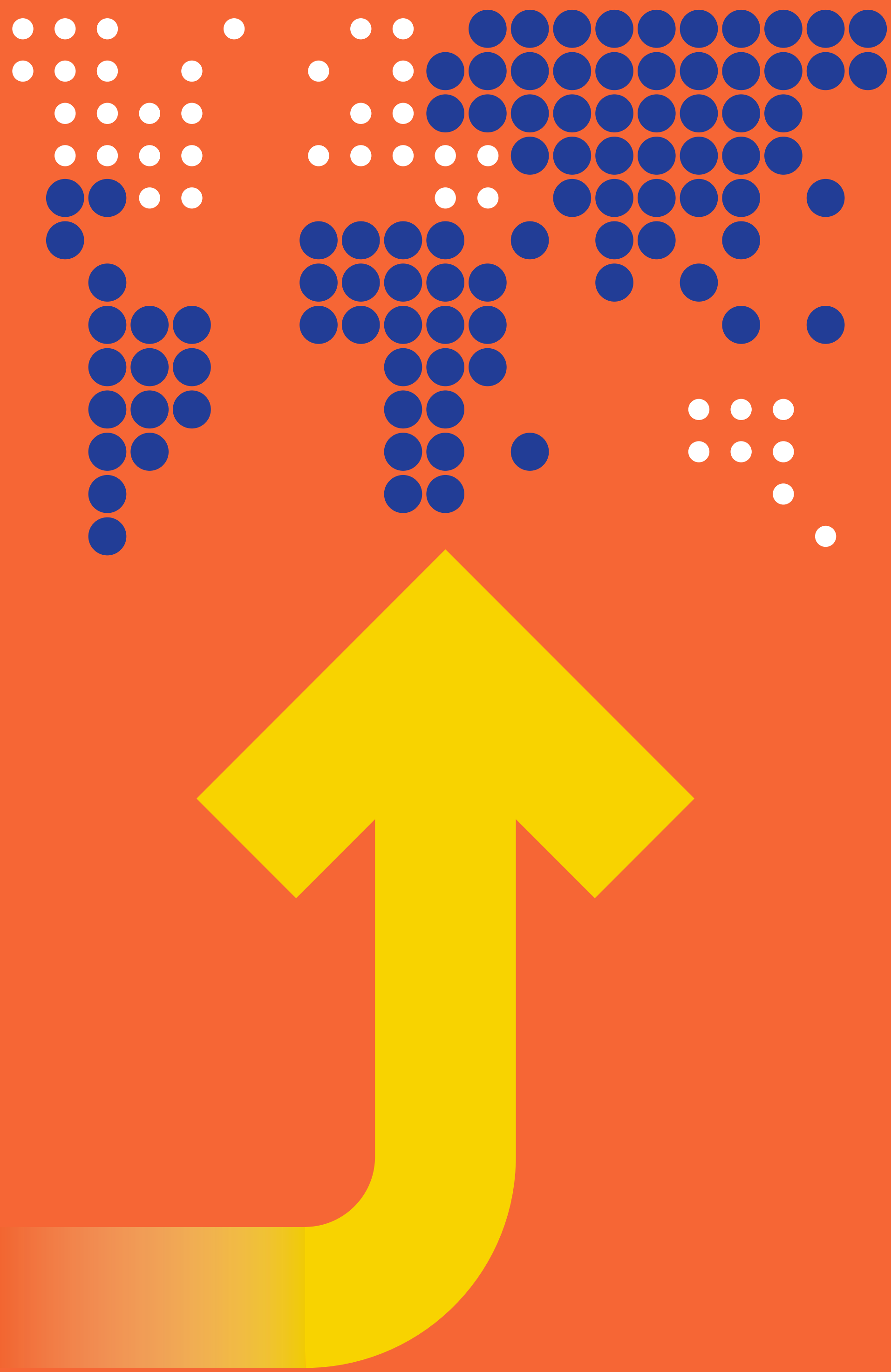

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AFRICA EMERGING MARKETS FORUM

The Impact of the Global Financial Crisis on Emerging and Frontier Markets in Africa

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Emerging Markets Forum
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The Impact of the Global Financial Crisis on Emerging and Frontier Markets in Africa

Jack Boorman and Benedicte Vibe Christensen[2]

The financial crisis that has swept through the global economy since the middle of 2007 has led to a sharp deceleration in economic growth of the emerging and frontier market economies in Africa, particularly since the end of 2008.[2] While the origin was elsewhere, African countries have suffered serious collateral damage from the crisis. The absence of sophisticated financial instruments in the banking and financial systems of these countries shielded them from the initial wave of the crisis. However, subsequent waves—manifested in falling demand for exports, weakening commodity prices, and declining capital and remittance inflows—have all hit individual countries hard. Most importantly, the global crisis has interrupted the record growth performance of GDP of about 6 percent per annum that Africa had experienced during 2002-07. That record growth was due, in part, to an improvement in economic policy, but also reflected the supportive global economic and financial environment of those years.

The consequences on employment and poverty of this interruption in rapid rates of growth could be dire, particularly if sustained for some time, and could seriously threaten the progress being made towards the Millennium Development Goals. In the end, the economic impact of the crisis on Africa depends crucially on the duration of the global recession, the strength of the recovery, the revival of capital markets and foreign investment, and on developments in commodity prices. How Africa emerges from the crisis will depend, as well, on the policy reactions of the countries that are most seriously affected. The first section of this paper will look at the prospects for the global economy. Section II will trace the transmission channels through which Africa is being impacted by the crisis. Section III will identify some of the issues to be considered in deciding the appropriate policy response by African countries. Finally, possible issues for discussion are set out in Section IV.

I. The Global Environment

Global activity is expected to contract by 1.4 percent in 2009 in the deepest recession since World War II (Table 1). While growth in the United States is projected to decline by about 2.6 percent, the decline in GDP in the euro area and in Japan is expected to be even more severe, by about 4.8 percent and 6.0 percent, respectively. These contractions in the major industrial countries are unprecedented in the post war period. The main bright spot is the reasonably well sustained growth performance of the largest Asian economies, such as China and India, which the IMF projected in July to grow at healthy rates of 7.5 percent and 5.4 percent, respectively, and which official projections put even higher, at 8 percent and 7.2 percent.

There are encouraging signs that the recession in some of the major advanced countries, such as the United States, Japan and Germany, might be bottoming out. This is reflected in the latest projections which have seen upward revisions in expected growth rates for the first time in two years. Global growth is now projected at 2.5 percent in 2010, with a further contraction of activity expected only in the euro area. However, most observers are forecasting a recovery that is not expected to be robust–at least not by historical standards and greater than usual uncertainty surrounds these projections.

The current recession is much more complex than previous recessions, not least as it originated in a systemic financial crisis in some of the largest advanced economies that migrated to most credit markets around the world. Recessions and recoveries in the wake of financial crises tend to follow a different pattern from other cycles. In the boom period leading up to the crisis, credit expands and asset prices increase at unsustainable rates. In the lead up to the crisis in the United States, this process became self-aggravating as consumers came to rely on credit to an exceptional degree and ceased saving as the rise in asset prices came

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2 African emerging market countries in this paper comprise Algeria, Egypt, Morocco, South Africa, and Tunisia; frontier market economies, which cover countries that either have tapped international capital markets or have attracted foreign investors in local currency markets include 5 middle-income countries (Botswana, Cape Verde, Mauritius, Namibia, and Seychelles) and 7 low-income countries (Ghana, Kenya, Mozambique, Nigeria, Tanzania, Uganda, and Zambia). The selection criteria include bank assets to GDP and the degree of capital market development (see IMF's Regional Economic Outlook for Sub-Saharan Africa, April 2009).

Table 1: Global Economic Outlook (Percentage change)

	2007	2008	2009	2010
World Output	5.1	3.1	-1.4	2.5
Advanced countries	2.7	0.8	-3.8	0.6
United States	2.0	1.1	-2.6	0.8
Euro area	2.7	0.8	-4.8	-0.3
Japan	2.3	-0.7	-6.0	1.7
Emerging and dev. countries	8.3	6.0	1.5	4.7
Africa	6.2	5.2	1.8	4.1
China	13.0	9.0	7.5	8.5
India	9.4	7.3	5.4	6.5
World trade volume	7.2	2.9	-12.2	1.0
Oil prices	10.7	36.4	-37.6	23.1
Non-fuel commodity prices	14.1	7.5	-23.8	2.2
Foreign direct investments (in billions of US$)*	520	583	385	…

Source: IMF, World Economic Outlook, July 2009 and for FDI, World Bank, Global Development Finance 2009, Charting a Global Recovery
*Net foreign direct investment flows to developing countries

to be seen as a permanent source of wealth, making saving unnecessary. In the recessionary phase, households have no choice but to reduce consumption. Residential investment is also typically much weaker than during other cycles. In the current crisis in the United States and parts of Europe, for example, the collapse of the housing market, the decline in consumption, and the seizing-up of credit markets have all been unprecedented. Finally, these dramatic developments have had an unusually severe psychological impact on consumers and investors, both in advanced and developing market countries, further weakening confidence.

It is also possible that the financial crisis itself may not have run its course. While easing from the seizure that characterized many markets late last year and into the first quarter of this year, credit conditions remain tight in some markets and the health of many of the major financial institutions in the world remains uncertain. The impact of the collapse of the previous boom on the balance sheets of those institutions is still evident. The loss of equity in houses, combined with the unprecedented level of household debt, is likely to weigh heavily on bank balance sheets for some time. The fact that unemployment will, inevitably, continue to increase even as activity begins to recover suggests that default rates on consumer credit are likely to rise further.

There is also a major threat looming in the commercial real estate loan market in the United States and in some other countries. A massive amount of such debt comes due during the remainder of this year with the possibility of widespread defaults. Downside risks may be further heightened by the possibility that the stimulus programs in some countries could be withdrawn early or not renewed as a result of political fatigue with aggressive government support policies, the analytic debates about the effectiveness of those policies, and concerns about government debt.

Another risk to the global outlook is the possibility of a continued contraction of global trade, which is projected to decline by as much as 12 percent in 2009 and to stay about flat in 2010. Earlier episodes of declining trade were often followed by protectionist measures. Unfortunately, protectionism appears to be on the rise in many parts of the world despite the pledges made by the G20 countries and in other fora.[3] If protectionism increases, the recovery in the

3 Although Africa is the least integrated region in the world in terms of trade and financial flows, the global economy still has a major impact on economic developments in Africa. Empirical evidence suggests that a 1 percent decline in GDP growth in the global economy tends to reduce growth in sub-Saharan Africa by ½ percentage point. This is an "average" estimate and the actual impact depends on the various transmission channels (see below).

Chart 1a: Stock Market Index, 2007 - May 2009

Source: Economist Intelligence Unit

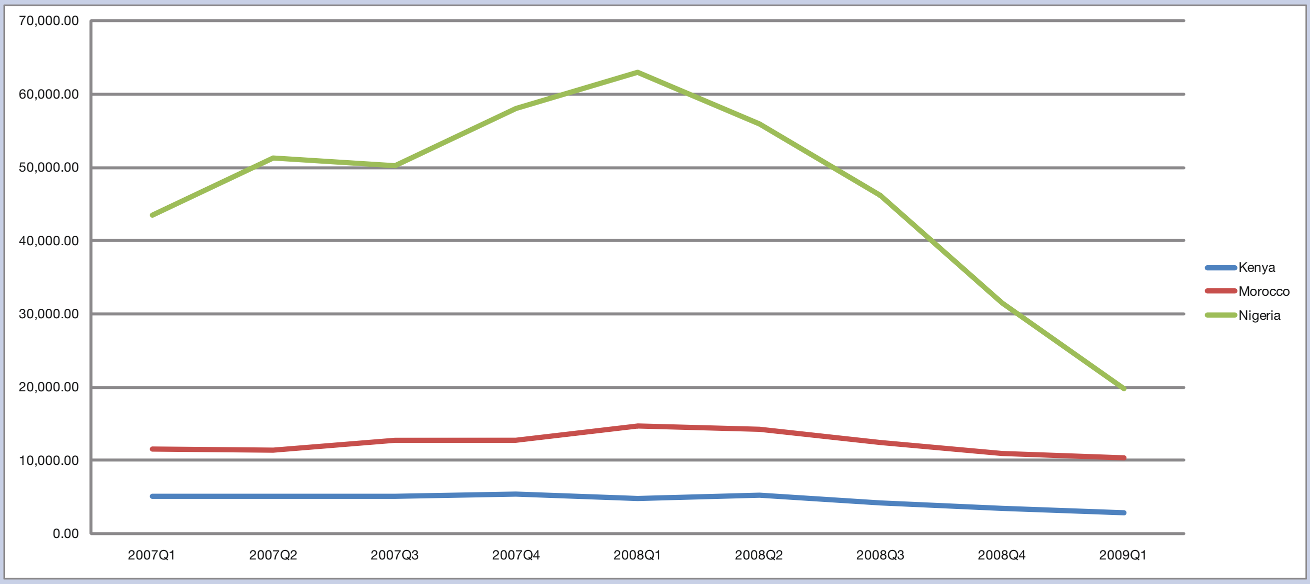
global system could be even weaker than expected. And, of course, any delay in the recovery increases the political pressures for a protectionist response.

Despite these evident risks, some analysts, and, more importantly, recent events are beginning to argue that there is upside potential in these forecasts that could lead to an earlier and more robust recovery. They point to the generally encouraging news that is coming out of the U.S. housing market, the stabilization and recovery of profits that has become apparent in the financial sector, the unfreezing of some credit markets, and improved consumer and business confidence indicators in a growing number of the advanced countries. They point, as well, to the emerging evidence that the stimulus packages adopted in China, the United States and other countries have had a demonstrable effect in reviving their domestic economies – stimulus that will continue well into 2010.[4] The strong performance of China and India has helped lead to a fairly rapid recovery in Asia, based on strong domestic demand and less reliance than usual on exports. Even the Japanese economy has recorded several months of increased industrial production after what was one of the most severe contractions ever recorded in the developed world. And, most recently, surveys of manufacturers in the European Union countries indicate a significant turnaround in the percentage of companies forecasting an increase in activity in the next several months. Moreover, for those who trust the equity markets as a leading indicator, the global surge in those markets since mid-March also holds promise (Chart 1a and 1b). In the United States, for example, the increase in wealth from the rebound in the equity markets, together with low interest rates and the stabilization of house prices, could limit any further rise in household saving, reducing significantly that drag on the economy. Finally, to the extent that expectations and confidence are key to a strengthening of the global economy – which they are, recent developments could help set up a self-fulfilling prophecy for a stronger than expected recover.

Only time will tell how these differing views on near term prospects turn out. In the meantime, policy makers in Africa

4 China has been the most aggressive in stimulating its domestic economy and those policies have helped sustain growth in China at well above the rates expected by most analysts. China's performance has also helped to support activity in many of the economies that form the supply chain for Chinese industry. China, however, was in the position to be particularly aggressive in stimulating its domestic economy because of both its fiscal situation and its extraordinarily strong external position. Besides helping to sustain its growth rate, this stimulation of its domestic economy has, at least temporarily, helped move the global economy to a more balanced position. This will have to form the basis for a sustained rebalancing of the global economy if the risks inherent in the previous imbalances are not to resurface as the global economy recovers.

Chart 1b: Stock Market Index, 2007 - 1st Quarter 2009



Source: Economist Intelligence Unit

must decide on what expectations they will base their policy actions and must remain ready to alter course if developments prove better or worse than expected. Policy issues are considered in Section III.

II. Transmission Channels

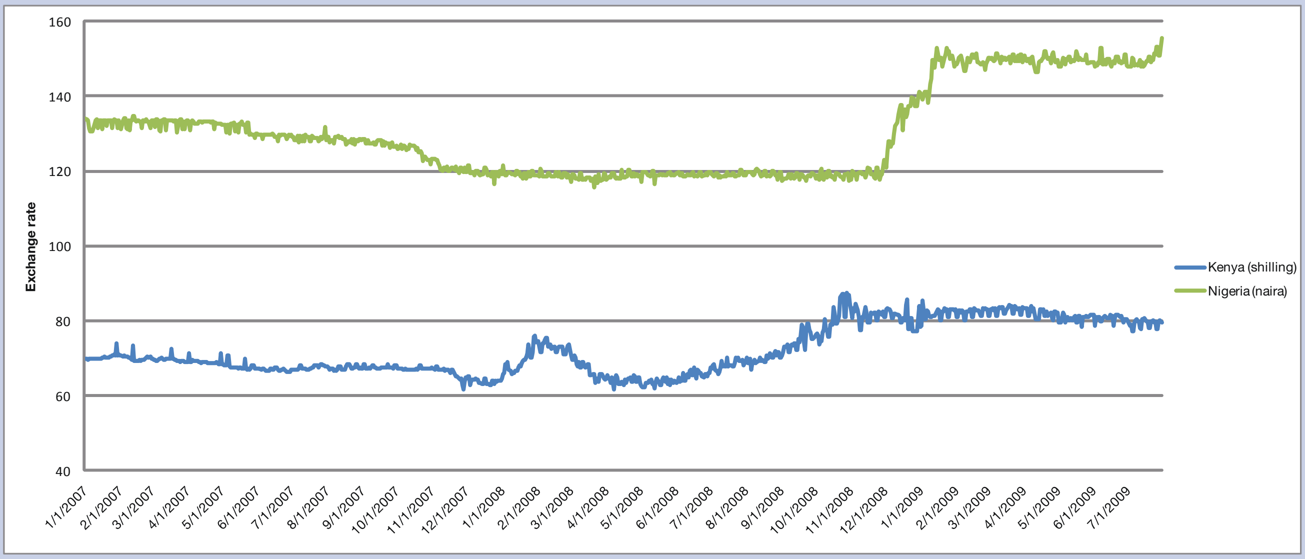
The current crisis differs from previous cyclical downturns in both its breadth and the complexity of the transmission channels through which events in the global economy impact Africa. Africa is all too familiar with commodity price booms and busts, but the current global financial crisis clearly affects the African economies in many other ways and manifests itself through different channels across the continent. All emerging and frontier market economies, and particularly the more advanced countries among them, were affected by the crisis in the financial markets abroad and the drying up of private capital flows. Virtually all countries have suffered a decline in exports, as the economies of the major trading partners sank into recession. Similarly, most countries appear to have experienced a negative impact on foreign direct investment. Finally, the weakening in tourism activity and remittances has seriously affected many countries. All these developments have been reflected in either a decline in official reserves (Table 2) and/or a weakening of the exchange rates (Chart 2a and 2b). This section traces through the impact of each of these developments on the emerging and frontier countries of Africa.

Financial Sector Impact and Private Capital Inflows

The financial institutions in Africa have been less affected than those in other parts of the world for several reasons. First, because of the lack of trading or investment in derivatives and other sophisticated financial products, African banks were not hit directly by the global financial meltdown. It proved to be an advantage to be behind in this activity. Second, African banks typically have a strong local deposit base and rely less on external funding from foreign banks or funding from parent institutions abroad[5]. This has provided some stability in the current environment. Third, they have limited off-balance sheet operations. Fourth, African financial institutions are generally well capitalized. And, finally, in a few cases, exchange controls might also have dampened the impact of the global crisis. As

5 The World Bank, The Impact of the Global Financial Crisis on Financial Markets in Sub-Saharan Africa, Finance and Private Sector Development, Africa Region, April 2009.

Chart 2a: Exchange Rates of African Currencies vis-à-vis the U.S. Dollar (excl. gold) 2007- July, 2009



Sources: Oanda.com and International Financial Statistics

Chart 2b: Exchange Rates of African Currencies vis-à-vis the U.S. Dollar (excl. gold) 2007- July, 2009

Sources: Oanda.com and International Financial Statistics

Table 2: Official Reserves (excl. gold) (In billions of U.S. dollars)

	2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009	Proposed SDR Allocation
Algeria	110.3	123.6	133.4	140.8	143.2	140.1	1.5
Egypt	30.2	32.2	32.7	33	32.2	30.3	1.1
Morocco	24.1	25.7	26.5	24.2	22.1	21.6	0.7
South Africa	29.6	30.6	31.1	30.8	30.6	30.4	2.2
Tunisia	7.9	8.4	8.7	8.7	8.8	…	0.3
Botswana	9.8	10.2	10	9.6	9.1	8.1	0.1
Cape Verde	0.3	0.3	0.3	0.3	0.3	…	0.0
Ghana	…	…	…	…	…	…	0.4
Kenya	3.4	3.4	3.4	3.2	2.9	2.7	0.3
Mauritius	1.8	2	2.1	1.9	1.7	1.7	0.1
Mozambique	1.4	1.6	1.7	…	…	…	0.1
Namibia	0.9	1.1	1.2	1.4	1.3	…	0.2
Nigeria	51.3	59.8	59.2	62.1	53	47.1	2.0
Seychelles	0	0.1	0	0.1	0.1	0.1	0.0
Tanzania	2.9	2.7	2.6	2.7	2.8	2.7	0.2
Uganda	2.6	2.7	2.7	2.5	2.3	…	0.2
Zambia	1.1	1.2	1.4	1.3	1.1	1.0	0.6

Sources: IMF, International Financial Statistics and IMF, Public Information Notice No. 09/94, 7/29/2009.

a result, with the exception of Nigeria (see below), financial institutions did not require direct support from the monetary authorities, as was the case in many of the industrial countries and some of the larger emerging market countries in other parts of the world. In a few cases where deposit insurance schemes existed (e.g., Egypt), the relevant authorities reaffirmed their commitment to support such schemes to allay the fears of depositors. Some easing of monetary conditions also took place in a number of countries (e.g., Algeria, Egypt, Morocco, Nigeria, and Tunisia). Nevertheless, some vulnerability existed. South African and Nigerian banks, for example, had previously accessed syndicated loans abroad. But in the case of South Africa, these loans were mostly of a medium-term nature falling due in 2011-12 and foreign financing accounted for less than 6 percent of their liabilities. Also, as they hold sizeable foreign assets, they were in a position to draw down those assets in 2008 and early 2009. Nigerian banks had sizeable liabilities to foreign banks of more short-term nature and a large share of those liabilities were not rolled over, which was reflected in a reduction in the stock of outstanding claims of BIS reporting banks on Nigerian banks (as reflected in the figures in Table 3). As a result, the Central Bank of Nigeria had to inject liquidity into the banking system. BIS-reporting banks also reduced their exposure (through end-March 2009) to other countries, including Cape Verde, Mauritius and Zambia. By contrast, with the exception of Tunisia, BIS reporting banks generally kept up their exposure to most of the emerging markets in Northern Africa.

On August 14, the Governor of the Central Bank of Nigeria announced a first government-initiated shake-up of African banks through the dismissal of the management of five banks that had failed the stress test and were close to insolvency and the promise of $2.6 billion to save the country's banking system from the risk of a systemic crisis. These banks had reportedly had huge concentrations in their exposure to certain sectors and also suffered from a general weakness in risk management and corporate governance (Financial Times, August 15, 2009). While the problems of these banks were due to underlying weaknesses of management, the losses resulting from relatively heavy concentration of assets in the stock market and loans to the oil and gas sector were intensified by the recent economic crisis.

If the slowdown in economic activity continues, non-performing loans in all countries are likely to increase, and the balance sheets of the banks could be adversely affected. In addition, as in the rest of the world, trade finance has been affected in Africa, with its cost increasing and its availability reported to have been seriously affected.

Since credit availability has tightened, small and medium-size enterprises (SMEs), which are usually considered more risky than larger enterprises, have started to suffer, again an experience similar to that of other regions in the world. These enterprises are often the engine of growth, as they are more adaptable than larger enterprises and generally account for a high proportion of employment in most countries. Therefore, if these enterprises continue to see their credit restricted in the current downturn, it could have grave consequences for growth in the future.

The crisis in the international capital markets reduced borrowing in several emerging and frontier market economies. In particular, countries such as South Africa, which depend crucially on portfolio inflows to finance current account deficits, experienced a drying up of inflows, higher spreads on international borrowing, and a weakening of both the currency and financial markets (Table 4). Also, several countries that had planned to borrow externally such as Ghana, Kenya, and Zambia, had to postpone their plans, thereby reducing financing for the governments budgets, which were already under pressure from reduced revenues.

Stock markets and local currency bond markets weakened in almost all emerging and frontier market economies, not least from the withdrawal of portfolio inflows. Declines in local equities redounded negatively on the banking sectors in Kenya, Nigeria, South Africa, and Uganda. The impact was particularly large in Nigeria where banks had raised significant amounts of capital through the equity markets and provided large amounts of credit for share purchases.

The impact on foreign direct investment is potentially serious, although it is still too early to tell because of lack of high frequency data. Africa has become increasingly dependent on foreign direct investment to finance infrastructure and other key investments that are essential to promote economic growth. With a slowing in global demand, the weakening in economic activity and the scarcity of financing, foreign direct investment has reportedly been adversely affected. There is already anecdotal evidence that some foreign investors are canceling or postponing investment projects, including in the mining industries.[6] In this context, one of the major unknowns is the prospects for China's investment in Africa. A part of this investment is probably motivated by more long-term and strategic considerations and, thus, is more likely to be sustained.[7] But a part might also be adversely affected by movements in commodity prices and by overall confidence in the pace of recovery from this crisis.

Weakening in Foreign Demand for Africa's Exports and in Commodity Prices

Developments in commodity prices affect countries unevenly. Oil prices weakened significantly initially, as did the prices of copper and cobalt (Chart 3). However, in recent months, some of those prices – and the prices of other commodities - have started to recover. Even with the recent rebound however, oil exporters (e.g., Algeria and Nigeria) have suffered a significant decline in the terms of trade from their previous very high levels. Other countries (e.g., Botswana, Mozambique and Zambia) also suffered a significant decline in

6 This is easier to document in regions outside of Africa where data and investment activity reporting tends to be more timely. But The Africa Investor (August 6, 2009) reports as follows: "Crashing commodity prices and the slowdown in demand from China has hit the mining industry. Companies have cut jobs and capital expenditure and postponed risky forays into new markets. Rio Tinto plans to shed 13% of its global work force and Anglo American says it will slash global capital spending by more than half to US $4.5 billion and delay expansion projects across the world. Fallout in South Africa has manifested in 14,000 jobs lost so far. The DRC says it expects to shed 300,000 jobs by the end of 2009 from its main mining region."

7 On July 23, 2009, the Financial Times reported that Premier Wen Jiabao of China had said the following to Chinese diplomats, "We should hasten the implementation of our 'going out' strategy and combine the utilization of foreign exchange reserves with the 'going out' of our enterprises". This might suggest that China is in Africa for the longer term.

Table 3: BIS Reporting Banks' Claims on Emerging and Frontier Markets in Africa
(In billions of U.S. dollars)

	2007	Q1 2008	Q2 2008	Q3 2008	Q4 2008	Q1 2009
Algeria	6.6	6.8	6.6	7.4	7.1	7.3
Egypt	34.4	39.2	37.9	35.7	39.7	40.1
Morocco	17.9	16.4	14.5	14.2	13.0	12.3
South Africa	119.9	111.1	117.8	115.0	99.8	106.0
Tunisia	7.2	8.4	8.6	8.2	7.8	7.7
Botswana	2.5	2.4	2.5	2.6	2.5	2.2
Cape Verde	0.8	1.1	2.1	1.3	1.5	1.0
Ghana	4.1	4.5	4.1	3.9	4.0	3.6
Kenya	2.3	4.3	4.4	4.2	3.8	3.9
Mauritius	16.4	16.4	14.5	14.2	13.0	12.3
Mozambique	2.3	2.4	2.5	2.7	2.7	2.7
Namibia	0.7	0.6	0.6	0.6	0.6	0.5
Nigeria	10.5	13.1	15.2	16.9	11.6	7.5
Seychelles	1.4	1.7	1.9	1.7	1.4	1.4
Tanzania	1.6	1.9	2.1	2.0	1.9	1.9
Zambia	1.3	2.4	2.9	2.6	2.1	1.8

Source: Bank for International Settlements.

Table 4: Emerging and Frontier Market External Financing: Total Bonds, Equities, and Loans on Emerging and Frontier Markets in Africa (External public syndicated issuance)
(In millions of U.S. dollars)

	2007	2008	Q1 2008	Q2 2008	Q3 2008	Q4 2008
Algeria	411	1738	0	1738	0	0
Egypt	5472	6695	1853	3802	368	672
Morocco	1721	473	0	197	276	0
South Africa	19798	2800	31	1550	751	468
Tunisia	403	402	0	402	0	0
Botswana	0	0	0	0	0	0
Cape Verde	13	0	0	0	0	0
Ghana	1464	1000	0	0	1000	0
Kenya	10	277	0	183	25	69
Mauritius	0	29	9	0	20	0
Mozambique	0	834	0	826	9	0
Namibia	0	98	0	88	10	0
Nigeria	4884	224	0	155	0	69
Seychelles	30	0	0	0	0	0

Source: IMF, Global Financial Stability Report, based on Dealogic.

the terms of trade. By contrast, a number of countries, such as Ghana and Kenya, did not experience a decline in the terms of trade, in part because the weakening in oil prices dampened import prices. For policy makers, the volatility in commodity prices and uncertainty about the level of future prices has made policy decisions difficult.

Weakening Tourism Receipts and Remittances

Countries that traditionally have relied on tourism, such as Egypt, Kenya, Mauritius, Morocco, the Seychelles, and Tunisia have experienced declining receipts with weakening incomes abroad. Recession in countries such as Italy, Germany and the UK are expected to have a profound effect on the tourist industries of North Africa's more diversified economies such as Egypt, Tunisia and Morocco. Remittances are also seen to be declining in Africa as they are in much of the rest of the world. Remittances tend to respond with a lag. By the first quarter of 2009, it was clear in several countries (including Kenya) that the growth in remittances had started to weaken. In July, the World Bank revised downward its projections for remittances in the world to a decline of 7-10 percent in US dollar terms in 2009. Sub-Sahara Africa is expected to experience a fall of 8-9 percent in its remittances flows.

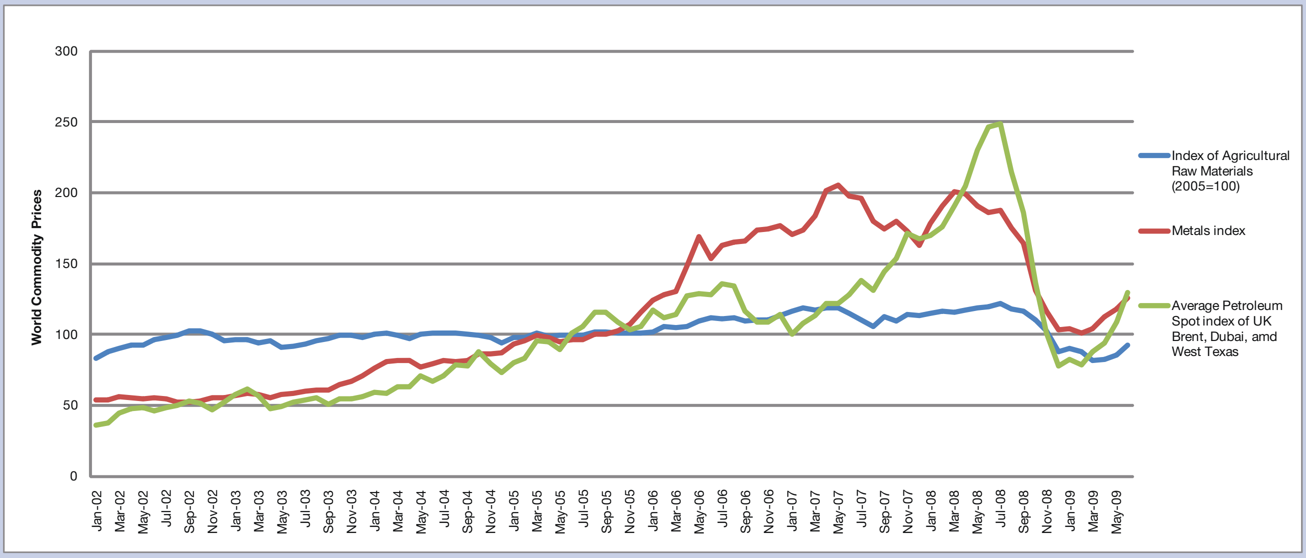
In conclusion, the global crisis has affected the African countries through various channels and to varying degrees across countries. Most countries, and particularly those with large current account deficits, have been affected by the reversal of private capital flows and the decline in global demand. The weakness in commodity prices, however, has hit primarily the oil-producing countries and exporters of certain commodities such as copper and cobalt, while other countries have benefited from lower import bill because of lower oil prices. Remittances and tourism receipts have particularly affected countries in Northern Africa and other main destinations of those flows (including Kenya, Mauritius, and Nigeria).

III. Policy Responses

The identification of the transmission channels through which the global crisis has affected Africa points to the challenges faced by policy makers. Since the impact of the forces working through the various channels varies significantly across countries, setting common policy guidelines for a group of countries as diverse as the emerging and frontier economies of Africa is impossible. The fact is that each country needs to be looked at in the context of its own situation – its position before the crisis, and the particular ways in which it has been affected by the crisis.

The task is made even more difficult by the fact that the near term prospects for the global economy are so uncertain, as stressed in the first section of the paper. There is positive news for some emerging market economies in Africa because of recovering commodity prices and, of course, renewed growth in their major markets could help exports recover. There are also signs of an easing of conditions in global capital markets- after the near-closure in 2008. Bond issues of both sovereigns and corporations, including by some well-established issuers in Africa, have recovered and, across the emerging market countries of the world, they have exceeded their pre-crisis levels in the first half of 2009. Africa's near-term prospects depend importantly on how these global conditions evolve and how they impact the continent. But policy makers must act. They are faced with the dilemma of responding to the short-term declines in output and rising unemployment that have already occurred, but in an environment of great uncertainty about whether the global situation will cause more damage or become more benign, or even supportive. In the face of such uncertainties, maintaining a focus on the medium-term goals of fostering growth and reducing poverty must be kept in focus. It is therefore important that any short-term responses do not impair medium-term prospects. For example, for countries that have achieved macroeconomic stability in the form of a sustainable fiscal and external debt position with low inflation, such progress should be maintained. Measures taken to counter the effects of the crisis should not put the fiscal or external positions at greater risk. In this connection, for some countries, support for such measures should be sought, on appropriate terms, from the World Bank, the IMF and other institutions that have scaled up their resources to be in a better position to help.

Chart 3: World Commodity Prices, 2007- June 2009



Source: IMF Primary Commodity Prices Database

In the following paragraphs, some key policy issues are examined. These include confronting the challenges facing the financial sector, formulating appropriate fiscal policy, dealing with the decline in private remittances and tourism, and the likely weaker prospects for foreign direct investment, and determining the scope for official financing. In general, it is essential that countries continue to pursue policy reforms that allow them to be in the best possible position to take advantage of the improvement in the global economy when it occurs. Two factors, in particular, should be kept in mind. The first is that many African countries are not well placed to engage in counter cyclical policies, both because they lack the institutions and policy levers needed for effective action and they lack the timely data on which such policies need to be based. Second, they may better devote their limited policy-making resources to use the crisis to press ahead with the more fundamental reforms that are needed to make their economies more productive. While there is much debate about the proposition, there are good arguments – and lots of evidence – that crises present opportunities for change. If anything, this would call for even bolder reforms than before, e.g., improving the business environment for private sector activity to help set the stage to benefit from the global recovery.

One lesson from the recent crisis should be emphasized at the outset. A major challenge in doing an assessment of the current situation, and a stumbling block for policy makers in deciding the appropriate response to the unfolding crisis is the paucity of data on recent developments. The institutions and policy levers in some of the emerging and frontier economies of Africa have been strengthened and improved in recent years. This creates new opportunities for these countries to conduct policy in a manner that can help to offset and counter developments in the global economy. However, this opportunity can be fully exploited only if policy makers have at hand reliable data about how external developments are affecting their economies. In addition, there should be greater transparency of the data that is available. At present, and in many countries, the minimum data that should be provided to policy makers and markets are not available, hindering policy-making and possibly increasing the volatility of markets – and even the real economy.

Challenges in the Financial Sector

The global financial crisis has underscored how the financial systems in Africa are becoming increasingly integrated into the global economy. As in other regions, in responding to the still unfolding crisis, central banks should be prepared to inject liquidity into the financial system, if needed, either through repos, collateralized lending, or other tools at the disposal of the authorities. If confidence in the system begins to falter or credit remains tight, other actions, such as reinforcing or extending deposit insurance mechanisms, bank closures, capital injections, and other such tools, should be considered.

In the case of the frontier market economies, in particular, the capacity to monitor capital flows and the health of the banking system needs to be bolstered. In general, the monetary authorities should monitor the financial markets, including the liquidity position of banks, cross-border credit lines, and, where they may exist, off-balance sheet items. While stress-testing of banks' balance sheets is not customary in most of these countries, in the current environment this should be considered, just as it is becoming more common in advanced countries.

A very large share of the banking system in African countries is foreign-owned - often more than 50 percent and in some cases (e.g., Botswana and Mozambique) close to 100 percent. This raises several issues. First, there is a risk that foreign-owned banks will repatriate additional capital if they continue to deleverage their balance sheets. In extreme cases, they may even try to withdraw their operations. Fortunately, this risk does not yet appear to have materialized to any significant extent. Second, the liquidity constraint of parent banks might constrain the operations of subsidiaries. Fortunately, subsidiaries operating in Africa generally raise a large share of their deposits locally rather than from parent banks, thus limiting this risk. Third, calls in the home country of foreign banks to strengthen their capital base (on a consolidated basis) could constrain the lending operations of some banks. This has reportedly affected lending by a number of banks in Africa.[8] Cross-border banking within Africa has expanded significantly in recent years (e.g., banks

8 Sub-Saharan Africa Financial Systems and the Global Financial Shock, IMF's Regional Economic Outlook, April 2009.

headquartered in Nigeria and South Africa operate in many countries in the region). This, in turn, necessitates closer cooperation between the supervisory and regulatory bodies, as well as the monetary authorities, in the headquarter country and their counterpart in other countries in the region to monitor developments in the financial sector.

Short-term measures taken in response to the crisis should not detract from the medium-term need to further develop the local debt markets to facilitate more financing for both private and public investments, including for infrastructure. Many countries have made progress in this respect in recent years (including Ghana, Kenya, and Zambia)[9]. However, because of the still small size of the domestic markets, the withdrawal of foreign investors has had a relatively large impact on those markets and has increased their volatility. Therefore, further emphasis needs to be put on building up the local investor base, including through further participation of pension funds and insurance companies. This needs to be accompanied by strengthening in the regulatory environment for these institutions, which remains weak in some countries. Moreover, market-based monetary policy instruments should be strengthened and the functioning of foreign exchange markets improved. The ability of financial institutions to assess and manage the risk of lending to households and enterprises is still very weak and needs to be strengthened, as do debt collection mechanisms. Moreover, banks–and the regulatory authorities—need to keep up with the innovations in lending instruments, including mortgages and credit cards, which are developing on the continent.

In this connection, there is a need for the lessons learned from this crisis – especially in those countries at the heart of the crisis – to be applied in the emerging and frontier market economies in Africa. There have been major regulatory failures that should not be repeated in any country. These include weak capital requirements; insufficient oversight of off balance sheet operations of banks; insufficient transparency in a host of areas, including in the use of derivatives; failures by the rating agencies stemming in large part from the conflicts of interest evident in many of their operations; failures of credit risk models – or a lack of attention to their warning signs; and failure at the most basic levels of mortgage and credit card origination. There has also been a systemic failure to prevent financial institutions from becoming too big – or too complex and too interconnected – to fail. Any institution that is "too big to fail" is simply too big! This is only a sample of the regulatory issues that need to be reviewed in virtually all countries. One operational step should be taken immediately. All regulatory and supervisory offices should be instructed to ask themselves what incentives are driving the participants in financial transactions and, especially, in the origination and the rating of credit. The conflicts of interest that developed in the U.S. financial system were probably the most important factor leading to the current crisis.[10] While the regulatory and supervisory frameworks remain rudimentary in many countries, and risk assessment remains undeveloped, these lessons from the recent crisis hold lessons for all countries. But even if regulators and supervisors ask the right questions, they will be effective only if they have the legal authority and the institutional power to act. This was one of the main lessons from the Asian crisis of 1997/98 and it, too, should be heeded in Africa.

Fiscal policy

In many countries in Africa, the current crisis has led to declining fiscal revenues, including from weak commodity prices, reduced foreign direct investment and tourism receipts, and falling tax receipts as the economy weakens. On the other side of the ledger, expenditures are under upward pressure for social spending, employment–generating projects, and other measures to provide social support to the economy. The government budget might also be under pressure from declining external financing from either private or official sources, including from the postponement of bond offerings and the freezing-up of bank credit markets. Wider spreads have also increased the debt service burden in many countries. How can policy makers maintain a constructive focus on the future while dealing with these short-term problems?

Countries with a sustainable debt situation, a reasonably robust fiscal position before the crisis, and significant external

9 See Local-Currency Government Debt markets in Africa: Experiences and Policy Challenges, IMF, Regional Economic Outlook for Sub-Saharan Africa, April 2007.

10 See "The Impact of the Financial Crisis on Emerging Market Economies: The Transmission Mechanism, Policy Response and Lessons" by Jack Boorman, Emerging Markets Forum, Mumbai, India, June 23, 2009, p. 11.

reserves have some scope for letting the automatic stabilizers work or, additionally, for pursuing expansionary fiscal policy and allowing fiscal deficits to increase. For example, a country like South Africa that has pursued prudent fiscal policies over the last several years has had some scope for increasing the fiscal deficit in the short run. Similarly, oil exporting countries, such as Algeria might have scope for running down part of their reserves. By contrast, countries where the macro situation is already under pressure have less room to maneuver.[11]

For the more mature emerging market economies, including those in Northern Africa and South Africa, which have either introduced fiscal stimulus packages or let the automatic stabilizers work, there is a need to prepare an exit strategy so that the fiscal position remains sustainable and to give confidence to the private financial markets to resume or increase lending once market conditions improve. Implementing expansionary fiscal policies in the African context in the midst of a crisis raises different challenges from those that confront the advanced economies.

- First, the deterioration in the fiscal position is generally due to a decline in external demand rather than domestic demand, and thereby associated with a simultaneous deterioration of the balance of payments.
- Second, the scope for financing an increase in the fiscal deficit from domestic resources is generally less in Africa than elsewhere, since the domestic financial markets are less well developed. In the case of frontier markets, in particular, where domestic debt markets were being built up only in recent years, foreign investors have pulled back, leaving the markets thin. In the absence of additional external resources, governments need to be particularly careful in accessing domestic markets. The experience in some economies (e.g., Kenya) demonstrates the difficulties in increasing domestic financing by the government in the current environment and the risk of crowding out private sector activity.

11 The IMF estimates that about two thirds of countries in sub-Saharan Africa have only limited debt distress (in part because of debt relief) and therefore some fiscal space to allow an increase in the fiscal deficit, Fiscal Policy in Sub-Saharan Africa in Response to the Impact of the Global Crisis, IMF Staff Position Note, SPN/09/10.

Among spending measures for countries with fiscal space, the following could be considered:

- Expand safety nets and pro-poor spending to address rising unemployment and poverty.
- Increase spending on infrastructure by bringing forward already screened investment projects. This is consistent with the medium-term need for improving infrastructure. However, it is important to limit the introduction of new projects as they are likely to be implemented too slowly to counter the impact of a weakening economy.
- Protect spending in health and education and in other sectors related to the Millennium Development Goals.
- Give priority to stimulus measures that benefit small and medium-sized enterprises so as to support these firms in the current downturn.

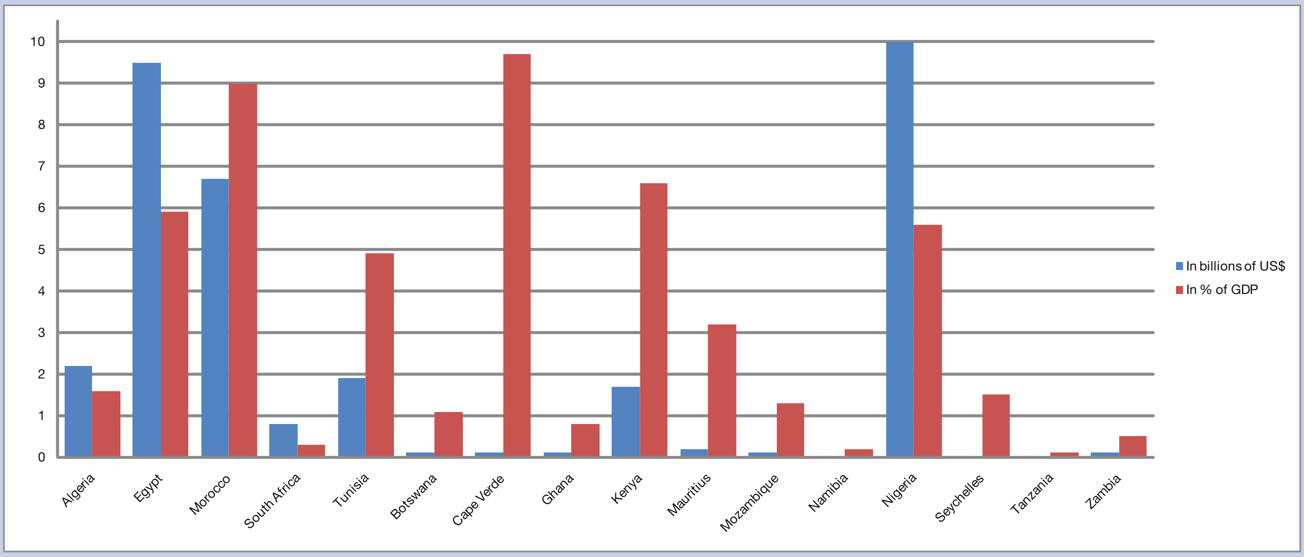
In many cases the scope for increasing fiscal space in the short term is limited, which again raises the issue of external financing (see below).

Remittances

Remittances provide substantial resource transfers to Africa, although they vary greatly by country. Egypt and Nigeria are not only the largest recipients in Africa but among the world's 10 largest recipients of remittance inflows (Chart 4). In the current global crisis, the growth of remittances has already slowed substantially, and, in some countries, they are actually in decline. At present, remittances through the formal channels are impeded by large transfer costs and restrictions on the kind of institutions that can undertake those transfers. For example, the cost for modest amounts of transfers is very high. It costs on average 10 percent of the amount to transfer $200 from the UK to Nigeria, and as much as 20 percent to transfer funds from South Africa to Mozambique.[12] Thus, there might be scope for policy makers to reexamine the formal channels for such transfers. There have been good examples from countries outside Africa where large banks have cooperated in the introduction of transfer schemes that have significantly reduced the cost of remittance transfers.

12 See World Bank data base on http://remittanceprices.worldbank.org/countrycorridors/.

Chart 4: Migrant Remittance Inflows in Emerging and Frontier Market Countries in 2008



Source: World Bank Migration and Development Release 10, July 13, 2009

In addition, proposals have been put forward for using other instruments to attract financing from the Diaspora, e.g., issuance of Diaspora bonds, a debt instrument issued by a country or by a sub-sovereign body or a private corporation to raise financing from its overseas Diaspora.[13]

Dealing with the Slowdown in Foreign Investment

It is not possible to put together a comprehensive picture of the ongoing impact of the crisis on foreign investment in Africa. Nevertheless, some things are reasonably clear. The sharp withdrawal of portfolio investment in the early phases of the global crisis has been reversed. This is manifest in the recovery in a number of the major stock exchange indices in Africa since the first quarter of the year. The largest exchanges in South Africa, Nigeria and Kenya have risen by between 20 and 40 percent from their lows even though they remain below the pre-crisis peaks. It is less clear what is happening to foreign direct investment. There have been many announcements by the largest mining companies of cut backs in activity and a scaling back of planned expansions. On the other hand, there is the announcement by China of a major increase in funding for its "going-out" program of acquisitions by Chinese state companies.

The impact on the countries in Africa will have to be examined individually, amidst much uncertainty over the near-term prospects. It is possible that the global recovery – whether it is already underway or will be delayed for some further but brief period – will bring with it resurgence in interest in investment in Africa. However, if the recovery is weak, or if the risk aversion associated with the crisis persists, Africa, amongst the most risky regions, may well see a prolonged period of foreign investment below pre-crisis levels. In the latter instance, in particular, it will be those African countries that offer foreign investors the best environment for productive investment that will be in the best position to benefit from whatever renewed interest. Perhaps the most important challenge for policy makers right now is to make sure that the business environment is attractive to foreign investors and that their institutions are up to the task of attracting, supporting and managing the investments that may be on offer. This involves governance issues, the development of local financial markets, the screening of and planning for large infrastructure

13 Ghana has begun marketing the Golden Jubilee Savings Bond to the Ghanaian Diaspora in Europe and the United States (World Bank, New Paths to Funding, Suhas Ketkar and Dilip Ratha, IMF's Finance and Development, June 2009).

investments, and many other challenges. This would seem the time to devote all the attention possible to this endeavor.

Aid and Other Official Financing

Aid and other official financing still play an important role in the frontier market economies, if less so in the emerging market economies in Africa. The scope for loosening domestic policies in response to the downturn in global activity is likely to remain limited in many of those countries. Also, while reserves have been built up in many countries and are relatively ample in some oil exporting countries, they cannot be relied upon for more than the short term to ease the adjustment, especially if oil prices remain permanently lower than they were a year or two ago. To avoid a major impact on economic activity and poverty, there is a need to urgently step up official financing from both bilateral donors and multilateral institutions.

In the current global environment, it will not be easy to get political support for increasing bilateral aid from the advanced countries, let alone to assure that they honor the Gleneagles commitment to double aid to Africa by 2010. With economic activity down significantly in all the traditional donor countries and unemployment rising, even a modest increase in aid is likely to be difficult. This being said, aid continues to constitute a small part of government budgets in most advanced countries and compared to the bailout packages that have been agreed with individual banks in those countries and the domestic stimulus packages that have been adopted, aid to Africa is small. At the AU Summit of the Heads of State and Government in February 2009, Prime Minister Meles Zenawi of Ethiopia put into perspective the size of aid versus budget constraints in donor countries, *"A bank in these [advanced] countries which is deemed too important to fail is getting more assistance than the whole continent of Africa."*[14]

At the recent G8 Summit in Italy, leaders recognized that the global financial crisis could jeopardize the progress towards the Millennium Development Goals. But they were vague on concrete initiatives to counter this effect and surprisingly silent on the prospects for aid to Africa.[15] The most promising prospects for additional resources are from international financial organizations. There might be scope for advancing aid disbursements from some of the major multilateral donors, including the World Bank and the African Development Bank. In July, the IMF announced that it is revamping its instruments for low-income countries and establishing three new facilities for medium-term and short-term balance of payments support as well as for dealing with exogenous shocks and the special needs of fragile states. The aim is to significantly increase the scope for lending to these countries by doubling available concessional resources and better tailoring the instruments to the needs of low-income countries. It is expected that low-income countries could benefit by up to $17 billion during the next five years, of which up to $8 billion in the next two years. Concessional financing would be at zero interest through end-2011.This will be financed in part by using additional resources from agreed sales of IMF gold to provide $6 billion in additional financing over the next 2-3 years. In addition, to boost general lending of the IMF, including to emerging market countries, the IMF will increase its resources by about $500 billion through loans frommembers, including under the New Arrangements to Borrow (NAB).

Finally, in addition to introducing new facilities and raising substantial amounts of new resources to support its lending operations, the Executive Board of the IMF has backed the allocation of SDRs for all members in an amount equivalent to $250 billion. This will help boost reserve assets of emerging and developing countries by about $100 billion, of which those in Africa about $10 billion (Table 2). Moreover, some large member countries that do not need the extra liquidity are apparently ready to consider a transfer of part of their allocations to other countries in need of reserves, possibly through an "Administered Account" in the IMF. This could be of significant benefit to African countries.

14 Statement at the AU Heads of State and Government, February 3, 2009, Addis Ababa, Ethiopia.

15 The G20 promised "to fulfill their ODA commitments, including on aid for trade; keep markets open to re-launch economic growth to the benefit of the poor; enhance transparency and competition among intermediaries to halve transaction cost of migrants' remittances; strengthen partnership with Africa to improve access to water and sanitation; support innovative financing instruments for health; and put agriculture and food security at the top of the agenda, by increasing multilateral financing to support comprehensive country strategies and improving coordination of existing mechanisms" (Chair's Summary, July 10, 2009).

IV. Issues for Discussion

1. What are the prospects for the global economy and, at present, what scenario for a global recovery should policy makers in Africa employ for their near-term policy planning?
2. In the financial sector, what can be done to assure that the lessons of the crisis in the advanced countries are learned in Africa? Is there a role for stress-testing bank balance sheets? Are there perverse incentives in the financial markets—and in the regulatory regimes—that need to be corrected? What can be done to accelerate the development of local financial markets? How can Africa partner with emerging market countries in other regions of the world to share relevant lessons in these areas?
3. What has been the likely impact of the crisis on foreign direct investment in Africa and what measures can be taken by African governments to foster such investment?
4. Do the African countries —especially those with little fiscal headroom to counter the crisis—need to mobilize to assure that they are in a position to benefit from the expressions of support from the multilateral institutions? How can the forthcoming Annual Meetings of the IMF and the World Bank be used for that purpose? Beyond that, how can Africa help push forward the IMF quota increase? How can Africa convince the major countries to combine the agreed SDR allocation with a mechanism for those countries to transfer some portion of their allocation to the developing countries?
5. What are the social consequences of the crisis in Africa? Has the momentum for reform suffered a set-back, as the populations do not witness the promised improvements in infrastructure? Are there more calls for government intervention in the economy?
6. What can be done concretely to accelerate the process of improving data and transparency of information in African countries? Are the multilateral institutions doing enough to help?

The Emerging Markets Forum is a non-profit venture of the Centennial Group, a Washington-based strategic advisory firm specializing in emerging market economies. The Forum was created to allow senior political and corporate leaders and public servants reach actionable conclusions on economic, political, and social issues facing emerging market economies.

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