



Strengthening Africa's Economic Performance

BRENTHURST DISCUSSION PAPER 3/2009

AFRICA AND THE GLOBAL ECONOMIC CRISIS

Threats, Opportunities and Responses

Jeffrey Herbst, Greg Mills, Stephan Malherbe and Alberto Trejos*

THREE MAGAZINE COVERS of February 2009 sum up the uncertain nature of the global economy in the wake of the current economic crisis: *TIME* asks 'How Can We Get Out of This Mess?'; *Newsweek* states 'We Are All Socialists Now'; and *The Economist* contemplates 'The Return of Economic Nationalism'. It is therefore absolutely critical for Africa to draw the correct lessons from the current economic downturn and to respond in a manner that sustains the recent economic gains that the continent has experienced and positions African countries for further growth.

The global economy has entered into a very deep crisis, perhaps its most important slowdown since the 1930s, that today affects all economic activities and all places.

Critically, the priorities of African leaders should not change, despite the turbulence of the international economy. On the contrary, efforts to achieve goals associated with macroeconomic stability and the promotion of competitiveness should be accelerated. With growth and competitiveness as both national and continental priorities, resources can be mobilised, appropriate policies formulated and novel solutions brought to bear. When other priorities hold sway, growth is stymied. Only where a country has a sufficiently strong domestic coalition for growth is it likely that growth-oriented public policy will be pursued with vigour and determination.

The Global Economy

To understand Africa's prospects, it is first important to review the dramatic global events of the last year. The global recession, resulting from the excesses of the financial sector, spoils a period of record growth worldwide. In the early years of this millennium we were able to say, for the first time in history, that two-thirds of the planet's inhabitants lived either in a high-income or a high-growth economy. Technological and policy changes created new opportunities in the rich world, and most of the planet seemed to be able to participate in their benefits. A number of developing countries, especially in Asia, but also in Eastern Europe and Latin America, were pursuing a path of economic reform that unleashed their potential; the failure that most of Africa displayed in joining this trend seemed to be a specific problem of the continent, and hopefully a temporary one.

This good news emerged largely from three entwined changes that accelerated after the fall of the Berlin Wall and the collapse of Soviet communism at the end of 1989.

Firstly, the relatively protected economic environment that had existed for 40 years since the end of the Second World War moved rapidly towards greater integration of national and regional economies, in part sparked by the simultaneous application of digital technologies to communication flows. These comprise the policy and

* Professor Jeffrey Herbst is provost of Miami University; Dr Greg Mills heads the Johannesburg-based Brenthurst Foundation; Stephan Malherbe directs Genesis Analytics; and Professor Alberto Trejos is at INCAE Business School in Costa Rica.

technological phenomena we understand today by the term 'globalisation'. The cross-border global exchange of goods and services and gross domestic product doubled between 1990 and 2007, and foreign direct investment increased nearly threefold annually, creating employment and income opportunities worldwide and allowing the participants to reap the many gains from trade. Gradually, also, the world's national financial sectors integrated into one.

Secondly, half the world's population, including the citizens of India, China, Vietnam and the Russian Federation, along with some of the Soviet Union's former client states, became participants in the global market economy and shared in its fruits. The most salient case is the massive change enjoyed by China. Twenty million rural Chinese have moved to the cities annually over this period, where they are three times as productive. This has resulted in a manufacturing and consumer boom. Export markets are ground zero of this change. In 1989 some 300 million workers in the world were involved in export activities; today, there are more than 800 million. In 1980 China's exports were less than \$20 billion; in 2007 they exceeded \$1 trillion.

Thirdly, there was a massive increase in the world's labour supply, exerting downward pressure on wages and upward pressure on productivity. In essence, countries were able to import deflation. Nations that were able to join the process, develop an appropriately productive business climate, put their trade logistics in order, adapt technologies, or place skills or scarce materials in the global market, reaped benefits. This distinguished them, more than ever before, from those that failed to improve their economic conditions and solely offered unskilled labour.

These changes, largely beneficial to the world, did not require, but were temporarily facilitated by, the consumer boom in the developed world and the ensuing credit surge and massive financial flows that were the seeds of our current problems.

Africa benefitted significantly from the developments discussed above. On average, although there are important differences among the four dozen African countries, economic growth began again across the continent in the mid-1990s, as nations reaped the rewards of the difficult economic decisions that leaders had made to structurally reform their economies. Significant progress was made in revaluing exchange rates, improving economic governance and increasing transparency. As a result, Africa was well situated to take advantage of the commodity boom that began after 2000. Indeed, growth across the continent had, until the international economy began to slide in 2008, averaged a healthy 5 per cent across Africa and the continent was no longer the slowest growing of the world's major regions. Africa had reaped significant rewards from opening to the international economy.

With hindsight, while the global economy grew, profound weaknesses were building up in the ever more rapidly expanding financial sector, driven by unprecedentedly low interest rates and the rapid expansion of credit. The meltdown started through the bursting of the housing bubble that certain regions of the United States nourished, and in which the banking sector was deeply involved. Mortgage lending had become so profitable, and was so unregulated, that banks and brokers began lending to borrowers under conditions that expanded the risk and the moral hazard involved. Such high-risk loans were then repackaged — 'sliced and diced' — and became part of the holdings of banks throughout the world. As one set of banking assets lost value, the trust in and value of others eroded. Gradually, the dominoes kept tumbling, exposing all the excesses in risk with which the under-regulated American banking system indulged itself since the deregulation of the mid-1990s.

As banks and financial institutions kept reporting record losses and the real situation in their books became public, they lost access to funding and stopped granting credit.

Underfinanced, scared and having suffered some losses, the real economy of consumers and non-financial producers had to slow down and eventually cut their purchases, investments, production and jobs, and a vicious cycle plunged the American economy into deep recession. Why did the crisis not stay a purely American one? This was because of the extent to which financial institutions in the rest of the world had financed the American credit boom and now were affected by the collapse of those assets; and the extent to which American consumer spending had driven expanding production globally.

Currently, what started off as a localised crisis in the US mortgage market has expanded into a global liquidity and financial crisis. So, what is the likely environment that countries and businesses will have to operate in, and how might this affect Africa?

Some Impacts on Africa

For Africa, there are factors that both lessen and worsen this crisis.

In some respects, Africa is largely shielded from the immediate crisis because its financial systems, rudimentary and parochial, are not integrated with the global financial system. African economies have historically, with few exceptions (South Africa is one), progressed or struggled quite independently of the health and efficacy of their financial markets. For example, in many (though not all) African countries, interest rate levels — and levels of credit provision — are of little consequence for economic activity, because the penetration of the banking system is limited, and so reliance on credit is low to begin with. Further, sub-Saharan banks generally have minimal balance sheet exposure to foreign banks and securities, and therefore the type of balance sheet contagion now seen in Europe is unlikely to occur. Looking at the longer term, to the extent that it matters, African financial sector growth is far more reliant on local factors — inflation; economic health; and the long hard road of building sound domestic institutions and achieving a regulatory 'sweet spot' balancing supervision and market flexibility — than the health of global institutions.

Of course, this picture of a real economy floating free from a tiny financial sector is not wholly true. In Kenya and Nigeria, at least, a bank crisis would do real harm. In most other African countries, the very lack of development of financial intermediaries places a long-term brake on growth; yet, directly or indirectly, we all are borrowers from the very Western banks that are now illiquid and overly cautious. Also, South Africa's growth of the last decade has in large part been based on domestic credit extension that will not be sustainable under virtually any post-crisis scenario. Its vulnerability to portfolio flows to finance its balance of payments deficit threatens high inflation and a decline in the value of its currency — although in the long term this may not be a bad thing for its businesses and their competitiveness. Also, to the extent that large corporations rely on roll-over funding from international capital markets, the impact could be quick and painful, even calamitous.

But although comparatively shielded from the immediate consequences of the global financial crisis, African economies can be greatly affected by the crisis if any of six effects turn out to be both large (which they already are) and persistent (which they look likely to be). These are:

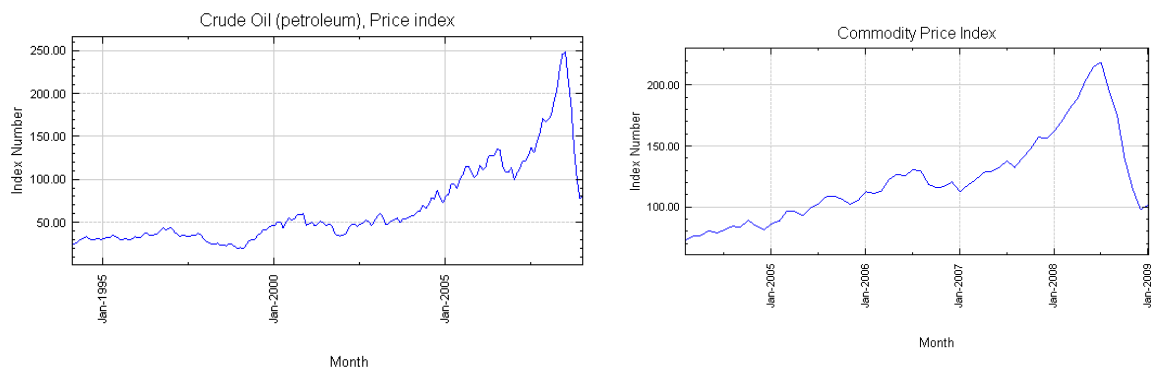
- (i) commodity prices settling at sharply lower levels;
- (ii) a shutdown of private sector international funding for long-term projects. The Institute of International Finance predicts, for example, that investment flows to developing countries may reduce by over 80 per cent from 2007 levels to \$165 billion in 2009. Equally, many private companies in emerging markets will

probably be unable to refinance their debt.¹ For example, there is a \$100 billion of maturing debt for private companies in Brazil, Mexico, India and others in the first half of 2009;

- (iii) a sharp fall in official support for Africa, both bilateral and multilateral (as occurred during the emerging markets crisis of 1997/98);
- (iv) a sustained fall in demand, not only for commodities, but for other products that African nations sell on the international market, which would endanger the sustainability of the export growth that we observe in a few countries, which was one of the few long-term drivers of economic prosperity observable in the last few years;
- (v) a reduction in tourism and other service sector trade and flows. The conservative expectation is that global tourism to developing country destinations will fall by 20 per cent during 2009, although the current experience in select African countries suggests a greater downturn; and
- (vi) a reduction in liquidity globally, placing downward pressure on African stock markets and currency values. Already, during 2009, African bourses are, on average, significantly down on their year-on-year values. Measured in dollar terms, most of the region's significant stock exchanges had already recorded negative returns during 2008: Egypt (-6.1 per cent), Nigeria (-54.2 per cent), Mauritius (-50.2 per cent), Kenya (-47.2 per cent) and South Africa (-45 per cent). Ghana, growing by 20.2 percent, was a welcome exception.²

Overall, for Africa, the most important possible short- to medium-term development is in the deflating of commodity prices. If the 'deleveraging' of assets persists worldwide, then everything that everyone owns will be less valuable. This would include commodities in the ground. This will be exacerbated by a recession in China — and there are already indications that China is, rhetoric apart, scaling back on its African interests. Oil is down nearly 300 per cent from its 2008 peak, and other commodities, from platinum to diamonds and copper to steel, have similarly collapsed. Like other developing regions, Africa should not expect much — in spite of the rhetoric — in the way of help from donors and other multilateral agencies. Even if the money is forthcoming, the history of the International Monetary Fund, for example, in managing such crises is less than spectacular. Even though the global economy has prompted the crisis in many African states, the trajectory of recovery is predominantly up to what African states do themselves.

Crude Oil and Commodity Price Indices: 1995-2009³



¹ *The Economist*, 29 January 2009 at www.economist.com/finance/displaystory.cfm?story_id=13035552.

² *Business Daily*, 13 January 2009 at

http://www.bdafrica.com/index.php?option=com_content&task=view&id=12238&Itemid=5813.

³ At <http://www.indexmundi.com>.

Of course, there are positive impacts, not least the effect on the balance of payments of fuel- and food-importing nations. But for the above reasons, the global financial crisis *will* affect Africa — and, on balance, more negatively and profoundly than most realise, or are willing to accept.

Possible African Responses

As Africa contemplates a less generous world of rising prices, with more people likely to fall into rather than be lifted out of poverty, how might its leaders respond? Like their peers in the rest of the world, African leaders will have to manage fast-changing and challenging conditions. Those who do best will succeed at balancing short- and long-term needs, and political pressures and policy imperatives.

◆ **Short-term (<12 months): Stability and empathy:** Leaders will have to manage the economic and political fall-out from (initially) sharply lower natural resources, trade and tax revenues, accompanied by smaller aid transfers carrying greater conditionality. Given rudimentary domestic capital markets, most African leaders will have less scope than Western nations to buttress domestic demand through stimulus programmes. This means that businesses — not least those with the state as principal customer — may well be under financial pressure. Governments may have to provide some legal protection to firms. Many households, particularly those producing cash crops, will face sharp falls in income, and may need assistance, including possibly food aid. Donor funds ought to fund such support, together with other income support through, for example, public works programmes. Donor programmes need to be aimed at domestic expenditure with a large pro-poor income impact.

African nations will also have to retain hard-won policy gains against temporary pressures. Unlike Western countries, where the greatest monetary policy risk is arguably deflation, African countries faced with large budget demands in the face of dwindling revenues may choose to increase money supply and accept higher inflation. The impact of *overly* loose monetary policies could be a sharp increase in domestic inflation, perpetuated by a falling currency. The resulting social, political and economic challenges would be large, and may stay with a country for a long time. Other sound policies also need to be protected: trade reforms should not be reversed for small countries, and key health, education and infrastructure programmes and expenditures need to be maintained. African leaders will need to build coalitions to support a small number of such clear priorities.

◆ **Mid-term (<24 months): Avoid learning the wrong lessons from the crisis:** Many international commentators are eager to use the current crisis to justify that nations should push away from market-minded economic reform, trade promotion, foreign direct investment attraction and the other elements associated with globalisation that acted as growth drivers in so many countries. They are prone to interpret this crisis as the final collapse of the market system or of international trade, and to instead promote the idea that developing nations should go back to the past. This is an incorrect interpretation of what happened, and, indeed, the wrong advice. All the economies in the world are suffering the crisis, and there is no sign that those that pursued reform more effectively are suffering more. What has failed is a particular way of exercising financial regulation, not the overall mechanism of international trade. And while much needs to change in the now moribund British and American banking and financial systems, including massive state intervention and restrictive re-regulation, there is no evidence yet that small developing nations should shy away from market democracies, good governance, international trade and institution building.

- ◆ **Longer term (<36 months): Build 'growth coalitions' for competitiveness:** Major long-term trends have been driving capital to developing markets. The sources of growth in Africa, and indeed the developing countries in Asia and Latin America, have a sound basis and will reassert themselves. Critically, therefore, the long-term priorities of African leaders should not change, despite the turbulence of the international economy. On the contrary, goals associated with macroeconomic stability and the promotion of competitiveness should be accelerated. With growth and competitiveness as both a national and continental priority, resources can be mobilised, appropriate policies written and novel solutions brought to bear. When other priorities hold sway, growth is stymied. Only where a country has a sufficiently strong domestic coalition for growth is it likely that growth-oriented public policy will be pursued with vigour and determination.

In summary, Africa's relative isolation from the global economy will shield it from some aspects of the current global economic meltdown. However, the downturn in commodity prices and possibly in aid flows will stress certain countries, especially given the expectation of a slow U-shaped decline and recovery with a long period of stagnation to come. Moreover, the policy measures that stimulate domestic consumption available to some in Asia, for example, and in Europe and the United States are not available to most African countries.

In positioning themselves to take advantage of the next phase of growth, African countries would do well to put in place policy measures that support innovation, reject failure and reduce costs to the economy. To do so, African governments will have to cut excessive expenditure (such as foreign air travel and other largesse) while focusing on long-term investments, including in infrastructure and training. They should aim to assist the emergence of financial institutions, because, without reliable banks and efficient credit markets, Africa will remain poverty-stricken, at the mercy of the costly finance provided by weak institutions and narrow networks. Finally, Africa countries will have to keep the improvement of the enablers of competitiveness — including tax regimes, productivity and essential services — central to the national agenda.