Impact of the Global Financial Crisis on Sub-Saharan Africa

African Department

INTERNATIONAL MONETARY FUND

Impact of the Global Financial Crisis on Sub-Saharan Africa

African Department

INTERNATIONAL MONETARY FUND

©2009 International Monetary Fund

Production: IMF Multimedia Services Division
Typesetting: Alicia Etchebarne-Bourdin

The downturn in global growth, the decline in most commodity prices, and tighter credit have significantly worsened the economic outlook for sub-Saharan Africa. Risks are rising and it is uncertain how long the crisis will last. Policy makers must walk a tightrope between not aggravating the shock in aggregate demand on the one hand, while protecting hard-won gains in economic fundamentals on the other. Any policy response must also take into account the impact on the poor and seek to incorporate social safety nets. Countries that do not have debt sustainability and financing constraints may have some scope for fiscal easing. But it is also clear that countries will depend critically on donors honoring their commitments to aid and even increasing aid, despite new competing demands on their own budgets. The IMF itself is moving fast to increase financial support to affected countries, step up technical assistance, and reinforce the policy dialogue with its African members.

I. The Global Financial Crisis and the Short-Term Outlook

The current financial crisis is more global than any other period of financial turmoil in the past 60 years. The extent and severity of the crisis that began with the bursting of the housing bubble in the United States in August 2007 reflects the confluence of several factors: some are familiar from previous crises, others are new.

- As in previous times of financial turmoil, the pre-crisis period was characterized by (i) surging asset prices that proved unsustainable; (ii) a prolonged credit expansion leading to accumulation of debt; (iii) the emergence of new types of financial instruments; and (iv) the inability of regulators to keep up.
- New this time is the rapid expansion of securitization (not itself a new phenomenon), which changed incentives for lenders and lowered credit standards. Systems became fragile because balance sheets became increasingly complex (further complicated by increased use of off-balance-sheet instruments); financial market players were highly leveraged; and they relied on wholesale funding and external risk assessments. Cross-border spillovers intensified after the crisis broke because financial institutions and markets across borders were closely linked and risks highly correlated.

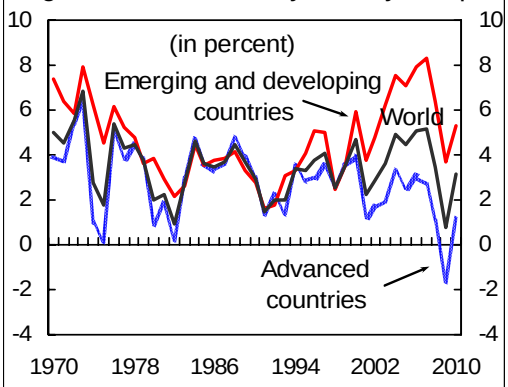
As a result of the financial crisis, the world economy is facing a deep downturn. The January 2009 update of the *World Economic Outlook* projects global growth to slow from just under 3½ percent in 2008 to about ½ percent in 2009 before recovering somewhat in 2010 (Figures 1 and 2). However, risks to this outlook remain on the downside.

Note: The projections presented in this note are based on the IMF's *World Economic Outlook* update published on January 28, 2009.

- Advanced economies are suffering their worst downturn since World War II, with economic output expected to contract by over 1¾ percent in 2009. With the help of monetary and fiscal stimulus and slowly improving financial conditions, growth is expected to resume gradually in 2010—but there is a significant risk that the downturn could be deeper than currently expected.

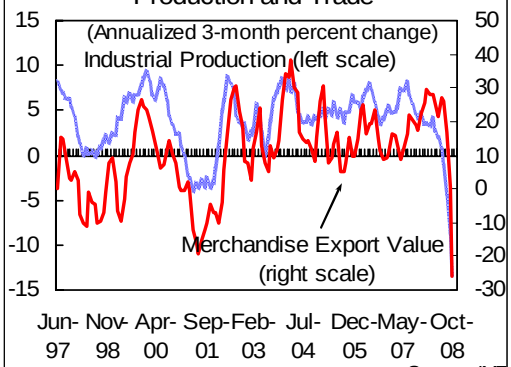
- Growth is also expected to fall in China, India, Brazil, and other emerging market economies, dragged down from 6¼ percent in 2008 to about 3¼ percent in 2009 by falling export demand, subdued capital inflows, and lower commodity prices. Similarly, growth in all emerging market and developing economies, including sub-Saharan Africa, is expected to slow to 3⅓ percent in 2009 from 6⅓ percent in 2008, and then gradually pick up with world demand in 2010.

Figure 1. GDP Growth by Country Groups



Source: IMF.

Figure 2. Growth in Global Industrial Production and Trade



Source: IMF.

II. How Is Sub-Saharan Africa Affected?

Many countries in sub-Saharan Africa enjoyed robust economic growth in recent years that strengthened their balance sheets. Sound economic policies were an important factor, as was the favorable external environment and increased external support in the form of debt relief and higher inflows.[1] But the food and fuel price shocks of 2007–08 that preceded the current global financial crisis weakened the external position of net importers of food and fuel, caused inflation to accelerate, and dampened growth prospects. The global financial crisis greatly compounds the policy challenges confronting the region as it strives to consolidate its economic gains and meet the Millennium Development Goals (MDGs).

The global financial crisis initially affected advanced economies, emerging markets, and low-income countries in very different ways. Advanced economies were first hit mainly by the systemic banking crisis in the United States and Europe. Emerging markets with well-developed financial systems were initially mostly affected by cross-border financial

[1]See *Regional Economic Outlook: Sub-Saharan Africa*, Chapter 2: "The Great Sub-Saharan African Growth Takeoff: Lessons and Prospects," October 2008 (Washington: International Monetary Fund).

linkages through capital flows, stock market investors, and exchange rates. In financially less-developed countries the growth and trade effects dominated, with lags. Now, however, growth and trade effects are crucial for all countries.

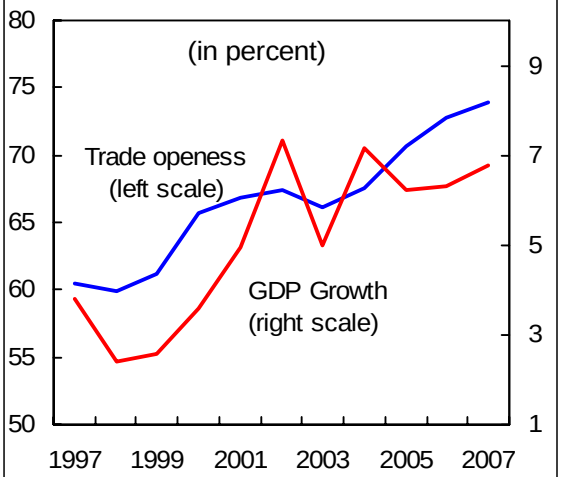
In Africa, frontier and emerging markets were hit first; by now indirect channels are fully at work in all countries, and risks are mounting that other channels may gain in importance, especially in the financial sector.

- *Frontier and emerging markets:* Through their financial links with other regions in the world, South Africa, Nigeria, Ghana, and Kenya were hit first, suffering falling equity markets, capital flow reversals, and pressures on exchange rates. Ghana and Kenya had to postpone planned borrowing, and in South Africa and Nigeria external financing for corporations and banks is becoming scarce.

- *All countries:* The global slowdown in economic activity has pushed commodity prices down (Figures 3 and 4), with negative effects on export earnings and the external current account, fiscal revenues, and household incomes. Commodity exporters face a major terms of trade deterioration. IMF research shows that in the past a 1 percentage point slowdown in global growth has led to an estimated ½ percentage point slowdown in sub-Saharan African countries. The effects may be more pronounced this time because the tightening of global credit compounds the impact of the slowdown, exacerbating risks for trade finance and other capital flows.

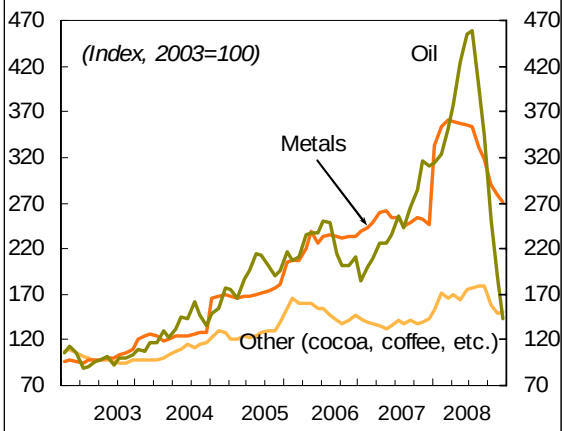
- *Fragile states whose political and social situation is inherently vulnerable.* Countries like Burundi, Guinea-Bissau, and Liberia are dependent on very concessional financing that may well be affected.

Figure 3. Growth and Trade Openness



Source: IMF.

Figure 4. Sub-Saharan Africa: Commodity Prices



Sources: IMF and UN Comtrade.

Financial sectors in sub-Saharan Africa are also vulnerable to several risks that could still unfold. Unlike in developed economies, there has been no systemic banking crisis in sub-

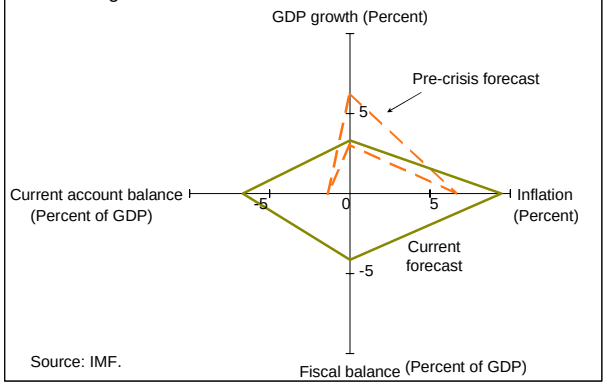
Saharan Africa. Commercial banks and other financial institutions there so far remain largely sound. Cross-border banking system linkages are minimal; there is less exposure to complex financial products, and financial systems are not well integrated with other global financial markets. However, as the crisis continues, risks could grow because

- A protracted economic slowdown elevates credit risk. For instance, the domestic financial sector is vulnerable to a substantial weakening in client incomes and debt servicing capabilities, particularly where credit growth has been rapid in recent years. Banks could also incur losses on other financial assets, such as deposits with troubled correspondent banks.
- Concentrated bank portfolios have become a source of vulnerability in several African countries. With global demand significantly lower and hefty declines in the prices of most commodities, major industries, such as timber and cotton, are hard hit. Problems in these sectors could quickly affect the banking sector.
- In some countries banking systems may be increasingly exposed to market volatility. Countries where high equity returns had led to borrowing for investment in the stock market (e.g., Kenya, Nigeria, and Uganda) are at greatest risk.
- Parent banks could withdraw funds from subsidiaries and local banks. Risks of contagion from distressed foreign parent banks to local subsidiaries within sub-Saharan Africa could be associated with parent banks (i) withdrawing capital from African subsidiaries; (ii) calling in loans to their African subsidiaries; (iii) no longer investing local profits in local subsidiaries; or (iv) a combination of these.

Thus, the financial sector, especially banks, must be monitored vigilantly in order to minimize vulnerabilities and mitigate risks.

III. What Is the Outlook for Sub-Saharan Africa?

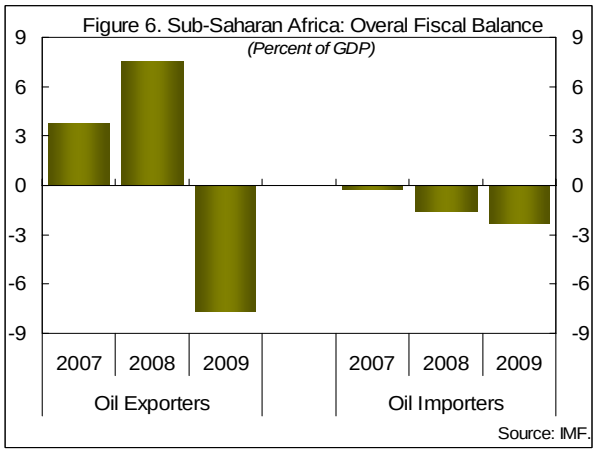
Figure 5. Current and Pre-Crisis Forecasts for 2009

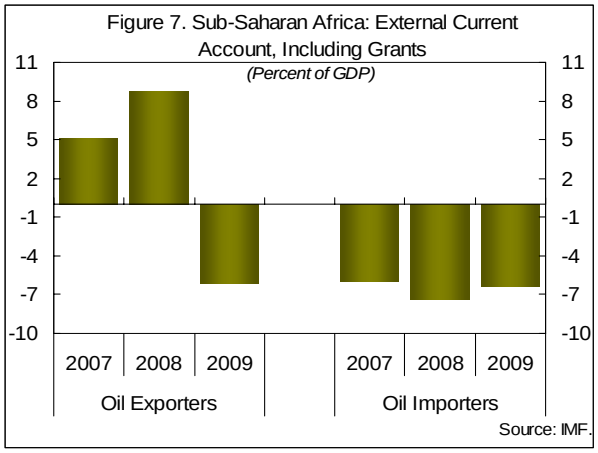


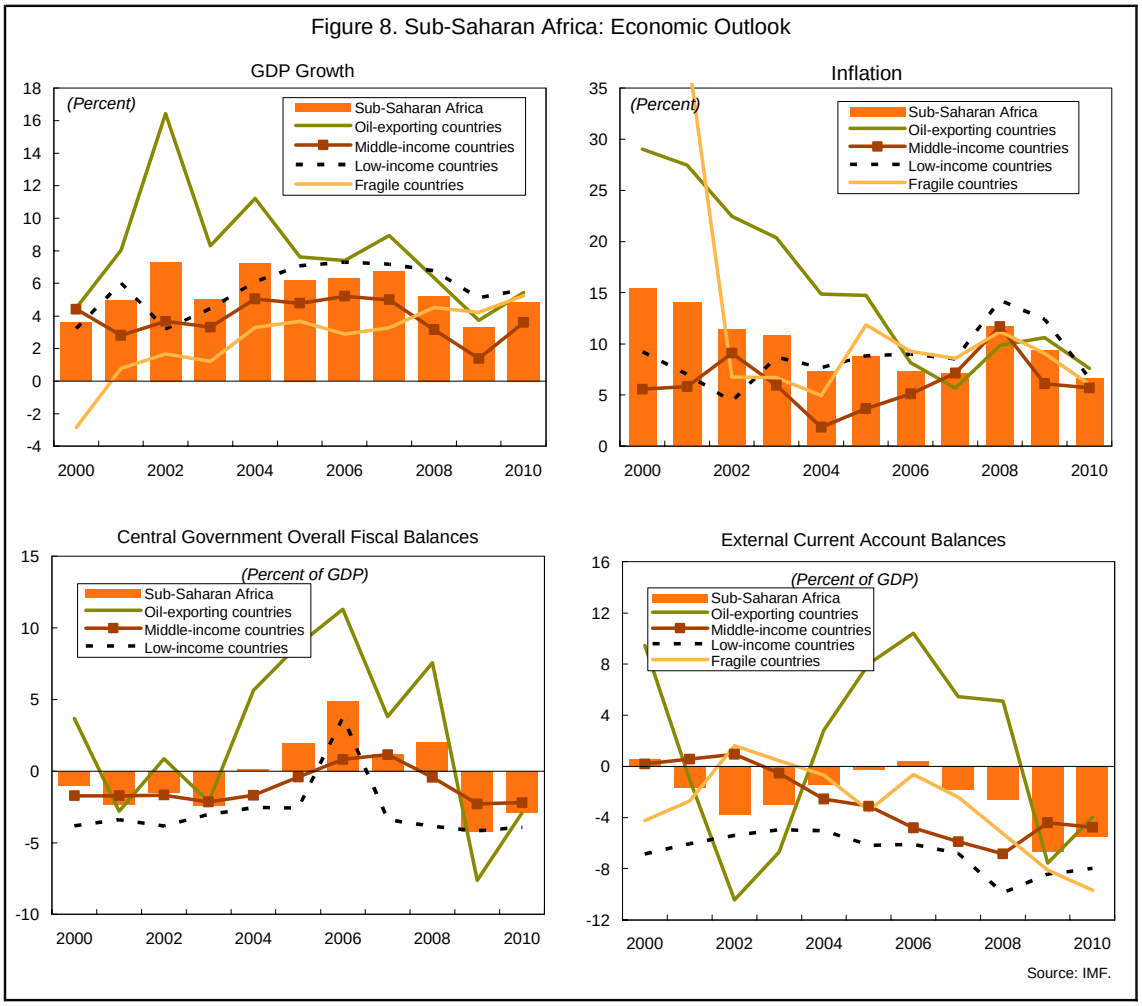
Source: IMF.

The outlook for economic growth in sub-Saharan Africa in 2009 has worsened in recent months (Figure 5). With the expectation of a more pronounced global downturn, lower commodity prices, and pressure on capital flows, in January 2009 the IMF projected that growth in sub-Saharan Africa will slow from just over 5 percent in 2008 to about 3¼ percent in 2009—over 3 percentage points less than forecast a year ago. Although annual inflation has started to decline, it remains high in many countries, largely because of the fuel and food price increases through mid-2008. Fiscal balances are expected to deteriorate significantly as tax revenues, especially those that are commodity-related, come under pressure because governments face additional demands for social spending (Figure 6). For sub-Saharan Africa as a whole, the fiscal balance declines by about

6 percentage points of GDP, from a surplus to a deficit of about 4 percent of GDP. The negative terms of trade shock to commodity exporters is also widening current account deficits, by about 4 percentage points of GDP for the region to 6¾ percent in 2009, though with significant divergence between groups of countries (Figures 7 and 8).



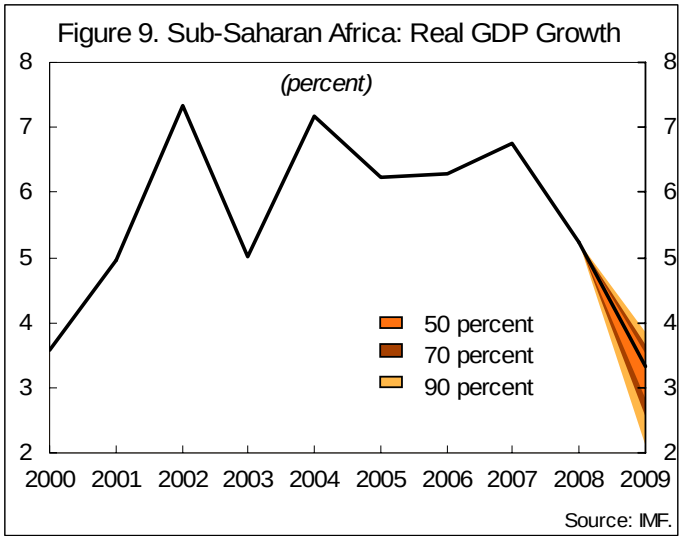




Aggregate projections mask stark differences from country to country. Oil and metal exporters have been hardest hit: oil prices have fallen over 60 percent from their mid-2008 peak. Oil exporters are going from fiscal and current account surpluses in 2007–08 to deficits in 2009, putting pressure on fiscal and external accounts. Oil importers benefit from falling oil prices but are affected by the decline in the prices of other commodities, such as coffee, cocoa, or cotton, and by lower global demand. Foreign exchange reserves—generally adequate now in most countries—are likely to decline in several countries in 2009.

The growing dependence of sub-Saharan Africa and other low-income countries (LICs) on export receipts from tourism and transportation services, which also tend to be procyclical, heightens the region's exposure to the global recession.

Risks to the outlook are serious and mostly on the downside (Figure 9).



- The slump in global growth could persist longer and the impact of the slowdown could be more pronounced than expected, negatively affecting sub-Saharan Africa's internal and external equilibrium.
- In some countries the global crisis could have a spillover effect on external competitiveness. For instance, countries with a fixed exchange rate pegged to the U.S. dollar could be adversely affected by the dollar's recent strength.
- Foreign inflows to the region are likely to slow. Remittances are likely to be affected because the majority originate in advanced economies where the economic slowdown is most pronounced. External aid could also be affected; aid has been found to be procyclical with both donor and recipient incomes. The actual decline in FDI and portfolio inflows could also exceed current expectations.
- Spending pressure might rise more as the economic slowdown continues. Pressures for added social spending and an increase in debt-servicing costs—associated with currency depreciation and higher borrowing costs in both domestic and international markets—could be greater than expected. Contingent liabilities associated with support for domestic financial institutions and depositors could also be higher.

IV. What Should Be the Policy Response?

Macroeconomic stability and steady progress toward medium-term development goals are both vital for sustaining growth in Africa. Thus, in responding to the crisis countries should strive to maintain stability and consolidate their hard-won gains while being mindful of general development goals. Countries should also seize the opportunity to advance their structural reform agendas in order to boost prospects for growth.

Fiscal Policy

Governments need to walk a tightrope to conserve gains in economic stability without aggravating the impact of the slowing external demand on domestic activity and especially on the poor. In countries that have created fiscal space in recent years, automatic stabilizers should be allowed to work. In low-income countries, stabilizers work mostly on the revenue side. A slowdown in economic activity tends to lead to lower tax revenue, but on the expenditure side there are few automatic stabilizers, such as well-functioning social safety nets. If countries try to keep expenditure at budgeted levels, the fiscal balance will deteriorate. Moreover, a few countries may have scope for discretionary fiscal easing to sustain aggregate demand depending on the availability of domestic and external financing. All this must be done carefully so as not to crowd out the private sector through excessive domestic borrowing in the often thin financial markets.

Fiscal revenues will drop most dramatically in oil-producing countries. While those countries that saved much of the recent windfalls may now have room for countercyclical policies, the extent to which they can or should maintain spending depends on the expected duration of the shock and their fiscal position relative to what is sustainable over the long term. For countries without savings, their ability to finance temporary deficits will matter.

In designing a fiscal stimulus, policymakers should be mindful of how different types of expenditure will affect the country's external position and economic activity. For instance, any countercyclical fiscal policy should not exacerbate the loss of foreign exchange reserves. Unlike in advanced economies, government purchases of the machinery and equipment associated with infrastructure spending is likely to have a heavy import component that could cause leakage of foreign reserves. Also, the slowdown in demand does not originate domestically, as in advanced countries, but externally. Given the region's heavy reliance on commodity exports, an expansionary fiscal policy cannot substitute for the decline in external demand. In any case, spending priorities and effectiveness should be reassessed to achieve maximum value for money.

In other countries, however, the scope for countercyclical fiscal policies is limited. It depends critically on their macroeconomic and debt conditions and on the financing available. As in the case of many advanced economies, any discretionary measures should be timely, targeted, and temporary and accompanied by a definite exit strategy for reducing debt as the crisis eases.

In designing the fiscal response, country authorities should also assess the impact on debt sustainability. Over the past decade, debt relief initiatives have significantly reduced external debt and improved debt indicators in sub-Saharan Africa. Recent debt sustainability analyses have found that almost two-thirds of sub-Saharan African countries now have low or moderate levels of debt distress. However, higher borrowing to help offset the impact of the crisis could reverse these gains and pose risks, in particular in countries that are at higher risk of debt distress.

To support growth and create fiscal space, all countries would be well-advised to persevere with structural fiscal reforms. Broadening the tax base would allow growth-boosting reductions in the most distortionary tax rates; efficiency-enhancing tax administration reforms would reduce both collection costs for the state and compliance costs for the private sector. Better cash and debt management would also provide fiscal savings.

Monetary and Exchange Rate Policies

As inflation falls, monetary policy could be eased. The plunge in global fuel prices, along with the more modest decline in food prices, is providing a disinflationary impulse that in many countries has reduced the need to tighten monetary policy and in others has allowed monetary easing, as has happened in several advanced economies. On the other hand, countries still experiencing demand pressures and excessive inflation may need to tighten monetary policy.

Exchange rate changes may help to restore competitiveness and growth should commodity price falls prove permanent. In countries with flexible exchange rate regimes that have experienced an adverse terms of trade shock, real exchange rates should be allowed to depreciate to keep the economy stable. Careful coordination with monetary and fiscal policy is needed to avoid a devaluation-inflation spiral. For countries such as those in the CFA franc zone, the decline in the euro against the U.S. dollar has already contributed to real effective exchange rate depreciation. Countries should avoid sliding into protracted exchange rate overvaluation, which would impair longer-term growth and could eventually trigger a disorderly adjustment.

Using reserves to support a fundamentally overvalued exchange rate would probably be futile. Where the capital outflow seems generalized, or where a persistent current account deficit can no longer be financed by the inflows available, a depreciation of the exchange rate would generally be necessary to help smooth the adjustment. However, this decision should be informed by an assessment of the possible negative balance sheet effects should the exchange rate weaken suddenly. This might warrant implementation first of measures to address weaknesses in bank balance sheets so that the depreciation can support the adjustment.

Introducing new controls on capital outflows should generally be avoided. Experience suggests that they are unlikely to be effective. Moreover, because circumventing them during the height of the crisis would have high returns, they would be hard to enforce. In sub-Saharan African low-income countries in particular, capital controls have been

ineffective even in normal conditions. Nevertheless, each country's own circumstances should be independently evaluated; it is conceivable that some controls could make sense in specific circumstances.

Financial Sector Policies

There is a need to strengthen supervision and enhance contingency planning. Sub-Saharan Africa has not faced a systemic financial crisis in recent months and its banks have few direct linkages with the toxic assets affecting major financial centers.[2] However, as the slowdown continues monetary authorities need to safeguard against financial vulnerabilities like rising credit risk and possible cross-border contagion, considering that many financial institutions in Africa are foreign-owned. Moreover, supervisory and regulatory oversight should be extended to encompass the entire financial sector.

- Monetary authorities should identify banking system vulnerabilities. For this, they should first identify the banks that are most likely to experience difficulties in the current environment. Banking supervision should also insist on high-frequency data to continually assess bank liquidity and solvency and conduct credit risk diagnostics and stress testing. Supervision should be as comprehensive as possible, covering foreign currency risk, bank risk management practices, lending standards, and funding reliability. It should extend to all deposit-taking and credit-creating institutions, including nonbank financial institutions.
- Procedures for handling a systemic crisis or failures within all the financial services markets should be drawn up promptly in preparation for contingencies.
- The region should track current G20 initiatives to strengthen regulation of cross-border financial flows and restore investor confidence in order to unfreeze international credit markets and encourage capital inflows and intraregional lending.

Government funds should be used only to protect the safety and functioning of the financial system. When a banking problem arises, the authorities should first assess whether the institution is suffering a liquidity or a solvency problem and what the systemic implications of failure would be. Individual banks facing solvency problems should receive support when their failure would threaten overall financial stability either directly or because, in the judgment of the authorities, their failure would undermine market confidence. Public funds should be provided transparently and with a view to minimizing moral hazard. Moreover, it would be useful for assistance to be provided in ways that allow the public sector to benefit if asset prices recover.

[2]A recent regional financial sector surveillance mission has found that African financial systems have little exposure to assets and institutions in distress.

V. How Can the International Community and the IMF Help?

Now is the time for development partners to honor and even scale up aid commitments. Current financing constraints make it even more important for donors to ensure, in keeping with the Paris Declaration, that aid is predictable, transparent, and aligned with the policy priorities of the recipients. Aid would be particularly useful now as fiscal pressures are building up, to prevent undue compression of investment budgets and make it possible to maintain the scope and size of social safety nets. Although many donor countries face problems of their own, aid flows are still a relatively small share of their budgets and can be accommodated even with the new competing demands.

Stalled global trade talks need to be resumed to stimulate global growth and welfare. Successful conclusion of the Doha Round would help to better integrate developing countries, including those in sub-Saharan Africa, into the global trading system, which would spur global and regional growth and facilitate African attainment of the MDGs. Temptations to respond to weakening balance of payments positions with protectionist measures need to be avoided. Less global trade would likely harm all countries.

The IMF is playing its part:

- The IMF increased its financial support to African countries during last year's food and fuel price crisis and remains a catalyst for critically needed donor support.
- The Exogenous Shocks Facility was modified in September 2008 to provide assistance more quickly and in larger amounts to low-income countries dealing with exogenous shocks. Malawi was the first country to benefit from this facility, and since then Comoros, Senegal, and most recently Ethiopia have accessed the facility. The IMF has also increased access to the Poverty Reduction and Growth Facility for a number of countries.
- To meet the diverse and evolving needs of low-income countries, the IMF is considering further major reforms of the architecture of its financing facilities, higher access limits to Fund resources, and additional concessional assistance, as well as more flexibility to finance infrastructure projects and other critical investments.
- The IMF will continue to provide extensive technical assistance to strengthen public sector capacity in Africa, because over the long term African countries need efficient and careful public financial management to ensure that their development priorities can be met. To this end, the IMF plans to add two new Regional Technical Assistance Centers in Africa to the three that are already operational.

Sub-Saharan Africa has made major progress in strengthening its policies in recent years, but the continent remains vulnerable to exogenous shocks. Sustaining that progress will be the major concern in coming years, and international support will continue to be vital.