THE INTERNATIONAL FINANCIAL CRISIS: CHALLENGES, PERSPECTIVES, AND THE IMPACT ON AFRICAN ECONOMIES

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I. THE GLOBAL FINANCIAL CRISIS AND THE GREAT RECESSION

As has been well documented, the origins of the global crisis were to be found in the financial sectors of the advanced economies. The U.S. subprime crisis in late 2007, which led to a tightening of credit conditions and a mild economic slowdown, was initially believed to be contained. But in 2008 it spilled over to core financial market institutions, prompting a huge increase in perceived counterparty risk. In the flight to liquid government securities, the wholesale funding market evaporated. Businesses were unable to find hitherto routine trade and working-capital financing. Banks tightened lending standards even further. Equity prices fell steeply. Previously unaffected markets, including in emerging market economies, were suddenly also facing funding problems and spreads on sovereign borrowing spiked.

The impact of this financial crisis on real activity was inevitable, immediate and widespread. Starting in the final quarter of 2008 and into 2009:

- Industrial production *fell* about 17 percent in the advanced economies, about 5 percent in the emerging economies;
- The value of world trade *fell* over 25 percent in SDR terms.
- Unemployment *rose* sharply, leading to significant job losses in the advanced economies, but also in some emerging market economies such as South Africa.
- And financial sector losses, which the IMF now estimates at USD 2.3 trillion, led to a contraction of private sector credit in many countries.

In response, economic policy decision-makers took dramatic and unprecedented monetary and fiscal measures. In mid-2009, world trade and industrial production rebounded and retail sales started growing again. Employment continued to fall, but at a far slower rate. A global recovery is now underway, albeit at different speeds in different regions. It is tepid and policy-dependent in many advanced economies; fairly vigorous in many emerging and developing economies. Global output is expected to rise by 4¼ percent in 2010, following the unprecedented contraction of ½ percent in 2009.

II.

III. The Impact on Sub-Saharan Africa

And this average masks a wide variation: in oil-exporting and middle income countries, the impact of economic growth and employment was much more severe. Low income countries in Sub-Saharan Africa, fortunately, suffered a less severe slowdown and we estimate that growth averaged about 4½ in 2009 – and even higher in some cases, such as Mozambique. But we should also not forget that it is the low-income countries that are the most vulnerable to an economic slowdown, and the World Bank estimates that up to 7 million in Sub-Saharan Africa failed to rise above the poverty line during this period.

The silver lining is that we now estimate that the slowdown will be mercifully short in Sub-Saharan Africa. By the middle 2009, much of Sub-Saharan Africa had reached a turning point. Trade had started to recover and bank credit had resumed growing. In hard-hit South Africa, industrial production began to recover around September and the rand rebounded. By the end of the year, bond spreads had returned to pre-crisis levels and Senegal was able to float its first international bond. Now, in our latest regional outlook, we project that sub-Saharan Africa real GDP will grow by 4¾ percent this year and, provided that the rest of the world continues to improve, accelerate further to 5 ¾ percent next year.

IV. Why Africa Weathered The Storm so well

The brevity of the slowdown owes much to the relatively favorable economic conditions going into the crisis. Many African countries had built up buffers while times were good. By the end of 2008, international reserves were high in terms of both share of GDP and months of imports. The median debt burden had fallen dramatically. Inflation was coming down rapidly, albeit after the food-and-fuel-induced spike of 2008. These conditions gave many African governments a margin of maneuver and they used it well. With declining rates of inflation and relatively well-anchored expectations, policy rates could be lowered in most places.

In about two-thirds of the countries in Sub-Saharan Africa, governments were able to provide a much-needed fiscal stimulus by maintaining spending in the face of falling revenues or, in

some cases, even raising spending. In stark contrast to previous episodes of global turmoil, the majority of African countries were in a position to mitigate its impact on their economies and their populations.

For example, health and education spending increased in real terms in half of the low income countries, protecting the most vulnerable from the impact of the downturn.

Supportive economic policies in Sub-Saharan Africa were also facilitated by a rapid response by the international community, including the IMF. In 2009, the IMF committed over US$5 billion in new lending, most of it at zero interest, more quickly, more flexibly, and with fewer conditions than before. The SDR allocations in August and September further bolstered reserve assets by nearly US$12 billion. This financing provided an additional cushion that allowed many countries to maintain more expansionary policies than otherwise would have been possible.

I would draw three lessons from Africa's experience with the Great Recession:

- First, the impact on Africa was less severe than in previous downturns because countries were better prepared, with strong policy buffers in place in many countries prior to the onset.
- Second, "sub-Saharan Africa," is becoming a less and less useful unit of analysis. The different impacts and responses show that African economies are getting increasingly diverse in their structure, sophistication and policy strength.
- Third, and notwithstanding this differentiation, most African economies are rebounding in parallel with the advanced industrial countries. This is a *marked* change from previous downturns, when African economies took far longer to regain their equilibrium and return to growth.

If the global financial crisis was a "stress test" of macro policy frameworks in Africa, most countries have come through in reasonably good shape, if a little bruised. African economies have a new resilience, and the challenge will be to maintain this resilience.

V. Poised for Recovery

As a global recovery gathers strength, what should the policy priorities be? Exit policies from the stimulus programs in advanced and emerging economies will necessarily be multi-speed, reflecting the differing strengths of the upturn. In advanced economies, the rapid rise in public debt will require a focus on fiscal consolidation and financial sector repair. This

should allow monetary policies to remain accommodative without leading to inflationary pressures. Emerging market economies where the recovery is more firmly entrenched will need to be more vigilant on the inflationary front. But the policy priority for the global economy will be to rebalance global demand. For the world economy to sustain a high-growth trajectory, the economies that had excessive external deficits before the crisis will need to consolidate their public finances in ways that limit damage to potential growth and demand. Concurrently, economies that ran excessive current account surpluses will need to further increase domestic demand to sustain growth, as excessive-deficit economies scale back their demand (and imports) in response to lower expectations about future income. Exchange rates will need to adjust, and rebalancing will need to be supported by financial sector reform and structural policies in both surplus and deficit economies. The Mutual Assessment Process, conducted by the G-20 economies and supported by the IMF, serves an important purpose by testing the policy consistency of the world's major economies with the rebalancing required for renewed and sustainable global growth.

What does this mean for Africa?

To my mind, now is the time for African policymakers to shift their focus from short-term considerations of crisis management, back to the medium-term considerations of sustainability and long-term considerations of growth that preoccupied us prior to the crisis and recession.

The first order of business should be *to rebuild the buffers* that served so well over the last 18 months. This implies unwinding fiscal stimulus as growth recovers, putting medium-term spending on a path consistent with debt sustainability, and adjusting monetary and exchange rate policies to rebuild international reserves. With the outlook for current accounts and external financing still so uncertain, a degree of self-insurance is both necessary and inevitable.

Next, I would highlight the need for *financial sector policy frameworks* that help to increase financial depth and strengthen institutions. Recent developments have sharply highlighted the costs of poor supervision. In many countries in Sub-Saharan Africa, financial sectors are still shallow and vulnerable; this is both a risk to stability and an impediment to growth. For those economies moving toward frontier or emerging-market status, economic and financial sector policies also need to take into account renewed inflows of more volatile forms of capital, if they are to avoid overheating, unwarranted appreciation, or disruptive asset price booms and busts.

Finally, long-term economic growth and employment creation depend on a vibrant private sector, which in turn requires a business environment conducive to direct investment, *indigenous as well as foreign.* The reforms that raise productive potential are also likely to make and keep countries attractive to private capital from abroad. These reforms include measures to promote trade and financial sector development, to encourage domestic saving and investment, that raise standards of governance, and strengthen key public institutions, including central banks.

VI. A Future Agenda

Macroeconomic rebalancing will need to be accompanied by steps that make the international financial system sounder in the short term and safer over the medium term. A key area will be financial regulation. Many of the largest banks and financial intermediaries, through weak risk management, built up enormous leverage that was funded through the wholesale markets. Capital standards were less than stringent and insufficient attention was paid to liquidity and credit risk outside the banking book. Moreover, many of the institutions that were the source of the problems fell outside the perimeter of the existing regulatory framework.

Regulatory reforms currently under discussion in international fora such as the G-20, the IMF, and the Financial Stability Board aim at ensuring that in future financial institutions hold more and higher quality capital; that they hold more liquidity for insurance purposes; and that they introduce more robust risk management systems and corporate governance standards. More comprehensive financial disclosure standards are also under discussion. These are complicated technical issues and regulatory reform in the financial sector always takes time. But good progress is being made.

There is currently less consensus, however, on how to address one of the issues that arose in the global financial crisis: how best to solve the problem that some financial institutions are "too-important-to-fail" by virtue of their weight and interconnectedness within the financial system. A range of proposals are on the table. One tool—one that the G-20 asked the Fund to assess—would be a levy on the financial sector in order to make "a fair and substantial contribution toward paying for any burdens associated with government interventions to repair the banking system". To the extent that such a charge is risk-based, it could help to discourage financial institutions from taking on excessive risk. It would also ensure that financial institutions contribute to the fiscal costs associated with financial sector failures and therefore, address the public policy concern that financial institutions are able to privatize gains but socialize costs arising in the financial sector. One thing is clear, however: to be effective, any measures will need to coordinated internationally. Countries cannot and should not go this alone. Global financial stability requires global financial cooperation

The IMF itself is adapting to better serve its members and contribute to a stronger global financial system. To that end, our governing body, the IMFC, called for a review of our mandate and financing role. The global financial crisis demonstrated that IMF surveillance needs to be more rigorous—with greater coverage of the financial sector and regulatory issues, and a better appreciation of systemic risks and cross-border spillovers. Prevention also requires timely detection, and the IMF is currently developing a so-called Early Warning Exercise that aims at better identifying risks at an early stage. Finally, we are exploring ways in which to complement our bilateral surveillance under Article IV with a more systematic and thorough multilateral surveillance process. There is also an ongoing discussion of the IMF's financing role to better help reduce risk, building on the success of the Flexible Credit Line which provided insurance-like support to emerging market economies with strong fundamental policies.

What does this all mean for Africa? Clearly, more global financial stability and steps to minimize the risk of future crises benefits all countries, especially those who seek to grow fast by attracting investment and boosting exports. But over the past year, the IMF has also taken steps to directly support its low income members. The Fund made comprehensive reforms to its low-income country facilities, to meet the diverse needs of low-income members, tailoring the facilities to specific problems, doubling access levels, and reducing the interest rate to zero through the end of 2011. We secured the funding, in part from gold sales, to double our capacity for concessional financing to US$ 17 billion through 2014/15. And we have increased our provision of technical assistance in areas of our core mandate: central banking, monetary and exchange rate policy, tax policy, revenue administration, public financial management (including debt management) and economic statistics. Increasingly, technical assistance is being provided through our network of Regional Technical Assistance Centers, the AFRITACs. We currently have three of them serving 25 countries, with plans for two more centers, which will cover all of Sub-Saharan Africa by end-2010.

As the global recovery strengthens, it will be important that Africa seize the momentum to regain its rapid growth path. Sound macroeconomic policies and the rebuilding of policy buffers to guard against future shocks are surely a prerequisite. But as many African governments have emphasized, including at our recent Spring Meetings, growth also requires more and better public infrastructure, ranging from roads and railways to ports and energy supply. Financing such infrastructure does imply a role for the public sector, both by raising public investment directly and by facilitating private sector involvement. Some of the resources will inevitably be coming from market sources at commercial terms, putting a premium on strong public financial management practices, or what Professor Paul Collier has called "Investing in Investing". Higher levels of public investment alone will not be enough, it is equally important that project selection, procurement, and implementation be held to the

highest possible standards to ensure value for money. Strong institutions, good governance, and reducing corruption all contribute to a better investment climate. It will also be critical to strengthen debt management capacity to ensure that public debt levels remain manageable and debt service does not crowd out other priority expenditures.

The global financial crisis has shown the importance of strong fundamentals and solid buffers against shocks. Mozambique demonstrated its resilience in the face of global turmoil. It is now poised to begin a new phase in its economic development. It can count on the IMF to be by its side.