Introduction

The world economy once again is in turmoil due to sovereign debt crisis in the United States (US) and Europe. The US credit downgrade came at a critical time for the world as it may have the effect of gearing up market sentiment against a rapid recovery. Stock markets plunged on news of the downgrade, but recovered shortly afterwards and remain highly volatile. Furthermore, European banks remain highly exposed to the European sovereign debt. For example, if Spain fails to meet its debt payments and needs to restructure its debt, European banks’ losses would sky-rocket to €1.1 trillion, or 62% of their total bank capital. Some American banks face the same level of exposure. For instance, JP Morgan holds close to USD 15 billion of total exposure to Greece, Ireland, Italy, Portugal and Spain. In this context, analysts reviewed downward both the Eurozone and US 2011 gross domestic production (GDP) growth forecasts. The International Monetary Fund’s latest World Economic Outlook (released on September 20) slashed a whole point off the US GDP growth forecast for 2011 relative to its June projections. The US economy is now expected to end the year with an anemic 1.5% growth. The euro area, with a forecast growth of 1.6% for the year (down from the June forecast of 2%), will not do any better, and prospects will only marginally improve in 2012. Similarly, the Economist Intelligence Unit (EIU) lowered its euro zone growth forecast from 2% to 1.7% in August 2011.

We estimate that a 1% drop in GDP growth in the Organization for Economic Cooperation and Development (OECD) countries will translate into close to half a percentage point change in Africa’s growth. If the 2008/09 global crisis is any guide, the most important dimension of the impact on Africa will be through significant reductions in Africa’s trade with OECD countries. Our estimates show that a 1% drop in growth in GDP of OECD countries results in a 10% reduction in Africa’s export earnings and 2.5% reduction in its imports.
The adverse effect of the 2008/2009 crisis would have been bigger had it not been for the increased resilience of African economies. This is due to better economic governance, and the rise of emerging economies, which helped the continent reduce its dependency on its traditional partners. However, unlike the 2008/2009 financial crises, the current sovereign debt crisis may also affect the pace of growth in emerging economies such as China, which could in turn have adverse effects on Africa’s growth.

On the other hand, for African countries there is a silver lining to the current crisis. Investor’s appetite for bonds issued by triple-A rated agencies from Africa has increased considerably recently. Even sovereign bond issues by African countries like Ghana, Nigeria, Gabon and Senegal have enjoyed success. For example, spreads on a new issue of 10-year bonds by the Government of Senegal in May 2011 narrowed by over 100bp in the secondary market within two weeks of the launch, confirming strong investor interest in such bonds.

The rest of this brief analyzes the potential impacts of the debt crisis in US and Europe on Africa’s growth prospects and identifies the different possible channels.

2 Channels of transmission of a debt crisis in US and Europe on Africa

Slower growth in OECD countries will affect African economies mainly through five channels: trade, liquidity, sovereign risk, foreign direct investment (FDI) and remittances, and volatility of portfolio flows, stock markets and exchange rates.

2.1 Trade

Slower economic growth in OECD countries will result in lower demand for Africa’s exports. This constitutes the most important transmission channel through which African economies will be impacted. Indeed, Africa’s trade contracted by 20.6% in the midst of the 2009 financial crisis. The decline was larger for exports (-29%) than for imports (-11.7%), and varied across countries and regions according to (i) the level of export concentration (market access) and (ii) the degree of export market diversification. The least diversified regions were most severely hit by the crisis.

Africa remains the least diversified region in terms of market access. Fifteen African countries send half or more of their exports to Europe.
These include the small and vulnerable island economies of Sao Tome and Principe, Cape Verde, Mauritius, Seychelles and Comoros, which, additionally, are highly dependent on European tourists, as well as oil exporters like Libya, and more diversified economies like Tunisia. These countries are therefore most exposed to the trade risks that a deepening crisis in Europe might entail. In addition, the US is the main market for oil exports from Chad, Gabon, Angola and Nigeria, and for Lesotho’s garments, which makes these countries particularly vulnerable to a fall in US demand. Regionally, North Africa is the most dependent on European export markets, with the European Union (EU) taking in 58% of the region’s exports in 2008 (Table 1). The CFA Franc zone countries, with 36.4% of their exports destined for Europe, come next on the vulnerability scale, followed by the wider West Africa region.

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### Table 1 Regional Indicators of Trade Risk

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<tr>
<td>North Africa</td>
<td>58.1</td>
<td>36.1</td>
<td>45.0</td>
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<td>CFA Franc Zone*</td>
<td>36.4</td>
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<td>West Africa</td>
<td>28.5</td>
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<td>27.1</td>
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<td>Central Africa</td>
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<td>East Africa</td>
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<td>Africa</td>
<td>40.1</td>
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Source: Authors’ calculation based on UN COMTRADE and UNCTADStat.
Notes: A higher value for the concentration indices means a higher degree of concentration.
*The export destination concentration index for the CFA Franc Zone refers to the year 2008 since more recent data is not available.

Many African countries export a few primary products that are vulnerable to price volatility often in a pro-cyclical manner. The debt crises and slower recovery in the world economy triggered a decline in the prices of some key export commodities. The price of Brent crude, which has been on a downward path since mid-July 2011, continued to fall in the two weeks following the US credit downgrade and, subsequently, poor second-quarter growth results from Germany (Figure 1). The prices of copper and of silver are also falling, and need to be closely watched. On the other hand, the price of gold is on the rise as...
The downward pressure on some commodity prices, if it persists, will entail mixed fortunes for African economies. Major oil-exporting countries are likely to see a significant contraction of domestic economic activity as a result of these price shocks; mineral and metal exporters like Zambia, Zimbabwe, Mauritania and Guinea would be the next most affected group. On the other hand, Africa’s gold exporters (Ghana and South Africa) may gain from the rising price of the precious metal but this gain is likely to be offset – at least partly – by declining prices of iron ore (for South Africa) and oil (for Ghana).

The price of cotton has been falling since March 2011 (Figure 2) and, more recently the price of cocoa too has started falling on the back of bumper harvests in the West African producers of this commodity. This region is one of the least diversified of Africa (see Table 1), which exposes it to high trade risk. If the euro zone debt crisis accentuates the decline in these agricultural commodity prices, most of the West Africa region will experience significant loss of export revenue, and slower growth.

2.2 Tight liquidity

The contagion effect of the European debt crisis on the African banking sector depends on the extent to which African banks are integrated into the European banking system. The presence of European banks is strong in some African countries, such as, Mozambique, Madagascar, Botswana, Ghana, Cameroon, Rwanda, Zambia and Tanzania, where these banks
Box 1 The impact of the 2008-2009 financial crisis on trade finance: the case of Cocobod

Cocobod is a state-run Ghanaian marketing board which oversees the cultivation, evaluation, transportation, and export of cocoa. Each year the export of Ghana’s cocoa production is financed using a receivables-backed, short term trade finance facility. In fact, ahead of every crop year in Ghana, Cocobod, a first-class borrower, raises syndicated loans through international financers in Europe for cocoa purchases. Although it successful raised funds from the international market throughout the years, this was seriously constrained during the financial crisis 2008-2009. Five commercial banks declined to participate in the syndication. Its borrowing cost shot up by Libor plus 250 basis points, compared to Libor plus 45 basis points in the previous year. Although the borrowing cost has declined since then, the latest transaction closed at Libor plus 90 basis points.

Even if the current debt crisis did not degenerate into an economic crisis of much bigger proportions, the cumulative effects of yet another financial turmoil – this time caused by banks’ losses on assets (government bonds) that they had long perceived as a safe haven – will surely increase risk aversion and raise the cost of trade finance, just as in the 2008-09 financial crisis. Box 1 provides an illustration of the experience of Cocobod in Ghana during the 2008/09 crises.

2.3 Sovereign risk

Sovereign risks to African countries could arise from three potential sources: (i) contraction in official development assistance (ODA) flows from Europe, (ii) decline in trade-related tax revenues for African governments, and (iii) higher cost of borrowing on the global credit market.
ODA flows to Africa from OECD countries are expected to face serious setback due to the looming debt crises. Net ODA flows to Africa did not decline during the 2008-09 financial crises (Figure 3). This arose because Development Assistance Committee (DAC) aid disbursements were buttressed by timely intervention of development finance institutions, including the African Development Bank.

However, the context in which the current crisis is unfolding is different. Fiscal austerity in much of Europe, is likely to translate into cuts in development assistance by the EU as a whole. The US may also cut aid as it tackles its growing budget deficit and national debt, and as attention turns to more pressing domestic issues with elections next year. African countries that rely heavily on aid from the OECD may face significant cut in the flow of aid.

Trade taxes and resource-related taxes are expected to decline as African trade flows subside. This deterioration is forecast to continue for the next two years. The European debt crisis could make it even worse.

28 countries (over half of Africa) drew 50% or more of their ODA flows from the EU and US in 2009. Poor countries that depend to a lesser extent on aid from EU and US but for which aid represents a significant share of their GDP – for example, Liberia (over 100% of GDP), Burundi (44.5%), Sierra Leone (29%), Mozambique (21%), Malawi (20.2%), and Rwanda (19%) – also run significant risks.

Figure 3 ODA and other financial flows to Africa

Source: UNCTAD (2011) and WDI (2011).
Declining demand for commodities can wipe off a large chunk of government revenue, thus compromising fiscal – and social – stability in these countries. Resource-related taxes are a significant source of revenue among Africa’s oil and mineral exporters, notably in Libya and Angola where such taxes represent 66% and 39% of GDP, respectively.

A negative externality of the debt crisis and of the US credit downgrade is that borrowing costs may increase as international credit markets demand higher risk premiums to buy government debt. Evidence indicates that the 2008-09 financial crisis raised the spread on sovereign bonds issued by several African governments. For example, Morocco’s issue of a 10-year bond in September 2010 (shortly after the crisis) was done at a spread of 200bp compared to only 58bp for the June 2007 issue (before the crisis), all other things equal. While it is still early to assess the impact of the current crises on credit risk, available data suggests that the credit default swap increased 49.5% on Tunisian bonds, 35.9% on Egyptian bonds and 22.8% on South African bonds over the month ending August 30, 2011 (Figure 4). Similarly, spreads increased on sovereign bonds issued by frontier markets such as Egypt (3.05%), Ghana (2.23%), Morocco (3.99%), Nigeria (2.7%), Tunisia (4.96%) and Senegal (1.2%) in the week ending September 2, 2011 (Bloomberg, 2011). Thus, a deepening of the crises could make it costlier for African governments to raise finance on international credit markets.

Fifteen African countries derive 25% or more of their current revenue from international trade taxes. Swaziland and Lesotho, with more than 60% of their current budget financed by trade taxes, and Uganda (47%) are particularly vulnerable to the erosion of the tax base as trade contracts. These countries experienced a sharp deterioration in their budget position in 2010, partly as a result of the lagged effects of the financial crisis.
Higher interest rates will also raise debt service charges on existing loans. This will most severely impact the highly indebted countries (Zimbabwe, Cote d’Ivoire, Guinea, Cape Verde, and Sudan) and those for which debt service charges weigh significantly in public finances. These include Liberia, where external debt servicing consumes 280% of the government’s current revenue, Uganda (85.3%), Zimbabwe (67.6%) and Sudan (60%).

2.4 FDI and Remittances

FDI flows, which peaked at USD 73.4 billion in 2008, have declined two years in a row to USD 55 billion in 2010 (Figure 3) due largely to sluggish economic growth in developed economies. The uncertainty and loss of confidence generated by the downgrade of the US credit rating, growing doubts about economic recovery in the US, and deterioration of the debt crisis in the euro zone will surely sustain the downward trend in FDI flows to Africa this year – and possibly the next – as it happened following the 2008-09 financial crisis. The downturn expected might be dampened by the emerging trend among investors being bullish about bonds issued by agencies based in Africa.

Africa’s biggest recipients of FDI are likely also to be the biggest losers. North Africa took away 35% of FDI to Africa during 2005-2009 while Angola, Congo, Nigeria and South Africa – all rich in natural resources – together accounted for another 45%. These countries – and especially North African countries like Tunisia, Egypt and Libya that are yet to recover from political crisis – are naturally the most exposed to any decline in FDI flows. China and Africa’s other emerging partners could help cushion the shortfall in FDI from Europe. However, the evidence from the 2008-09 financial crises is not very encouraging. FDI flows to Africa in the aggregate declined 37% in 2009.

Remittances have progressively increased since 2000, reaching USD 40 billion (2.6% of GDP) in 2010, and they proved resilient to the 2008-09 financial crisis, but this may not continue. Significantly, France, US, UK, Spain and Italy (in that order) figure among the top 10 destinations for African emigrants. A deepening of the debt crisis could therefore lead to a reduction in remittance flows to Africa, the magnitude of which is hard to predict. As usual, the countries that depend most on remittances will be most severely affected. These include Senegal, Sudan, Kenya, Nigeria, Morocco, and Tunisia, for which remittances represented over 5% of GDP in 2009.
2.5 Portfolio flows, stock market and exchange rate volatility

The US credit downgrade and the debt crisis have caused a significant degree of stock market volatility across Europe and beyond, the effects of which are difficult to separate. African stock markets have not been spared. Due to their higher level of integration with the global economy, South Africa, Nigeria and Egypt saw their stock market plunging by 6.9%, 5.5% and 10.6%, respectively in the first three days of trading following the US credit downgrade. During the 2008/2009 crises stock markets in Nigeria, Egypt and South Africa plunged more than 50%, which is a stark reminder of the sensitivity of African stock markets to external shocks. Many frontier markets in Africa witnessed a sharp reversal in portfolio flows during the financial crisis when portfolio investment to Africa fell from USD 6.9 billion in 2007 to negative USD 6.2 billion in 2008. The adverse shock of a sudden drop in capital inflows can be particularly severe for African countries, such as South Africa, which rely on such inflows in order to finance their current account deficits.

Sharp fluctuations of the euro have eroded the earnings for important sectors in Africa. In Kenya’s horticulture sector, for example, growth estimates for earnings during this year were reviewed downward to 8% from an initial 15%. This has put further pressure on Kenya’s weakening currency (Reuters, 2011). Similar pressure on African national currencies has been observed elsewhere.

3 Conclusion

The debt crisis unfolding in the US and Europe has a significant and far reaching consequence on the economies of most countries in Africa through more than one channel. On the whole trade risk appears to be the single most important determinant of the magnitude of the economic impact on African countries. Hence, countries that export primarily to Europe and are specialized in a few products whose prices are subject to pro-cyclical fluctuations are most vulnerable to the European debt crisis. Among these countries are Africa’s oil and minerals producers, and exporters of agricultural products like cotton and cocoa.

If the 2008-09 financial crises served any lesson, however, we expect African economies to be better prepared to face the current crisis. Expansionary demand management policies could help cushion the adverse impacts on jobs and growth. Unfortunately, most African economies
Governments will have little room for maneuver if sources of public finance such as ODA and trade taxes dry up. Development finance institutions will therefore have an important role to play in supporting government budgets during the crisis. On the other hand, Africa’s emerging partners, by helping to sustain commodity export volumes, can actually help minimize the impact of the crisis on the most vulnerable economies.

The African Development Bank is closely monitoring the unfolding events as it did in the past to help alleviate adverse impacts on regional member countries. During the 2008/09 crises the Bank put in place a successful Trade Finance Initiative, with an initial endowment of USD 500 million, and contributed a similar amount to the Global Trade Liquidity Program (GTLP). The African Development Bank is currently developing an African Trade Finance Risk Sharing Facility (ATFRSF), which involves a risk sharing arrangement between the Bank and a confirming bank to facilitate trade flows in Africa. The Bank will assume a higher share of risk to promote trade in strategic areas such as fragile states, longer tenors and intra-African trade. The Bank will also continue to deploy quick disbursement instruments in order to meet the urgent financing demands of its regional member countries during any future crisis.
References

Bloomberg, 1 September 2011. “BRICs No Cure for Global Economic Growth”.


Figure A1 Shares of EU and EU+US in African countries’ exports (2008)
Figure A2 Foreign banks’ dominance in Africa in 2005

Note: A South bank is a foreign bank incorporated in a developing or emerging country. Non-South Banks are all other banks. Source: Authors’ calculation based on Claessens et al. (2008).