African Development Bank. Unless cheaper resources can be found elsewhere, *large infrastructure projects* are at risk of being suspended as domestic resources become more expensive.

Second, the recent increase in ***Foreign Direct Investment (FDI)*** flows is not likely to be sustained due to the recession in developed countries which are the major source of capital. A slowdown in FDI will have serious implications on economic growth in Africa as FDI flows have been a major driver of recent economic performance on the continent. This decline in private capital inflows will affect capital intensive *infrastructure projects* in the medium-to-long term. Overall, according to World Bank estimates, private flows to developing countries are projected to decline from US$1 trillion in 2007 to around US$530 billion in 2009 (or from 7.7 to 3.0 percent of developing country GDP).

Box 2: The Kenyan market experience

The two-year bond of Kenya Shilling (Kshs) 6 billion was under-subscribed by 45 percent compared to a subscription rate of 161 percent of the last one-year bond issue on 23 November 2008. The Central Bank of Kenya, has announced that the threshold for investments in Treasury Bills in the primary market will be reduced from the current Kshs 1 million to Kshs 100,000.00 from the beginning of January 2009. This should help mobilize more domestic resources.

On the whole, weaker investment confidence is making access to finance more difficult as banks and investors take a more cautious approach, further reducing lending to the private sector. Small and Medium Enterprises (SMEs) are particularly affected by worsening credit conditions. In normal times, market failures and peculiarities of SMEs lead to a sub-optimal allocation of credit to SMEs. In an economic downturn, these effects are amplified by the regulatory framework for banking intermediation, which represents the point of reference for bank prudential supervision in African countries. Reduced access to domestic capital for SMEs will have an impact on employment creation and poverty reduction.

A third notable impact on the continent's real sector will depend on the extent of the crisis' impact on ***Africa's trading partners***. In that sense, the countries that will be most rapidly affected will be those with substantial links with the United States. This is applies to Nigeria, whose trade with the United States accounts for more than half of its total trade (52 percent). For most African countries, their primary trading partners are in Europe and increasingly in Asia (mainly China). Already, expected growth rates in Europe and Asia have been revised to -0.5 percent and 7.1 percent, respectively. African exports will, therefore, decline as the financial crisis spreads to the real sector in key markets, resulting in weaker demand for primary commodities.

It should be recognized that the overall impact of the crisis on Africa will depend on the *sectoral composition of exports*. For example, countries like Ghana have not been affected by the crisis because the main export is cocoa, a commodity which is still enjoying relatively high prices. In Lesotho's case, however, although total exports have increased, recent data show that exports in the manufacturing sector, which are driven by clothing and textiles exports, have started declining again in 2008 after the downturn as a result of the end of the Multi Fibre Agreement in 2005. For a small and poor country like Lesotho,

Box 3: Impact of the crisis on FDI in Egypt

FDI plunged by 44 percent in December 2008, compared to the corresponding period of the previous financial year. Meanwhile, portfolio outflows increased to US$3.5 billion against US$1.4 billion over the same period last year, with foreign investments in Egyptian treasury bills representing 90 percent of these outflows.

this type of disruption to the economy will have far-reaching consequences on efforts at reducing poverty.

The *tourism sector* is also likely to contract as a result of the financial crisis, especially in Kenya, Tanzania, South Africa, Mauritius, Egypt, Tunisia and Morocco, which had experienced substantial increases in tourism activity in recent years. Tourism sectors in Egypt and Mauritius have already been hit by the crisis as the number of tourists from developed countries continues to decrease. In Egypt, tourism booking indicators for the winter season are down by 40 percent compared to the same period last year. Therefore, the success of these countries in diversifying their sources of export earnings may be severely undermined by a global recession.

Furthermore, the impact on trade will be felt through the liquidity constraint which has already had an impact on ***trade financing***, especially in the case of short-term shipping contracts. Given that 60 percent of trade finance is handled by private agents and 90 per cent of the US$14 trillion worth of trade is financed by trade credits, the impact of further market tightening could have dire consequences on trade performance. Analysis by the World Trade Organization shows that the liquidity shortage and disproportionate aversion to risk has led to a shortfall in available trade finance of about US$25 billion, disrupting therefore trade and growth performance, and possibly exacerbating the effects of the crisis.

At the microeconomic level, firms involved in foreign trade may run into difficulties in maintaining their production and trade activities due to the lack of access to low-cost foreign currency denominated working capital. At the macro-economic level, the loss of liquidity in the trade sector, forces importers and exporters to obtain spot foreign exchange to make necessary payments and service debt falling due, thereby increasing demand in the foreign exchange market. It may also reduce the supply of spot foreign exchange, given increased probability of delayed receipts of foreign exchange earnings from exports and a decline in exports that depend on imported inputs and materials. The resulting pressure on exchange rates may compound the country's external debt and payment difficulties and increase country risk, leading to further cutbacks in all funding, including trade finance.
Finally, the scarcity of trade credit hinders potential export stimulus from exchange rate depreciation that accompanies the crisis, impeding economic adjustment and recovery. Thus, these negative externalities associated with sharp contractions in trade finance have damaging effects on the trade sector that extend to the wider economy.

Lastly, an important and growing source of household income in Africa is ***workers remittances***, estimated last year at about US$25 billion and, in some countries, these remittances outstrip FDI inflows (Figure 2). The World Bank estimates that remittance flows into developing countries, including Africa, are expected to decline from 1.8 percent of recipient country GDP in 2008 to 1.6 percent in 2009.

The main concern is that unlike other transfers, remittances are directly channelled to households and are used for family recurrent expenditures, such as food consumption, medical "out-of-pocket" expenditures and education for children. The financial crisis, which has slumped key developed countries into a recession will therefore lead to a slowdown in remittances as demand for unskilled labour declines in order to protect domestic jobs. Some developed countries may react by putting restrictions on migrations. In Africa, a slump in commodity prices such as gold, platinum and diamond has also affected demand for labour which has resulted in lay-offs of migrant workers from neighbouring countries.

In South Africa, approximately 32,000 mining workers were retrenched in the third quarter of 2008 after the sudden downturn in metal prices in the second half of the year, putting pressure on remittances in the case of workers from Lesotho.

The major concern in terms of the impact of the financial crisis on the real economy is the adverse effect on domestic demand, namely consumption, investment, exports and government spending. Any substantial decline in domestic demand will reduce income which will, in turn, affect employment and, consequently, growth. A reduction in growth will therefore reverse the modest gains made regarding poverty reduction over the past years. Africa is already doing poorly both in absolute and relative terms with regard to poverty. Further reduction in output will therefore make the poverty situation dramatically worse.

Box 4: Remittances some country experiences

In the case of Egypt, for example, remittances represent more than 32 percent of the total service receipt in the balance of payments account, while in Lesotho and Uganda remittances account for 60 percent and 40 percent of export earnings, respectively. Workers remittance flows in Kenya for 2008, for example, are expected to exceed those for 2007. The total flows during the first 11 months of 2008 to November amounted to about US$ 570,000 compared to US$ 573,000 for the whole of 2007. However, remittances since July 2008, except for October, are significantly smaller when compared to flows over the same period in 2007. This may point to lower remittance flows in 2009.

4. Next Steps

Cyclicality is part of the free-market economy. It is important for Africa and the international community to be wary of protectionist sentiment and related policy responses and the reallocation of resources away from ODA commitments to developing countries. Nevertheless, African countries have an opportunity to learn important lessons from this crisis and act pragmatically. Going forward, intervention should include policies to support *domestic resource mobilization* - public and private - to support planned government investment and to reinvigorate the private sector. On the global level, there is need for more pressure for the international community to conclude the *Doha Trade Round.*

Encouraging Domestic Resource Mobilization

The financial crisis is expected to reduce external sources of financing for African development, including FDI, portfolio investments, remittances and trade credits. Compounding this situation are the challenges created by the financial crisis in raising the levels of domestic resource mobilization in Africa. For example, tax revenue in oil exporting countries has already declined with the dramatic fall in oil prices since July 2008. Similarly, royalties from the mining sector have dropped, especially for existing flexible and new contracts, as commodity prices are also falling. Also, in the aftermath of the financial crisis, strengthened risk control by banks will increase their probability of rejecting good investment proposals. Thus, it is imperative that African countries strengthen their capacity for domestic resource mobilization, if the continent is to sustain the remarkable growth it has enjoyed in recent years.

What should African countries consider? The low level of financial sector development in Africa certainly raises the urgency of the financial sector and fiscal reforms. This is key to ensuring the existence of the necessary internal conditions for mobilizing development resources. In the financial sector, emphasis should be on the establishment of property rights, contract enforcement mechanisms and laws ensuring creditors' rights. Banking supervision authorities should also seek ways of encouraging banks to lend to SMEs as these have been proven to have a large impact on employment and the diversification of production. SMEs are an important component of the economic foundation for sustained job creation and poverty reduction.

Further, developing an efficient *domestic bond market* will help in the development of public bond markets as well as stock markets. Moreover, African countries are encouraged to deepen reforms in order to broaden the tax base and combat tax evasion. Introducing *funded pension schemes* will also help African countries improve resource mobilization. *Debt management* should also be part of the priorities going forward, especially for countries that have suffered currency depreciation in light of foreign currency denominated debt. Domestic resource mobilization should also entail increased importance on improving resource efficiency and *public financial management*.

Progress on the Doha Trade Round

At the global level, the resumption of the Doha Trade Round remains critical to stimulating the global economy. History indicates that recessions or cyclical slowdowns often coincide with an increase of *protectionist trade policy*. This is not only the case for the European Union and the United States, but also for emerging BRIC countries (Brazil, Russia, India and China). Africa - like other developing countries - stands to lose from increased protectionism in developed countries as well as a decline in their demand for exports from Africa, a situation which would have an adverse impact on economic growth and poverty reduction. Countries should also make progress on Aid for Trade in order to address internal supply side constraints to support the trade liberalization agenda. Key areas in this agenda include *trade policy and regulation, trade-related infrastructure, trade related adjustment and capacity building*, among others. However, it should be noted that Aid for Trade should be viewed as a *complement* to the Doha Round and not a substitute.

African countries should seize the opportunity presented by the crisis to continue deepening their *unilateral reforms* which can later be locked into the multilateral framework as bargaining chips. In addition, African countries should explore viable *bilateral trade agreements* with other Asian and Latin American developing countries. It is also important to bear in mind that the current financial crisis highlights the risks of becoming overly-dependent on foreign export markets for domestic economic growth. The risk of export dependency could be mitigated by boosting intra-African trade to reduce market concentration. This *“within the continent” growth strategy* will complement existing export channels to the European Union, America and Asia. Further, given the status of intra-African trade, African countries should increase momentum in addressing constraints that impede progress, going forward. This entails addressing critical issues such as overlapping membership and improving trade facilitation.

Realizing Commitments to Increase Development Assistance and Aid Effectiveness

African commitment to pursue pragmatic policy reforms is not enough. Development partners have an opportunity to complement pragmatic policy reforms by leveraging commitments made at the 2005 Gleneagles G8 summit, despite the financial crisis. While the commitments are still to be fulfilled, this event saw world leaders from industrial countries pledge an additional US$25 billion per year to Africa by 2010. Paradoxically, the size and speed of the bail-out in developed countries, exceeding US$950 billion, approved in a matter of days, appears to dwarf the resources needed to achieve the MDGs and reduce poverty. A move, by development partners, to adopt policies leading to lower disbursements as the fiscal situation tightens, would be regrettable.

Committing to these pragmatic policies by both African countries and their development partners will not only reduce the impact of current financial crisis, but will also lay the foundation for long-term equitable growth and sustained poverty reduction efforts. Donors such as the European Union have reaffirmed their pledge to meet the Gleneagles commitment despite the crisis. The recent G20 communiqué underscored the importance of the Monterrey agreement on ownership and resource mobilization in order for countries to make progress towards meeting the MDGs.

The aid effectiveness agenda should also consistently follow the *Accra High Level Forum on Aid Effectiveness Action Plan*. The key actions agreed in Accra include improving predictability of aid flows, supporting ownership of interventions by developing countries, increasing the use of country systems, streamlining the use of conditionality, untying aid, reducing fragmentation of aid and strengthening partnerships in the spirit of the Paris Declaration principles.

5. Possible Responses by the AfDB and other MDBs

The AfDB and other MDBs can help African countries through targeted interventions with a deliberate move to mitigate ***procyclicality***. Two important targets that are within the reach of MDBs are: (1) offsetting the decline in government revenues linked to falling trade volume; and (2) compensating the decline in loanable funds in the banking sector. The first target can be achieved through budget support while the second can be achieved through the provision of support to commercial and development banks notably by offering lines of credit and financing innovative projects in support of long-term private sector lending.

Further, the AfDB and other MDBs should consider establishing or strengthening *trade finance facilities* to address the issues that have emerged from the liquidity constraints, reducing letters of credit needed by importers and exporters to move goods. Specific products to mitigate procyclicality include the introduction of emergency liquidity facilities, loan guarantee products, portfolio restructuring, supporting the development of sound ***domestic debt*** markets in Africa through the creation of the African domestic bond fund (ADBF)(2).

The Bank should leverage its position and superior knowledge of country-specific environments to attract other financiers. Indeed, intervention by the Bank provides not only finance, but also the much-needed stamp of approval of the feasibility of projects with regard to political and financial risk.

Box: 5 The African Domestic Bond Fund

The ADBF will be invested in local currency denominated sovereign African bonds and it will be initially funded by the AfDB and African Central Banks. The specific objectives of this instrument are: (i) to reduce African countries' dependence on foreign currency denominated debt; (ii) to encourage the deepening of Domestic Bond Markets through investments in longer dated assets; and (iii) to contribute to enlarging the investor base in African Domestic Bond Markets.

(2)The activities of AFMI will be organized around the following components: i) the creation of an African Financial Markets Database; and ii) the creation of an African Domestic Bond Fund. Potential participants in AFMI include international financial institutions such as the World Bank, the IMF, the BIS and the OECD. Also, regional Institutions such as the Association of African Central Banks, the African Central Banks themselves, and a variety of experts from both, the public and private sector will take part in AFMI.

Questions for Ministers and Governors to consider

- **What instruments are in place for African countries to address issues related to trade financing (i.e. trade finance facilities)?**

- **What are the adjustment mechanisms or social safety nets available to support sectors (i.e. mining and manufacturing) that have been affected and how do governments plan to address the problem of workers who have been laid off?**

- **Which types of instruments are available for increasing domestic resource mobilization (i.e. bond market developments, taxation)?**

- **What types of assistance are Ministers and Governors expecting from institutions such as the AfDB, UNECA and the AU?**

Figure 1: **Trends in Commodity Prices**

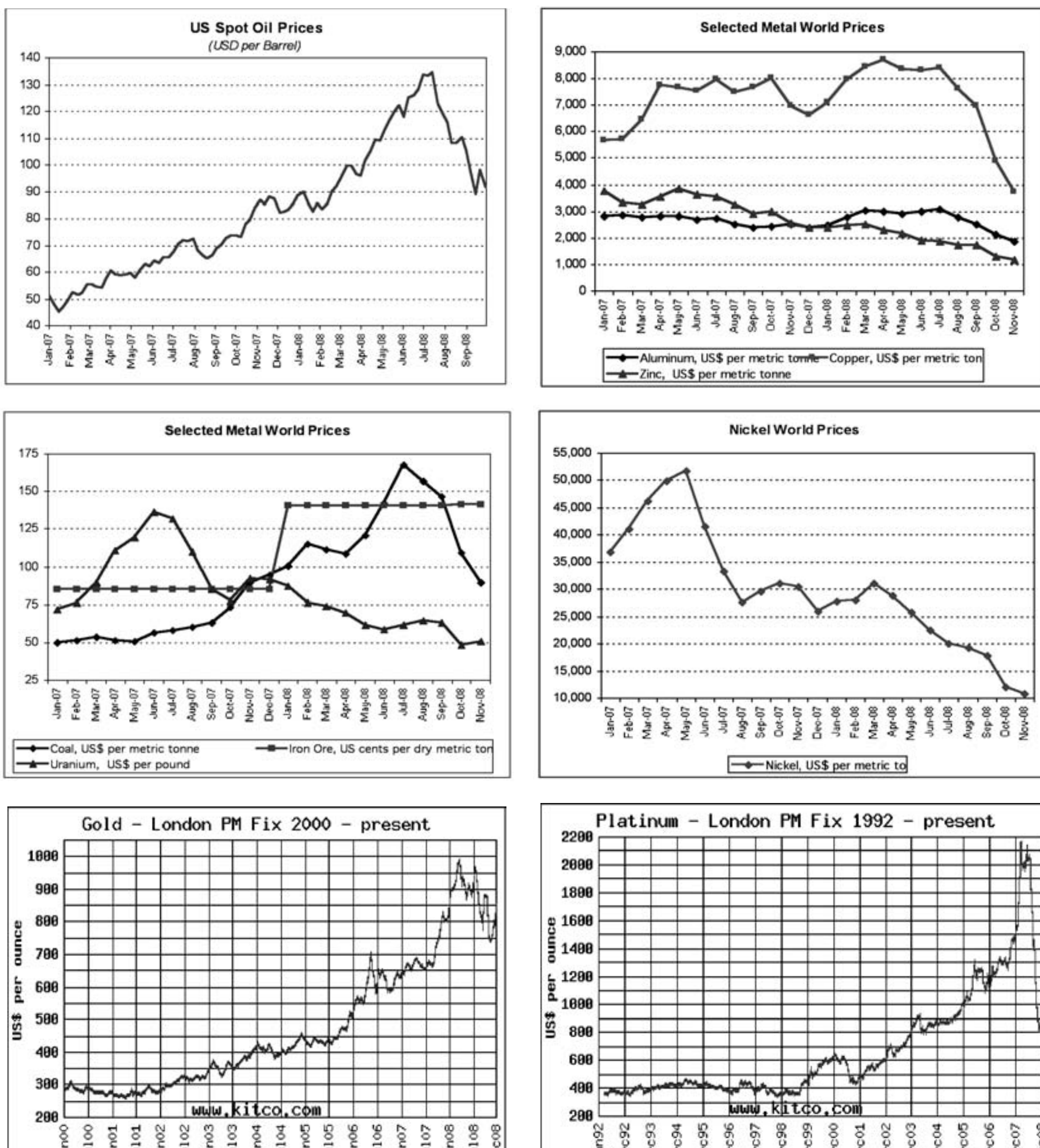
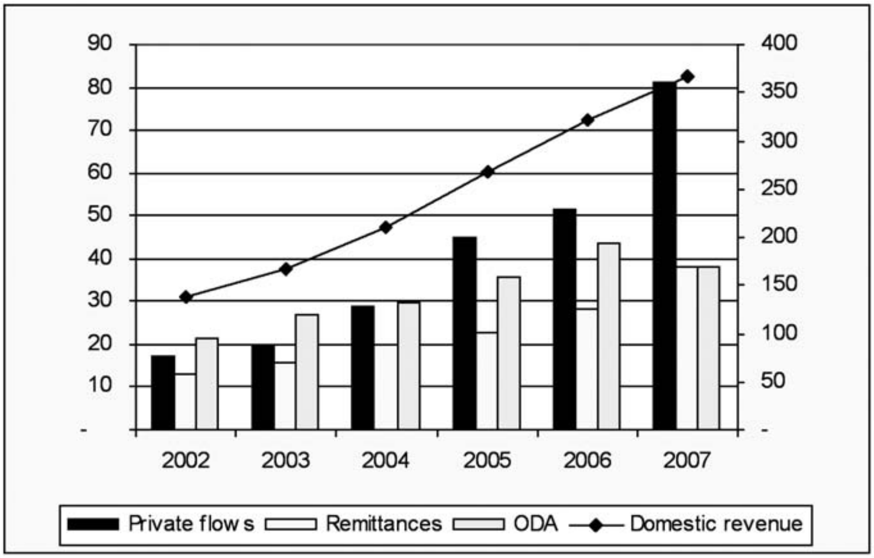


Figure 2: **Sources of Financing (billion US$)**



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African Development Bank

Angle de l'avenue du Ghana et des rues Pierre
de Coubertin et Hédi Nouira
BP 323 - 1002 Tunis Belvédère (Tunisia)
Tel.: + 216 71 333 511 - Fax: +216 71 351 933
E-mail: afdb.org - Internet: www.afdb.org