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How the Economic Crisis Is Hurting Africa—And What to Do About It

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May 2009

www.cgdev.org/content/publications/detail/1422072

Center for Global Development

ABSTRACT

Africa escaped the initial effects of the financial crisis but is now feeling the dire aftershocks from the global downturn. The ultimate effects on individual countries are far from clear or consistent. The medium-term reactions of China, donor countries, and private investors are also still unknown. Yet the impact on Africa already appears to be coming through three major channels: global trade, capital flows, and policy responses. Efforts to mitigate Africa's pain should tackle the risks in each head-on. The international community can take specific actions to address the fiscal and balance-of-payments shocks, as well as the sudden gaps in private capital. Regardless of steps taken externally, African leaders should seize the opportunity of the crisis to push through reforms that will position their economies to come out of the recession poised for renewed growth.

The Center for Global Development is an independent, nonprofit policy research organization that is dedicated to reducing global poverty and inequality and to making globalization work for the poor. This essay was made possible in part by support from the Australian Agency for International Development.

Todd Moss. 2009. "How the Economic Crisis Is Hurting Africa--And What to Do About It."
CGD Essay. Washington,D.C.: Center for Global Development.
http://www.cgdev.org/content/publications/detail/1421594

How the Economic Crisis Is Hurting Africa—And What to Do About It

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Introduction

Although the global financial crisis did not initially hit Africa directly, the effects of the global downturn are starting to bite. Real GDP growth is now projected by the IMF to drop to below 2 percent this year, down from an average of over 6 percent for the last few years. I suspect the actual drop this year may be even greater, probably resulting in close to zero growth. While the attention of the major economic powers is rightly on rolling out a fiscal stimulus and getting credit markets operating again, there is growing concern that the world's poorest nations will be hardest hit by the global economic downturn. And no region is as poor and vulnerable as sub-Saharan Africa.

As the region least integrated into the global economy, Africa was spared some of the primary effects of the initial financial crisis; it is instead being hit by the aftershocks and the resulting global recession. Identifying the specific channels through which Africa is being hurt is the first step toward formulating appropriate policy interventions to ease the pain—and to help position Africa to benefit from an eventual recovery.

A few contextual facts: First, we still do not know how long the global recession will last or how deep it will become. The crisis has already clearly shifted from a problem in the financial markets late last year to a global economic downturn with a direct effect on the continent. We also do not know if the current round of global fiscal stimuli will work or not. Without knowing whether we will face a robust recovery in 2010 or a prolonged depression, it is impossible to know how badly Africa will fare.

Second, after decades of low economic growth, Africa has recently achieved impressive rates of economic expansion. Between 2005 and 2007, the continent's average real GDP growth was 6.4 percent (excluding South Africa). This was a broad trend well beyond a handful of fast-growing oil exporters. In fact, 22 African countries had growth rates of 5 percent or greater during this period.

Third, Africa was showing promising signs of attracting real private investment. Total net private capital flows into the continent topped $57 billion in 2007, up from just $11 billion in 2000. As with the growth story, this was broader than traditional extractive investment in a handful of countries. The recent wave of investor interest in the continent also included a promising mix of private equity, venture capital, and other asset classes.

Against this background, the effects of the global economic environment on Africa are likely to come through three main channels: trade, capital flows, and policy responses.

The Global Trade Channel

Sub-Saharan Africa faces mixed prospects on trade—some countries are getting hammered, but others are actually finding positive effects. The region accounts for less than 2 percent of global trade, but many of its economies are heavily reliant on trade in a few commodity exports. These economies are being hit hard by falling prices. The oil exporters, especially Nigeria, Angola, Equatorial Guinea, and Congo-Brazzaville, are all taking a hit in revenue after years of an oil price boom. Along with copper exporters Zambia and the Democratic Republic of the Congo, the commodities exporters are nearly all facing serious fiscal and balance-of-payments shocks. African countries dependent on mining and oil exports were mostly unable to resist pro-cyclical spending in boom times that has left them with few resources to invest now that prices have dropped. Those that saved part of their windfalls, notably Nigeria, are already dipping deep into reserves.

At the same time, several African countries are actually benefiting from global price shifts. A year ago food and fuel price riots were a major concern across West and Central Africa, including eruptions of violence in Cameroon, Niger, Côte d'Ivoire, Senegal, and Burkina Faso. Those pressures are easing as grain and oil prices have slumped. Although the full benefits of the price declines have yet to trickle down to consumers, the threat of mass political instability has waned. Governments that had been subsidizing food and fuel prices are experiencing an easing of this pressure on their budgets. A handful of countries are experiencing positive terms-of-trade movements, notably Ghana which is benefitting from high prices for its exports of gold and cocoa and lower prices for oil, its principal import.

While the current impact is highly heterogeneous across countries, the overall environment for African trade faces new and potentially dangerous risks. Globally, world trade is projected to shrink by 9 percent in 2009, the first decline since 1982. This trend raises the specter of renewed protectionism, with some signs that backtracking on commitments to open trade may already be underway. The continent would be a bystander during a trade war among the major economies and the BRICs but would nonetheless suffer if protectionism surges. Preferential market access programs, such as the African Growth and Opportunity Act (AGOA) in the United States and the Everything But Arms (EBA) in Europe, should partly guard against such an outcome, but these could be threatened under a global protectionist wave. Hopes that the Doha Development Round of the World Trade Organization might be quickly concluded, and completed in a manner beneficial to Africa, are dead.

The Capital Flows Channel

The outlook on capital flows to Africa—official aid, foreign direct investment, portfolio flows, and remittances—appears more worrying over the medium term than the short term.

Official development assistance to Africa has risen from about $10 billion a decade ago to about $25 billion per year today. Although the aid budgets of all major donors are already coming under pressure, titanic drops in the next year or two seem unlikely. In the United States, the budget process is long enough and the pipeline full enough that, crisis aside, the United States should easily achieve its Gleneagles pledge to reach $8.8 billion by 2010, double the level of

2004 and up from about $2 billion in 2000. European donors have shorter budget cycles, and may be under stronger fiscal pressure, but few have yet indicated plans for major aid cuts (Ireland is a notable exception). The World Bank should also be in strong financial shape, having recently completed a successful replenishment of its soft-loan International Development Association (IDA) at a record level of $41 billion, which locks in IDA flows for several years. The main worry on aid flows is what may happen in 2011 and beyond, including the next IDA replenishment round, which is slated to start negotiations in early 2010.

Though aid flows are relatively secure in the short term, private capital is already falling and faces serious risks over the medium term. As credit tightens and risk aversion sets in, African countries may be hit even harder than developed economies. It is ironic that Africa could be disproportionately affected, considering that Africa never touched the complex financial derivatives that sparked the financial crisis. The surge in inflows over the past few years has been driven by new debt issuance, foreign investment in mining and heavy infrastructure, and some new foreign interest in South African and Nigerian banks. Ghana and Gabon had each successfully issued new sovereign bonds in late 2007, but plans for more issuances by Kenya, Ghana, Nigeria, Tanzania, and Uganda are being shelved for now.

The mining sector is taking a particularly hard hit, with mines across Africa shutting down as the prices for their output tumbles below production costs. Zambia's copper belt, which had been experiencing a boom, is now facing a gut-wrenching bust. DRC is reporting some 100,000 jobs lost already from the closing of smelters. Burkina Faso, Guinea, and Tanzania are also facing major delays in mining projects from lack of finance. There is also little chance, given problems at home, that western banks will be looking to expand into Africa anytime soon.

One unfortunate outcome of the crisis may be the strangling of the nascent and potentially very sizeable private equity sector. The Emerging Markets Private Equity Association reports that the number of its member funds targeting Africa rose from 16 to 21 in 2008 and new funds jumped by 37 percent to $3.2 billion. But it also expects a very difficult fundraising environment in 2009–10. Most of the private equity raised in recent years to invest in Africa (much of it with some official component, such as the multiple funds started by the Overseas Private Investment Corporation or the African Development Bank) should be locked up for the long term and is unlikely (or unable) to exit quickly. However, this asset class was just beginning to establish itself and the many funds that had not yet completed fundraising or were still being formed may find their plans delayed until the global situation stabilizes and appetite for frontier emerging markets returns. Based on the experience of Africa's funds after the Asian financial crisis, where it took some 8–10 years for demand to recover, this could be a long dry period.

Portfolio equity flows targeting listed securities are a smaller component of the overall private capital flows, but they also began to gain momentum in recent years. These are much more liquid and have already begun to withdraw, contributing to the steep declines in African stock markets. The Johannesburg Stock Exchange is off more than 40 percent from a year ago, and the Nigerian market is down nearly 70 percent, in large part a result of foreign investor exiting.

A channel of capital that gets less attention than it should is remittances. Africans working abroad and sending money home are a significant source of capital for many countries and have a major impact on their families' livelihoods. Although the numbers are only a best guess, the World Bank estimates that Africa receives $20 billion per year in remittances, which would put these funds roughly on par with official aid flows. With unemployment rising in the United States and Europe (and the possibility of new efforts to restrict additional migration), remittances are expected to fall this year. The World Bank recently projected a drop in remittances to Africa of 4–8 percent in 2009, which translates to about $1 billion less for the continent.[1] Data from Kenya suggest the decline could be even steeper for some countries.

There are two big unknowns on the future of capital flows that could be substantial. First is the reaction of China. Chinese investment in large infrastructure has been crucial in helping to fill the gap in roads, ports, rail, and energy that are a major constraint on Africa's competitiveness. So far, it appears that China is taking the long view and proceeding with these projects, many of which come with financing from the government through agencies like the China Export-Import Bank (which is larger than all the western export credit agencies combined). However, Chinese investments in commercial ventures, particularly those in industries like mining of commodities whose prices have collapsed, are reportedly being turned off as they become uneconomic under current conditions.

The other unknown is how investors will interpret risk in Africa over the medium term. Many of the large institutional investors had begun to look seriously at frontier emerging markets such as Africa. Whether they will now recoil because of the perceived risk or view Africa as a potential diversification play in a turbulent world is still far from clear.

The Policy Channel

The last channel of impact is through policy responses. Within Africa, improved macroeconomic performance—inflation fell from an average of 22 percent in the 1980s to single digits in recent years—was the result of ongoing economic reforms. Almost all African countries had moved steadily, if slowly and unevenly, toward a more open and market-oriented economy. With the major western powers facing their own economic crises, confidence in the capitalist system is likely to come under pressure and there is a risk that momentum for reform may stall. Countries that backtrack will find themselves left further behind when the global recovery begins.

Although it is unwise to exaggerate the risks, Africa's democratic progress is likely to become more fragile if economic conditions worsen significantly. To the extent that the "democracy dividend" is widely expected to also deliver positive economic benefits—and that such outcomes are threatened by current global conditions—the crisis may indirectly affect the popular support for democracy or potentially enable those seeking to use the downturn as a pretext for reversion. After a decade of declining conflict and improved political governance, Africa has had four coups within the past year and many more countries are facing political upheaval. Although none of the coups (in Mauritania, Guinea, Guinea-Bissau, and Madagascar) were directly a result

[1] Dilip Ratha and Sanket Mohapatra, "Revised Outlook for Remittance Flows 2009-2011," *Migration and Development Brief* 9 (March 23, 2009, Word Bank.)

of economic conditions, is seems reasonable to expect that pressure on young and tenuous democracies across the continent will grow if employment and livelihoods are endangered.

In addition, global attention to Africa seems certain to dissipate. The G-8 made Africa a centerpiece of each of its last eight summits, a move that enabled sweeping debt relief and encouraged sharp increases in aid budgets. The new relevant global grouping, the G-20, has only one African member, South Africa, which itself faces a very different set of challenges than the rest of the continent. For this and historical reasons tied to the apartheid era, South Africa has been not been accepted within Africa as a voice for the continent as a whole. Indeed, many of the proposed measures to help “developing countries” are really targeted to the middle-income emerging markets. It’s hardly surprising, then, that the G-20 has shown little inclination to focus on Africa’s specific concerns.

It also seems unlikely that the United States can maintain the unusually high attention to Africa during the Bush administration. (Full disclosure: I served in the Africa Bureau of the State Department during the end of the Bush administration.) Certainly, the level of global interest in Africa over the past few years, especially the initiatives on aid and debt relief generated during the 2005 Gleneagles Summit, seems unlikely to be repeated soon. (Whether all the hoopla around the G-8 was constructive or not is, of course, debatable.) The likelihood of diminished attention will certainly make it much more difficult to generate international support for seizing new opportunities (for instance, reconstruction in Zimbabwe or Eastern Congo) or to deal with new crises that will inevitably emerge (renewed violence in Sudan or Côte d’Ivoire come to mind as unfortunate possibilities).

Countries to watch

Nigeria and South Africa, the region’s two largest economies, are the ones most vulnerable to a prolonged downturn in the global economy. South Africa is among the emerging markets most integrated into global capital markets and has a significant mining sector. In particular, South Africa is directly exposed to international financial volatility by financing its current account deficit with foreign portfolio capital. Nigeria is less integrated, but its banking sector recently experienced a price bubble, the effects of which are yet to be fully felt. Dependence on international oil prices also exposes Nigeria to global fluctuations. (Ongoing violence in the oil-producing Niger Delta region increases the uncertainty about oil production and heightens volatility; current production is only about 1.6 million barrels a day, about one-third less than current capacity). Both of these countries significantly affect their respective subregions through regional investment, cross-border employment, and currency effects. They are also home to nearly 200 million people combined.

Ghana is also a country to keep an eye on, but for different reasons. It may be fairly small, but Ghana has been a bellwether for the rest of the continent since it became the first sub-Saharan colony to gain independence from Europe in 1957. Ghana has been a favorite of the donors for more than two decades and has shown impressive performance in most political and economic indicators. In December 2008, Ghana held its fifth successive democratic election and saw the second peaceful civilian transition of power from one political party to another. Economic growth has been strong for much of the past decade. Of the 48 countries of the subcontinent, Ghana appears among the best positioned to withstand an economic shock and be ready to thrive during a recovery. Nevertheless, even before the brunt of the crisis hit Africa, the IMF expressed concern that Ghana's rising fiscal deficits, which likely topped 14 percent in 2008, were becoming unmanageable. Although its current trade balance is not overly worrisome yet, if Ghana begins to show signs of serious deterioration, it will signal more acute problems in other parts of the Africa.

Ethiopia is another country to be concerned about. Home to some 78 million people, it is one of the world's poorest nations, but it also plays an important stabilizing role in the Horn of Africa, perhaps the most vulnerable region of the globe. Inflation has spiked in Ethiopia, with food prices some 60 percent higher than a year ago, pointing to renewed food security concerns and potential macroeconomic disruptions.

Response to the crisis: Attack the channels

The immediate focus of the international community has primarily (and rightly) been on coordinating fiscal stimuli in the major economies and finding ways to get credit markets operating again. The success or failure of these efforts will largely determine how Africa is affected over the immediate and long term. In short, the ultimate impacts on Africa will largely be determined outside of the continent itself.

Nevertheless, there are specific steps that can be taken to help Africa weather the crisis and come through with healthier economies better able to compete and grow. There are opportunities in each of these three channels for both the international community and for African governments themselves.

At a minimum, the United States and Europe should affirm their intention to keep their markets open to African products, regardless of trade disputes that may emerge among the major economies. The enormous trade finance facilities agreed by the G-20 to help get the wheels of global commerce moving again will rightfully focus on the big markets, but it would make sense to ensure that trade credit is also available for the low-income countries too, which may find it even hard to access this kind of capital.

Any immediate fiscal shock faced by particular African countries can most quickly and effectively be dealt with through an acceleration of IDA disbursements.[2] To boost confidence inside the World Bank to take this step, the shareholders could also commit to an early IDA-16 replenishment, beginning perhaps six or twelve months before the currently scheduled July 2011 start. The IMF shareholders should follow through on the idea, endorsed by the G-20, to revalue part of the Fund's gold stocks to finance additional Poverty Reduction and Growth Facility (PRGF) resources. They should seriously consider a proposal floated by the One Campaign to use the gold revaluation for a one-time injection of PRGF grants rather than loans.[3] These steps by the Bank and Fund would give African countries a cushion for both the short-term balance-of-

[2] Nancy Birdsall, "How to Unlock the $1 Trillion that Developing Countries Urgently Need to Cope with the Crisis," CGD Note February 17, 2009, http://www.cgdev.org/content/general/detail/1421143/.

[3] One Campaign, "Policy Recommendations for the G20," Draft, March 23, 2009.

payments shock they face from the global downturn and additional budgetary support to meet fiscal shortfalls, all without re-raising the risk of creating a new debt problem.

There may also be scope for public policy intervention to ensure that gaps are filled in shovel-ready infrastructure projects that are suddenly finding shortfalls in the private capital co-financing. Tasking the bilateral official agencies (such as the Overseas Private Investment Corporation and the Export-Import Bank in the United States) and the multilaterals (such as the International Finance Corporation and the African Development Bank's private-sector lending window) to utilize existing authorities and guarantees would go a long way to keeping critical infrastructure projects on track and private capital flowing. An early review of the capital adequacy of the African Development Bank might also be warranted.[4]

Perhaps more importantly, African governments cannot wait passively for external rescue. The first task is to not go backwards. Years of sometimes painful reforms are beginning to pay off and must not be lost. It would be a shame if governments gave into the temptation to return to a command economy or use the crisis as a cover to renationalize companies or interject the state into the market in ways that proved so harmful in the past (and so lucrative for an elite few).

Instead, the populist pressures must be taken head-on through positive action to seize the opportunity of the crisis to move aggressively on regional trade integration and to fix domestic business climates. History has shown that the window for forcing through the most sweeping policy changes often occurs during times of crisis. An acceleration of the scheduled reduction in barriers within regional economic communities would be a good signal that countries are serious about building markets of scale. Moving forcefully to address many of the regulatory, infrastructure, and other barriers to local business development will also lay the foundation for a private sector–led recovery effort within Africa.

Getting rid of unnecessary obstacles to opening, operating, and growing business will not only help to attract (increasingly scarce) foreign capital, but will help to unleash the vast yet untapped wells of Africa's own internal financial and human capital. Countries that take these steps seriously will be best placed to ride the global recovery; those that turn their backs on the global economy are likely to be left further behind.

[4] Committee of African Finance Ministers and Central Bank Governors, "Impact of the Crisis on African Economies – Sustaining Growth and Poverty Reduction," March 17, 2009.