

The Global Financial Crisis and African Economies: Impact and Transmission Channels

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1. INTRODUCTION

It is ironic that the global financial crisis occurred just at the time that many African economies had begun to see better economic performance, after many years of poor policies and outcomes. Indeed, until the emergence of the economic meltdown, most African economies had enjoyed robust economic growth for close to a decade. Beginning in 2000, Africa's average growth rate of real output was always above 5 percent and inflation rate had declined to a single digit in a number of countries, with net private capital flows increasing from US\$17.1 billion in 2002 to US\$81 billion in 2007 (ECA and APF 2008). The private capital inflows take-off had been driven by a number of domestic and external factors that contributed towards enhancing the region's attractiveness to foreign investors in search of high yields. Net foreign direct investment (FDI) grew progressively from US\$13 billion in 2004 to about US\$33 billion in 2007; portfolio equity flows also took off, reaching a value of US\$15 billion in 2006; flow of bonds increased rapidly by US\$7.1 billion from 2006 to 2007; and international banking activities expanded significantly (Jose and Massa 2009).

Even though African economies had been doing better than before, it is nevertheless important to note that they had often not quite developed the robustness of institutions and structures for sustainable development, which meant that they were still vulnerable to external shocks, particularly when the shocks were very severe. And it was this situation that was compounded by a number of shocks, starting with high food prices beginning in early 2007 through mid-2008, and which had serious implications for food and nutrition security, macroeconomic stability, and political security. Just at the time that the food crisis was beginning to abate, African countries saw the world thrown into a situation of fast rising crude oil prices, against which many of them could do very little. They saw oil prices rise from \$50 per barrel at the beginning of 2008 to \$126 in June of that year. This had a strong negative impact on the current account of many developing economies, including those in Africa not exporting oil. The global financial crisis emerged in this very unsettled environment.

There have been several impacts from the global financial and economic crisis on all African economies, even if initially this was expected to be muted. A major impact of the economic meltdown has been a decline in export growth in several African countries. Furthermore, both portfolio and foreign direct investments have dropped dramatically in several countries as investors move away from markets that are perceived to be riskier. Again, the sudden withdrawal of foreign capital from several developing countries has resulted in dramatic falls in exchange rates. Companies and governments with substantial foreign currency denominated debts have started feeling the pinch in very significant ways. As foreign investors keep withdrawing, risk premiums and interest rates have started rising for most developing countries in the global capital markets. A key concern for some countries (e.g. Ghana, Kenya, and Ethiopia) is the decline in

remittance flows from workers in recession affected rich countries. Aid is expected to decline shortly and this has caused governments to reassess their priorities. The effect on African countries will be negative, since a good number of them depend heavily on aid for development programmes and their annual budgets. Ultimately the crisis is reducing the rate of growth in most African countries and endangering the achievement of the Millennium Development Goals.

One might, however, argue that the several years of wide-ranging economic reforms that many countries had pursued prior to the crisis, have helped them to cope with these new shocks much better than they had dealt with earlier shocks, such as the oil price shocks of 1973 and subsequent similar shocks. Economic policies have not been as poor as they were three decades ago. Institutions and regulatory systems are generally better functioning than they were a decade earlier. The consequence is that, despite the fact that many African economies have been affected in significant ways by the new shocks, probably more so than in many other regions, the situation for a number of them is somewhat better than could have been. Also, even though the whole region has been negatively affected, there are significant variations across countries, often influenced by the initial conditions that the economies faced at the onset of the most recent crisis and the nature and speed of the response that came from the governments.

This paper is intended to highlight the general impact of the crisis on African countries in terms of economic performance and then show some variations across countries by discussing how the different transmission channels operated in them, and what their effects have been so far or will be in the near future. The paper will argue that essentially the impact to date has been determined largely by the initial conditions prevailing in each country and the speed and nature of government responses, as already indicated.

Section 2 of the paper will provide a broad overview of aggregate economic performance in Africa in the crisis period. This will look at the general performance in terms of growth and what the prognosis has been on welfare indicators, particularly poverty. In section 3 the discussion will focus on the transmission channels through which the effects have been observed, namely international trade, private capital flows, aid, remittances and competition among financial institutions. Section 4 of the paper will briefly explain the varied impacts looking at initial conditions and using Tanzania and Ghana for illustration. Section 5 will conclude.

2. OVERVIEW OF ECONOMIC PERFORMANCE IN AFRICA

There is emerging and growing consensus that the global financial crisis and economic slowdown have worsened the macroeconomic situation and introduced new serious challenges for many countries, especially the poor. This is in spite of the fact that many argued in the early days of the crisis that Africa would escape from it by virtue of the fact that its financial systems and markets were not integrated into the global system

Indeed, emerging signs that the crisis has affected the African region are evident in the International Monetary Fund (IMF) growth estimates for 2009 and projections for 2010 and after contained in the October 2009 *Regional Economic Outlook* (REO). IMF research suggests that in the past a 1 percentage point slowdown in global growth led to an estimated 0.5 percentage point

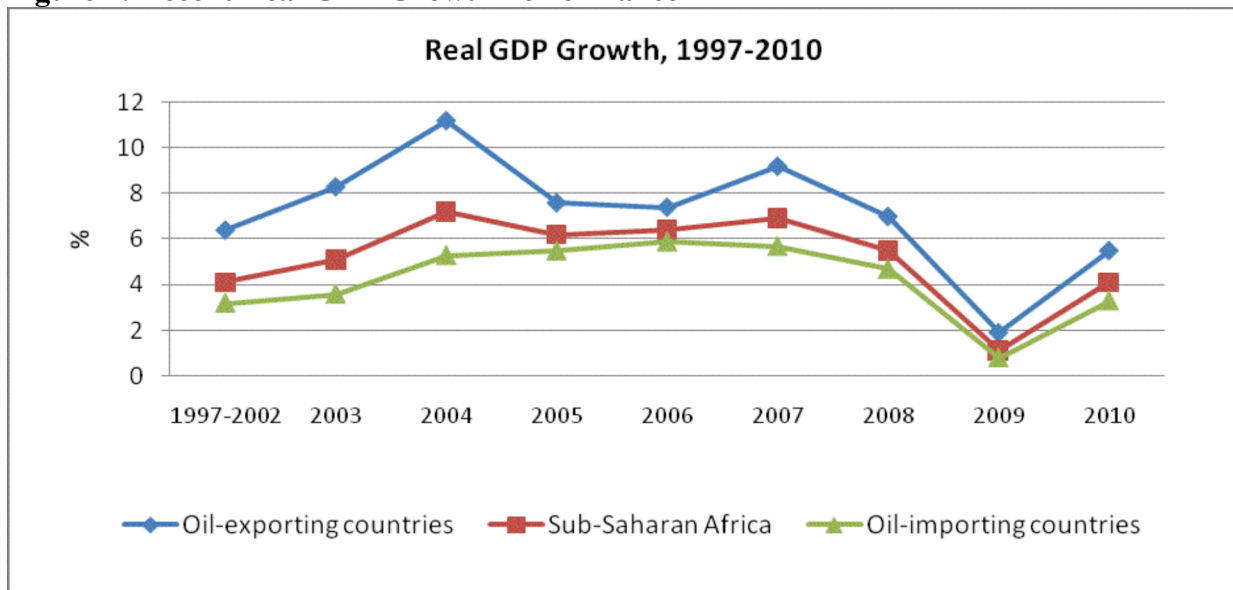
slowdown in sub-Saharan African countries. The effects may be more pronounced this time because the tightening of global credit compounds the impact of the slowdown, exacerbating risks for trade finance and other capital flows (IMF 2009). The evidence on the performance of many African countries indicates that Africa has received a significant dose of the negative impacts of the economic meltdown in various forms, depending on the particular economy and markets as initial conditions vary significantly across the region. Some countries have had a greater degree of resilience than others in coping with the shocks.

With the onset of the crisis, economic growth has faltered in many economies in the region. On aggregate, the crisis is currently expected to reduce Africa's economic growth in 2009 by 2 to 4 percentage points. For individual African economies, 2009 economic growth is expected to fall by more than 4 percentage points in Angola, Botswana, South Africa, Equatorial Guinea and the Sudan. For Egypt, Kenya, Cape Verde, Nigeria, Ethiopia, Tunisia, Namibia, Mozambique, Sierra Leone, Lesotho, Ghana and the Democratic Republic of Congo growth is expected to be reduced by between 2-3 percentage points in 2009. For sub-Saharan Africa as a whole, weighted-average growth is expected to drop from about 6.5 percent in 2002-2007 - the highest rate in more than 30 years - and 5.5 percent in 2008 to a mere 1 percent in 2009, after nearly a decade of strong economic performance (Figure 1).¹ This will cause per capita income in the region to drop by about 1 percent - the first such decline in a decade (IMF, 2009b).

Clearly a lot happened between 2008 and 2009 as some countries maintained fairly high growth rates while others could not. The significant variations across countries is reflected by the 2008 GDP growth figures among the top ten performers in the region contrasted with the poorest in the region and also an average performer in Europe, namely Portugal (Figure 2). It is remarkable that a number of countries were able to achieve significantly high growth rates in a year in which economies were shrinking worldwide. A partial explanation for such good performance was that most of it occurred in the first three quarters of the year on the back of still robust export demand and high commodity prices. For 2009, there are clear indications that the best performers will continue to do reasonably well but somewhat less so than in 2009.

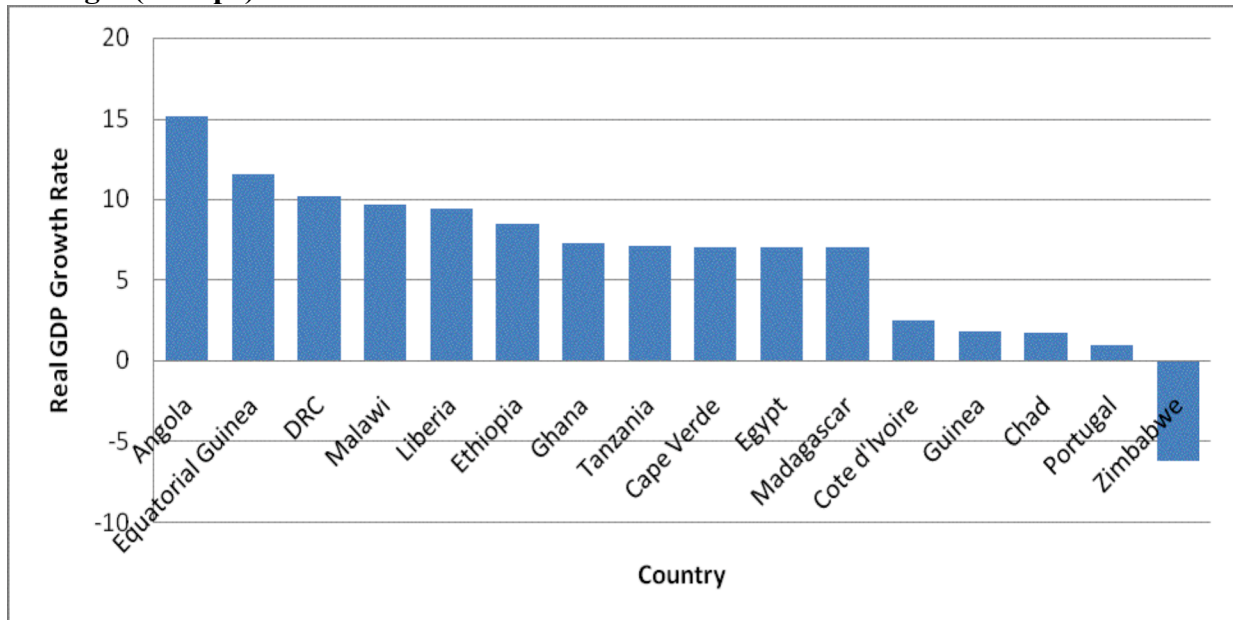
¹ There has been considerable uncertainty regarding earlier growth projections by the IMF. In January 2009, the IMF cut its earlier forecast for growth for 2009 by 1.6 percentage points to 3.5 percent before downgrading it to 1.7 percent in a subsequent review in April 2009.

Figure 1: Recent Real GDP Growth Performance



Source: IMF, *World Economic Outlook*, October 2009.

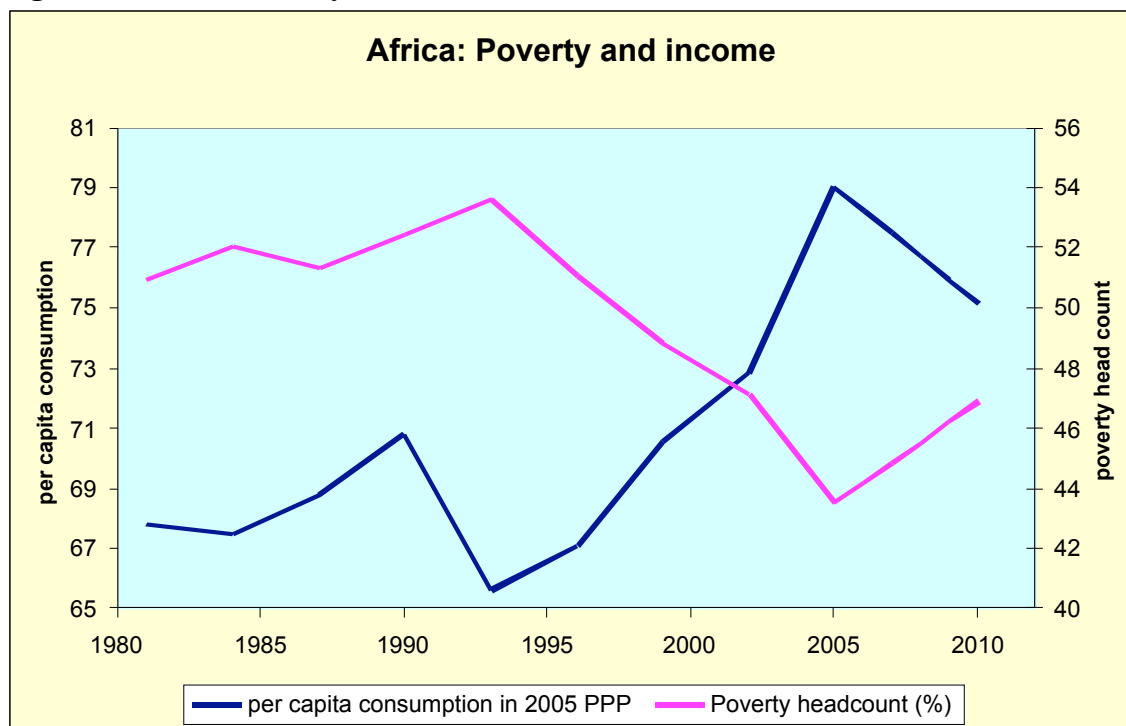
Figure 2: Growth among Top 10 Performers and Lowest 4 Performers in Africa and Portugal (Europe) in 2008



Source: *African Economic Outlook*, 2008/09

Concern has been expressed about the certainty that these sobering growth statistics will translate into a slowing down in the rate of poverty reduction in the region. In a recent study, Chen and Ravallion (2009 cited in IMF, 2009b) estimate that compared with pre-crisis estimates, the crisis will force an additional 7 million people below the US\$1.25 a day poverty line in 2009 and a further 3 million in 2010. The African Development Bank's projections of the poverty and income trends are as shown in Figure 3 below.

Figure 3: Africa: Poverty and Income Trends



Source: Leonce Ndikumana (2009)

It may appear surprising that the poor in Africa have been so significantly affected by the crisis considering that they are somewhat removed from the financial centres of the world and do not necessarily directly engage in international transactions. The drop in their incomes is largely a consequence of the three sets of shocks, starting with the food crisis, then the high oil price and finally the financial crisis. The food crisis became significant for most African economies because they are net food importers. It may be noted that even African farmers are net buyers of staples. In that situation they could simply not take advantage of rising prices, and this could be easily attributed to various structural constraints, including the rising prices of fertilizer and imported inputs, difficult credit access and poor market access. Apart from having to pay higher prices, their incomes have suffered from reduced remittances in some cases and reduced demand for their produce. By far, however, their problems have been exacerbated by the reduced ability of states to deliver public services, which had been a major factor behind declining poverty figures in the region.

Due to the paucity of data on employment in Africa, it is not possible at this stage to tell whether there have been any major changes in the employment situation as a consequence of the financial crisis. This is linked to the fact that there are no recent reports on firm performance in the region and hardly any recent documentation of informal economic activities. In many countries there is some anecdotal evidence of firm closures that have left employees out of work.

3. TRANSMISSION CHANNELS BETWEEN GLOBAL CRISIS AND AFRICAN ECONOMIES

Although it is not yet clear what the definitive effect of the current economic meltdown on African economies would be, there is no doubt that it has affected African countries in both direct and indirect ways. Direct impacts are seen as the result of direct exposure to the international financial system, i.e., via financial linkages with local debt, equity and currency markets. The direct channels were expected to generate the first-round effects through the financial sectors and then spread later to the real sectors of the affected countries. The effects on the financial sector include effects arising via such channels as the stock markets, the banking sector and foreign direct investment. The impact through these direct channels has been expected to be stronger for countries with a higher degree of financial integration. This section will show that even though the effects through this channel have been less widespread, there has nevertheless been cause for worry. For most countries in the region, this channel has played a relatively limited role so far, although injuries are not completely ruled out as banking systems may be weakened through a decline in the quality of credit portfolios, losses on other financial assets including deposits with troubled foreign correspondent banks, or capital repatriations by troubled foreign parent banks (IMF 2009a).

The financial channel is expected to be reinforced through secondary effects on the real economy arising through lower global growth, which is likely to reduce the demand for African exports, exert downward pressure on commodity prices, and curtail the flow of remittances from abroad. The tightening of global credit conditions is likely to lower further foreign direct investment flows and reduce or reverse portfolio inflows as investors flee into more liquid or safer assets. Trade finance flows are also being affected.

3.1 The Direct Financial Channels

Owing to the gradual but increasing integration of developing countries into the global economy, it was inevitable that developments in developed countries' financial markets should have some impact on these countries' financial markets and consequently on the real economy. Even though African banks may not have invested in the US mortgage assets that have been at the centre of the recent financial and economic crisis, which allowed them to avoid the substantial credit losses incurred by many of their international counterparts, the disruption in global credit markets has placed significant pressure on the major African banks' funding and liquidity. The truth is that access to offshore debt markets has become increasingly difficult and expensive for the African banks and other borrowers, ultimately leading to tighter credit conditions in the real economy. Stock market developments and banking operations are important financial institutions through which the global economic and financial crisis impacted the African economies.

According to ILO (2009), one of the critical issues in the wake of the 1997 Asian financial crisis was the health of the domestic financial systems. The imprudent lending that fed an investment boom, especially in real estate and construction, and which created the crisis when investment sentiments turned sour, could be attributed to weak and poorly regulated domestic financial systems. Interestingly, in the aftermath of the 1997 crisis, African countries undertook substantial reforms of their financial systems which led to considerable improvements in the regulatory regimes and the development of institutions. It is believed today that the worst of the direct effects of the global financial crisis has been avoided as a result of the improved regulatory environment in many countries.

Capital Markets

Stock market developments represent an important transmission channel of the global economic and financial crises to other economies. Stock markets serve as a conduit for the flow of portfolio investment (portfolio equity and bond flows). The recent global economic and financial crisis is associated with increased stock market volatility and wealth losses in the major stock markets across the globe, especially the developed economies. Equity prices declined as investors reassessed the price of risk. In developed economies, like the USA and Europe, measures of market volatility reached record highs and a number of prominent financial institutions encountered severe balance sheet distress, especially as the cost and availability of new equity capital and wholesale debt funding became increasingly restrictive.

There are indications that African countries' stock markets, though not all that integrated with the global stock markets, have been affected by the crisis. Portfolio investment flows were initially the most impacted by the crisis, reversing from inflows of \$18.7 billion in 2006 to outflows of \$16.7 billion in 2008. These outflows really hit Africa's "frontier economies" the hardest as foreign investors fled the region's stock markets for safer and more liquid investments at home (ODI 2009). Indeed, portfolio investment has been found to have experienced a dramatic drop and net outflows were recorded in 2008 for a number of countries. Thus, while foreign portfolio investment declined sharply during the first and second quarters of 2008 in Uganda and Zambia, Kenya experienced net portfolio outflows of about \$48 million in June 2008 and \$12 million in October 2008 (ODI 2009). Foreign portfolio investors withdrew \$15 billion from the Nigerian stock markets in January 2009.

The major drop in portfolio equity flows in African stock exchange markets is consistent with the sharp fall in the stock markets indicating the overall poor performance of the industry as stock market indices for Nigeria, Ghana, Uganda and Zambia dropped significantly at different time periods between 2008 and 2009, after two years in which markets yielded double digit returns (see ODI 2009). In Egypt and Nigeria, the stock market indices declined by about 67 percent between March 2008 and March 2009. The IMF (2009a) has also reported that the stock market indices for Botswana, Kenya, Namibia, Nigeria, South Africa, Uganda, and Zambia registered large declines in dollar terms in 2008 and only three markets (Ghana, Malawi, and Tanzania) closed in 2008 with positive returns.

Initial public offerings have also decreased considerably in some African countries (e.g. Kenya). According to UNESCECA and AU (2009), the turmoil in stock markets is having significant negative effects on the financial sectors' balance sheets and on aggregate demand with the increased likelihood of increasing non-performing loans in the banking sector, and which could have negative consequences for financial stability in the region. The flow of bonds has declined considerably as governments and many companies have postponed their bond issuance plans.

Raising funds from the international capital markets has also become more difficult. The increased risk premium paid by African countries in the international capital markets as a result of the crisis has affected their ability to obtain external funds. Kenya, Nigeria, Tanzania and Uganda have cancelled plans to raise such funds in these markets. There are reports that external

financing for South African and Nigerian corporations and banks became very scarce in the wake of the crisis. The drying-up of this source of external finance has provided a serious setback for development in the region as such funds would have been channeled into the finance of infrastructure development and boost growth.

Banking Sector

Banking systems were always expected to be a major channel through which the direct/first round impacts of the cross border financial and economic crisis would be found, depending on the extent of global integration associated with the country. It was expected that, through the movement of funds between cross-border banks, international bank lending could be compromised during the crisis. A decline in the flow of funds between these banks could lead to bank failures and credit tightening.

While sub-Saharan African economies have so far not experienced much widespread turbulence in the financial markets, a number of countries that had experienced rapid credit growth in recent years are now expected to observe record spikes in non-performing loans as a result of the deceleration in economic activity. In some countries, there has been evidence in recent months of increased strain in the financial sector. Countries with a high degree of foreign-owned banks are more exposed to the sudden slowdown in cross-border bank lending caused by the global financial and economic crisis. Since the inception of this crisis, no bank failure has been observed in the region, perhaps due to the fact that most African banks do not have any significant exposure to the sub-prime mortgage market and asset-backed securities (UNESCECA and AU Commission, 2009).

African banks generally have little exposure to complex financial instruments. They rely largely on low cost domestic deposits and liquidity. Some countries are, however, vulnerable to contagion effects arising from the high number of foreign owned banks (Ackah et al. 2009). To the extent that foreign-owned banks provide little or reduce support to local banks or sell their assets, it will have serious negative consequences for the financial sector in those countries. Countries that have such significant foreign ownership of banks include Botswana, Cape Verde, Central African Republic, Chad, Côte d'Ivoire, Equatorial Guinea, Lesotho and Zambia.

The quality of banks' aggregated loan books has deteriorated in some countries, on account of sub-standard and doubtful loans (Ackah et.al. 2009). In Ghana, a recent credit conditions survey undertaken by the central bank showed a consistent general tightening of credit conditions for enterprises in every quarter since December 2008. Banks continued to have a favourable but more selective and much tighter credit stance for households because of rising cost of funds and a preference for shorter maturities. The Bank of Ghana reported that the cost of funds and expectation regarding economic activities were the most important factors cited by lenders for the tightening of their credit stance. The loan portfolio quality of the banking industry as measured by the ratio of Non-Performing Loans (NPL) to gross loans moved up marginally over the quarter from 7.6 percent in September 2008 to 7.7 percent in December 2008. Similarly, loan loss provisions to gross loans ratio went up from 5.9 percent to 6.3 percent over the same period. Loan loss provisions to gross loans ratio and NPL net of provisions to capital ratio also deteriorated somewhat over the quarter and on year-on-year basis (Table 1).

Table 1: Asset Quality of the Ghanaian Banking Sector

	Dec-07	Mar-08	Jun-08	Sep-08	Dec-08
Sub-standard GHc)	62.8	109.4	113.3	109.7	124.0
Doubtful (GHc)	77.9	119.7	136.0	134.1	129.2
Loss (GHc)	125.2	155.7	163.5	164.3	205.0
NPL (GHc)	266.0	384.7	412.8	408.1	458.1
NPL ratio (%)	6.9	8.7	8.7	7.6	7.7
NPL net provision to capital (%)	4.8	14.0	12.7	9.2	7.7
Loans provision to gross loans (%)	5.5	5.9	6.2	5.9	6.3

Source: BoG, Financial Stability Report (February 2009)

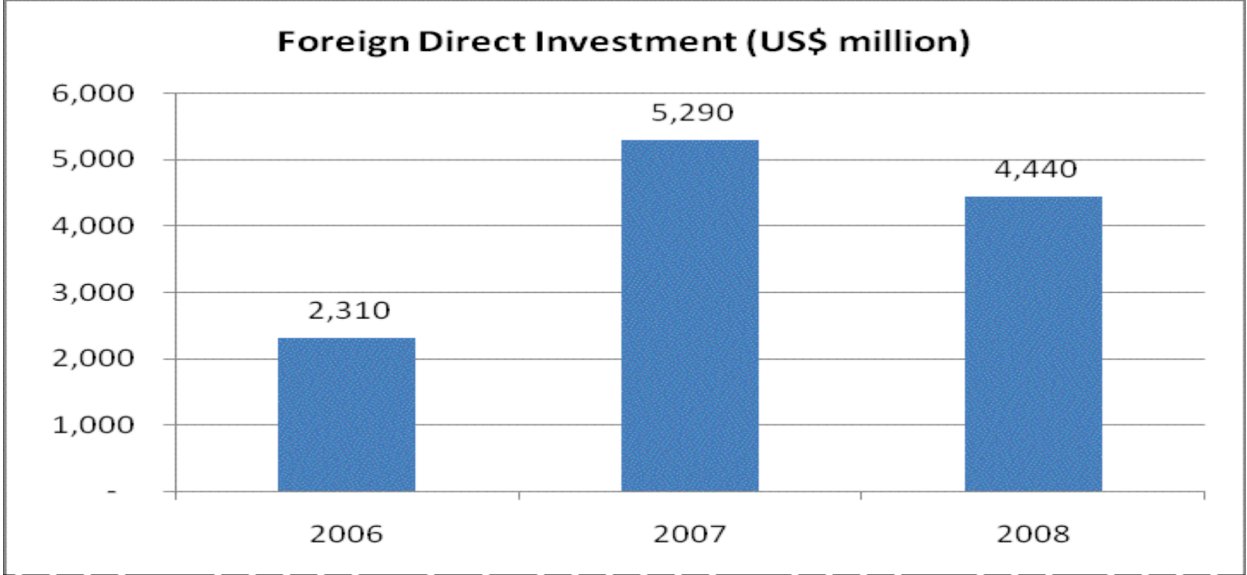
Aryeetey (2009) has reported some of the observed changes with the availability of credit in a number of countries since the financial crisis hit. For Ghana he reports changes in the flows since the last quarter of 2008 and suggests that the availability of credit to small and medium sized enterprises increased in the last quarter but the increase was smaller than it was in the third quarter. The difference was, however marginal. He also reports that credit to households for house purchase declined significantly in the last quarter of 2008 and this was attributed by banks to concerns about the economic outlook. There were also indications that even though households received more consumer credit in the last quarter, the increase was less than had been observed in the third and earlier quarters in the year. While larger enterprises submitted more applications for loans in the last quarter than they had previously done, this was mainly for short term facilities. Their demand for long term loans dropped significantly in the last quarter of 2008 and the trend continued into 2009. The drop in demand for long-term credit was explained with firms' low expectations about global demand for their products as exporters. Aryeetey (2009) also reports that the flow of credit to the private sector in Kenya rose by 7.4 percent in the third quarter of 2008 but this dropped to 2.5 percent in the last quarter. Interestingly in the last quarter of 2007 the growth of credit to the private sector in Kenya was as high as 9.6 percent compared to the third quarter increase of 3.9 percent. This reflected the sharp drop in credit flow to the private sector in the wake of the crisis. The situation appears to be quite similar for many other African countries. When credit flow was tightened, it was largely the SMEs and households that bore the brunt of it.

Foreign Direct Investment

It is important to observe that Foreign Direct Investment (FDI) helped significantly to fuel Africa's more recent economic growth. Between 2000 and 2007, private capital flows were the most important source of external finance for the region, growing from an estimated \$8.9 billion in 2000 to \$54.8 billion in 2007 or 6.5 times global foreign aid of \$8.5 billion. FDI peaked in 2008 at \$32.6 billion, and accounted for between 2.5% and 5% of annual GDP between 2001 and 2007. At the same time, flows of FDI and portfolio investment were clustered around Africa's oil-exporting economies and South Africa, and may have had little impact in many African countries. The contraction of such capital flows to Africa has been sharp. The IMF expects FDI in Africa to drop by 26.7 percent in 2009, compared to 2008.

In the case of Ghana, FDI inflows doubled from about US\$2.3 billion to US\$5.3 billion in the period 2006-07. However, by end-December 2008, FDI had declined by about 16 percent to US\$4.4 billion (Figure 4).

Figure 4: Foreign Direct Investment in Ghana, 2006-2008



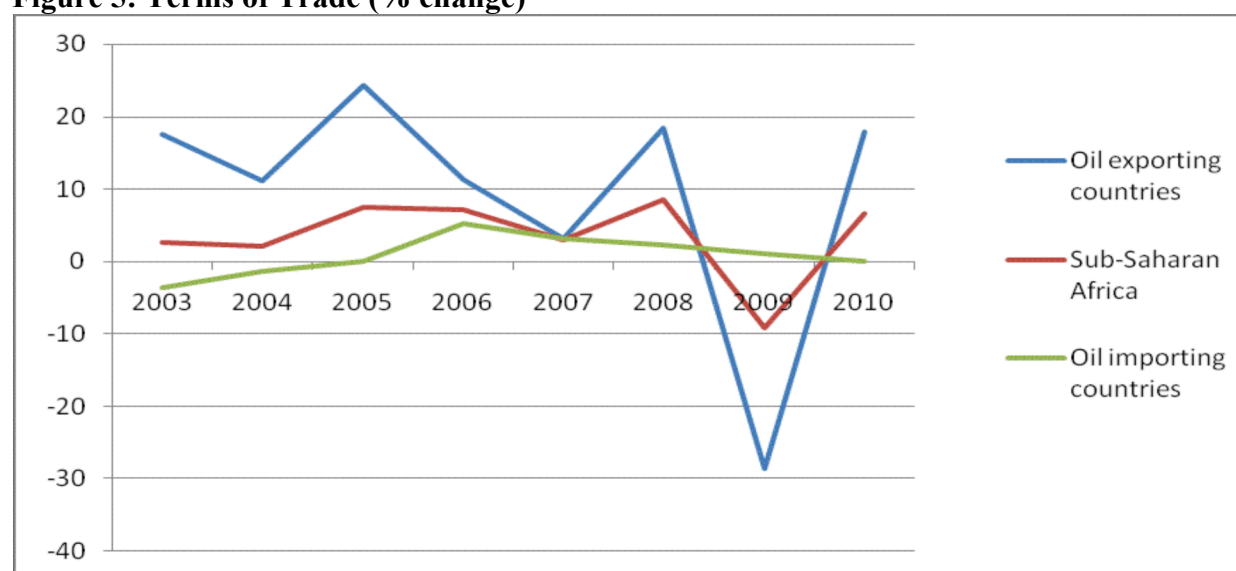
Source: Authors' calculations using data from GIPC quarterly update (2008).

3.1 The Indirect Real Channels

This section looks briefly at developments in the area of international trade, migration and remittances, aid flows, exchange rate and inflation as well as management of the fiscal sector.

The global slowdown in economic activity has pushed commodity prices down, with negative effects on export earnings and the external current account, fiscal revenues, and household incomes. Oil and other primary commodity exporters have faced major terms of trade deterioration (Figure 5). Within sub-Saharan Africa, the October 2009 REO indicates that the global financial crisis appears to have affected oil exporters and some middle income countries the hardest, as they faced a sharp decline in commodity prices, thus putting pressure on external accounts and government finances. The extent to which countries have suffered has varied according to the commodity exported and their ability to withstand shocks of such magnitude influenced by initial conditions.

Figure 5: Terms of Trade (% change)

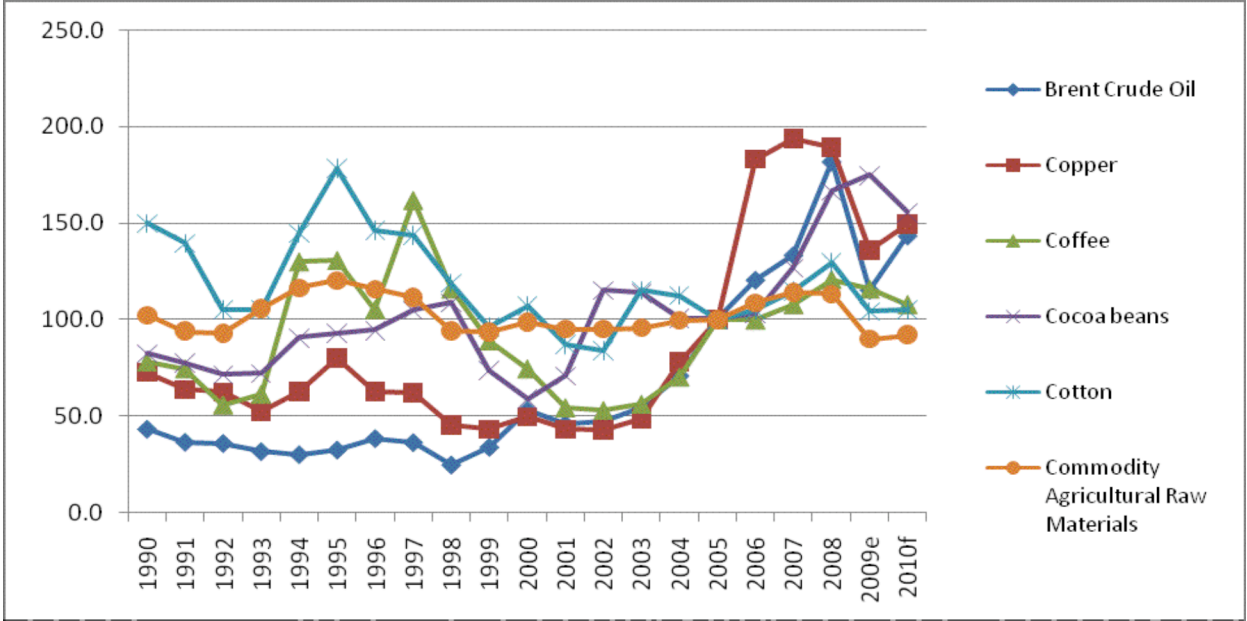


Source: IMF, *Global Economic Outlook*, October 2009.

In view of the fact that most countries in the region are highly dependent either on one or a narrow set of primary commodities or on a concentrated range of simple manufactures, this makes them very vulnerable to price volatility. It may be observed that before the crisis, a good number of African countries, including Nigeria and Zambia, benefited considerably from commodity price booms – in this case crude oil and copper respectively. The trend appeared to change for them when prices for almost all major commodities, except gold and cocoa (which held firm in 2008) began to decline. The price of oil fell from an average of US\$100 in 2008 to US\$40-45 by the end of the first quarter of 2009. Major declines in commodity exports were particularly noticeable in the Central African Republic (timber and diamonds), the Democratic Republic of Congo and Zambia (copper), and Gabon (manganese). The price of copper, for example, fell almost 50 percent from 2008 to the end of the first quarter of 2009; this was highly detrimental to the export regime of Zambia (ODI, 2009). Another metal that suffered a huge price drop was aluminium where the fall was more than 50 percent. Coffee and cotton have also experienced some price declines (Figure 6).

In terms of how specific commodities and countries have fared and will continue to fare in the foreseeable future, it may be noted that crude oil and copper prices are forecast to edge up a bit going into 2010 but they are still expected to be below their pre-crisis levels. Cocoa prices are expected to decline sharply in 2010 after peaking in 2008 while coffee price is forecast to continue its downward slide which began in 2008 into 2010. Indeed, the IMF forecasts the Commodity Agricultural Raw Materials index, including Timber, Cotton, Wool, Rubber, and Hides prices, to remain quite flat moving into 2010.

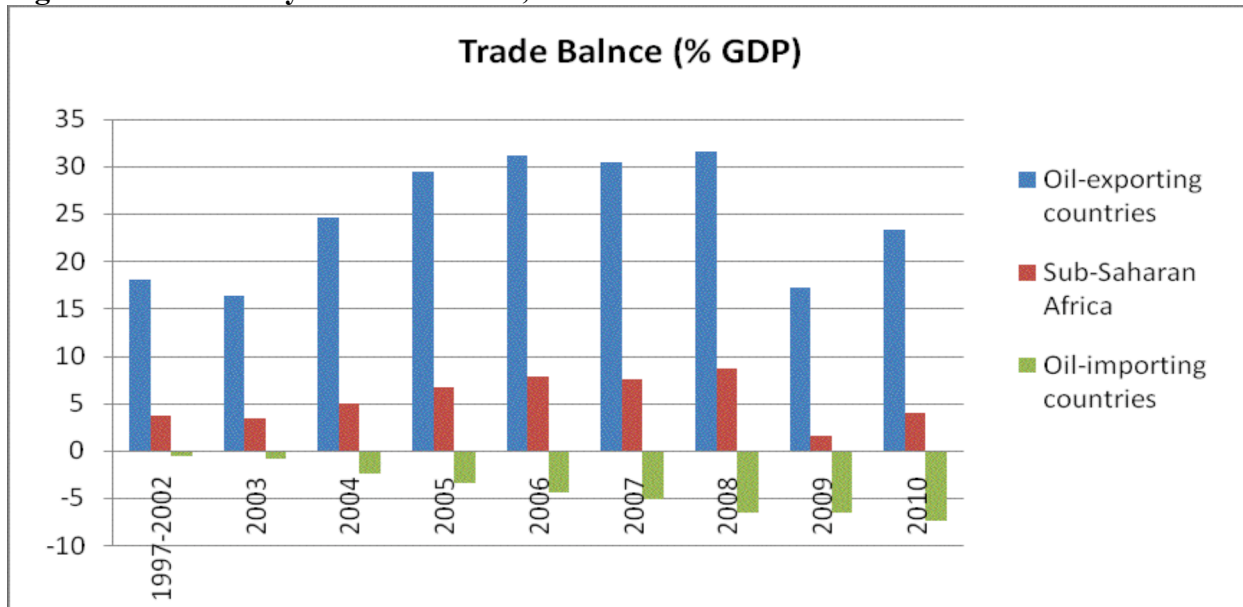
Figure 6: Commodity Price Indices, 1997-2010



Source: IMF, *Global Economic Outlook*, October 2009.

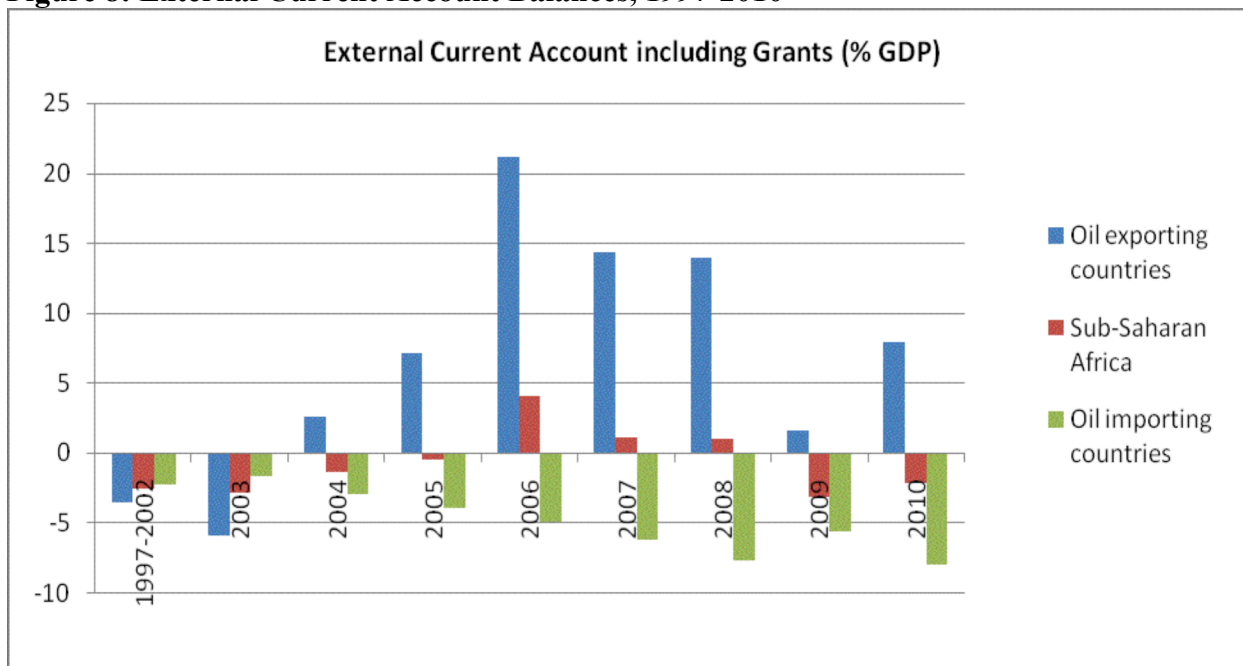
External positions have weakened in 2009 as trade and current account balances and their projections into 2010 are being shaped by the collapse of commodity prices. The net effect could be benign for some net food and oil importers, compared with 2008 when the external position of many sub-Saharan African countries weakened as the current account deficits of oil importers widened and reserves declined. Despite declining oil prices toward the end of 2008, their current account deficits deteriorated, due in part to high food import bills, a collapse in prices for nonfuel commodities, falling export volumes, and in some cases declining remittances and tourism receipts. Going forward, the current account deficits (including grants) are expected to stabilize at about 8 percent through 2010 as the positive impact of cheaper oil imports compensates for the negative impact of lower merchandise exports and remittances. As for oil exporting countries, it is anticipated that the effect of the sharp reversals in terms of trade will be decisively negative in 2009 with a sharp recovery in 2010 as oil prices begin to urge upwards.

Figure 7: Commodity Trade Balances, 1997-2010



Source: IMF, *Global Economic Outlook*, October 2009.

Figure 8: External Current Account Balances, 1997-2010



Source: IMF, *Global Economic Outlook*, October 2009.

Migration and Remittances

In the last decade, remittances have become very important to many African economies as a major source of additional revenue. Total remittances to Africa in 2008 amounted to US\$38.61 billion and this was an increase over the 2007 figure of US\$23.1 billion. Migrant remittances to

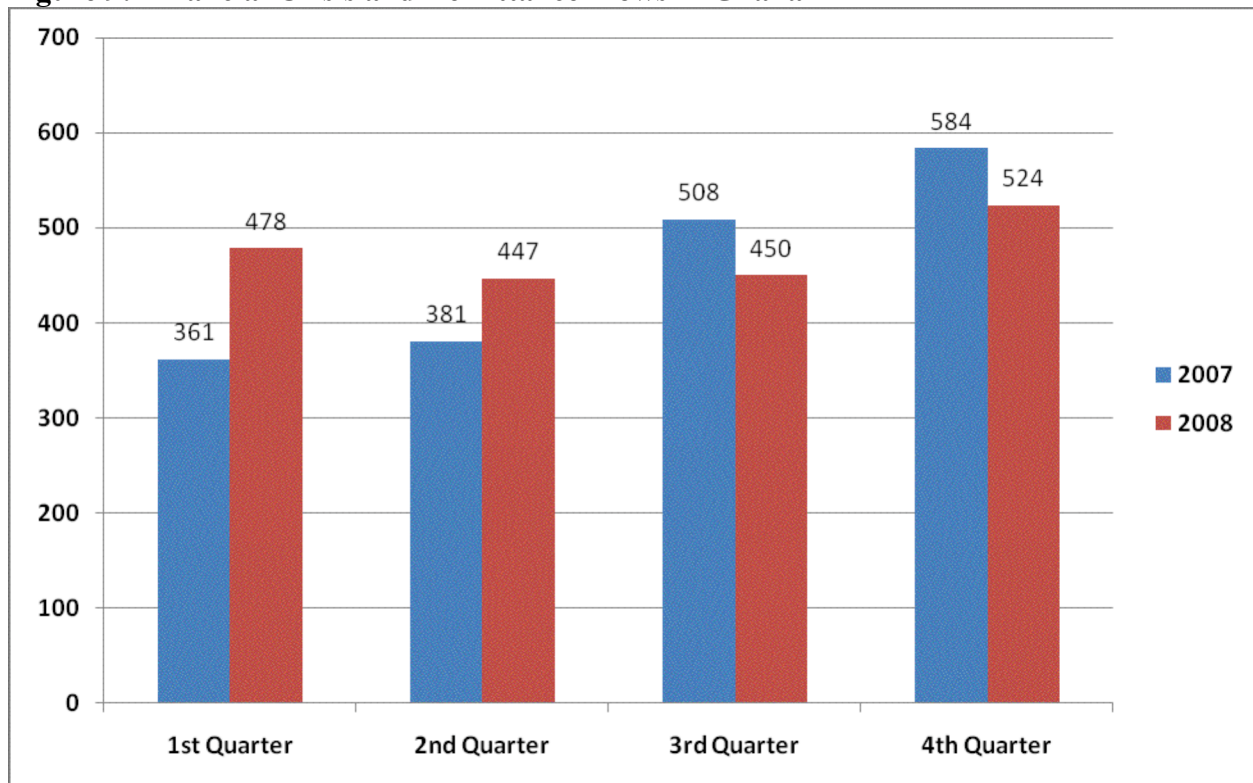
Ghana, for example, increased from about \$449 million in 1999 to \$1.8 billion and \$1.9 billion in 2007 and 2008 respectively, (Bank of Ghana, 2009).

In countries such as Ghana, Kenya and Uganda and many others, the construction sector which is relatively labour intensive, has benefited enormously from remittances in recent years. Remittances constitute about 10 percent of the total household consumption expenditure of remittance-receiving households in Uganda. In Kenya, the World Bank estimates that remittances have reduced the number of people living in absolute poverty by 8.5 percent (World Bank, 2006). Migrant remittances enhance the growth of the private sector through its impact on the financing of small and medium scale enterprises especially the real estate industry.

Remittances are set to decline in the wake of the crisis but their flow has not been uniform and the crisis is affecting countries differently. Kenya reported an increase in the flow of remittances at the end of 2008 while Ghana only showed a marginal decline.

However, even though remittances seem to be holding up to the crisis in many countries, it is unlikely that the growth in international migration and the income transfers associated with it will be sustained at pre-crisis rates. In Ghana private inward transfers received by individuals through the banks for 2008 began to show signs of contraction in quarter three (US\$450 million), falling below the 2007 figure of US\$508 million before recovering to \$524 million in the peak season of quarter four, albeit still lower than the 2007 figure.

Figure 9: Financial Crisis and Remittance Flows in Ghana



The impact of declines in remittance flows will be most felt by the poor. The indication is that there may be some direct negative effects on households who are close to the poverty line if the

crisis persists for a longer period since remittance-dependent households may not be able to access external resources any longer for their livelihoods. Ackah, Aryeetey and Aryeetey (2009) have indicated that a sharp drop in remittances resulting from the financial crisis will more likely hurt relatively unskilled migrants and recipient households in Ghana. In a study of the impact of remittances on poverty and inequality in Ghana Adams et al. (2008) show that for observed expenditures, households receiving international remittances have the highest mean per capita expenditure and the lowest observed poverty on average of all the household groups. The economic status of this group of households improves even further with the receipt of remittances. Comparing their predicted poverty values with counterfactual poverty values, Adams et.al (2008) suggest that, for households with international remittances, the poverty headcount of households is reduced by 88.1% and the poverty gap by 90%.

Official Development Assistance or Aid Flows

Almost all African economies depend on aid flows. A good number of them, including Tanzania and Rwanda, are heavily dependent on external assistance for close to half of their development budgets. Many African economies are therefore vulnerable to a downturn in foreign aid flows, particularly those that are not natural resource exporters, and many rely on donors for budget support. Compared to other regions, Africa receives the highest total amount of overseas development assistance (ODA), including international debt relief, according to the Organization for Economic Cooperation and Development (OECD). In 2006-07, Africa is believed to have received the equivalent of nearly US\$27.19 billion in bilateral ODA as defined by the OECD, far greater than the next largest recipient, the Middle East and North Africa, which received US\$14.03 billion.

During the 2005 Group of Eight (G-8) Summit in Gleneagles, members pledged to double annual aid to Africa by 2010. Some countries such as the United States committed to a dollar-figure increase, while European countries committed to raising the percentage of national income spent on aid to Africa. The overall result of the 2005 G-8 commitments, given subsequent revisions and changes to GDP in individual countries is the equivalent of increasing overseas development assistance to Africa by about \$21.48 billion per year (in 2008 dollars) on top of what was already being spent in 2005 by 2010 (see Arief et al., 2009). African governments have requested donors to increase aid flows in order to help offset the impact of the crisis on their domestic economies. However, most observers believe G-8 members will fall short in their commitments to increase aid to Africa.

According to the OECD, Development Assistance Committee (DAC) countries will need to provide an additional US\$18 billion in aid to meet Gleneagles' 2010 targets. Using an analysis of aid in the pipeline to be disbursed by 2010, it is estimated that G-8 members will fall short in their commitments by a total of US\$3.59 billion. This may be attributed mainly to shortfalls from France, Italy, and Germany, while other G-8 members, including the United States, are believed to be on track to meet their commitments. Additionally, reductions in projected national income in European donor countries have negatively affected the real value of targeted commitments (see Arief et al 2009). While only a handful of donors to date, including Italy, France and Iceland, have reduced bilateral foreign assistance due to the crisis, the global flow of foreign aid could suffer in the medium term if the global downturn continues. A more significant decline in

aid flows, if it occurs, is expected to be delayed due to the long-term planning process in donor countries. Most observers believe that while most aid levels will not be impacted by the crisis in 2009, they may drop in 2010 and beyond as developed countries experience continued fiscal strains and political pressures to balance budgets.

Tourism

Countries that depend on tourism are also facing declines in tourist arrivals and the associated drop in foreign exchange earnings. International tourism receipts are important revenue for sub-Saharan African countries, accounting for an average of about 4 percent of GDP for 29 popular Africa tourist destinations. Cape Verde, Mauritius, Namibia, Kenya, Seychelles, Tanzania, and Uganda, to name a few, are some of the countries that stand to be hit by a slowdown in tourist arrivals to the region. While the full effect of the financial crisis on Africa's tourism remains to be seen, it is already evident that the growth rate of international arrivals to the region is slowed down to 4.2 percent in 2008 compared to 7.5 percent in 2007 (UNWTO World Tourism Barometer January 2009). Cape Verde and Gambia reported declines in tourism receipts in the last quarter of 2008 and this continued into 2009. In Tanzania some firms have reported reductions in receipts of 7-18 per cent beginning in the last quarter of 2008 (IGC 2009). The prospects for 2009 generally look grim as the UNWTO expects international tourism to stagnate or even decline slightly by 1 to 2 percent.

Exchange Rate and Inflation Developments

Portfolio outflows, sharp declines in FDI and export revenues and steep increases in import bills have combined to push down a number of currencies as foreign exchange reserves declined in many countries. The currencies of the relatively open economies of Kenya, Mauritius, South Africa, Uganda, and Zambia have come under particular stress. The volatility of the US\$ and EURO during the crisis affected the exchange rate and competitiveness of most African countries depending on the leverage of options available to the various central banks in the region.

The foreign exchange markets of African countries have been under enormous pressure since the onset of the crisis. Angola, Nigeria, Mauritius, and Zambia lost more than 15 percent of their reserves from September 2008 to early 2009, though balances remained comfortable in several countries. South Africa, for example, suffered a severe real effective exchange rate depreciation where the rand was embattled by significant portfolio outflows (IMF 2009a). Ghana's cedi lost substantial value vis-à-vis the euro and the US dollar since 2008. In the first quarter of 2009, it depreciated against the United States dollar by 14 percent which reduced the country's potential benefits from lower fuel and food prices. By the end of the first half of 2009, the Ghanaian cedi had depreciated by 6.0%, 4.6% and 11.7% against the US\$, the pound sterling and the euro respectively (GOG 2009). The high depreciation of the Zambian Kwacha was expected to increase competitiveness of non-traditional exports albeit with negative consequences on the economy due to the high exchange rate volatility in the presence of the crisis and flexible market determined exchange rate despite the political pressure to change the policy stance (ODI 2009). Varied significant expected changes in exchange rates for selected African countries in 2009 ranging from 21 percent in Ghana to 84 percent in Seychelles suggests rising inflation. Also,

given the high foreign debt of African countries the expected depreciation of their currencies against the dollar will impose serious debt-service burdens on the region. It will also increase the cost of imported intermediate inputs, with consequences for production, output and employment. Exchange rate depreciation will also increase exchange rate risks faced by domestic firms and increase the likelihood that they will default on loans owed to domestic banks, thereby increasing the vulnerability of these banks (EECY and AU, 2009).

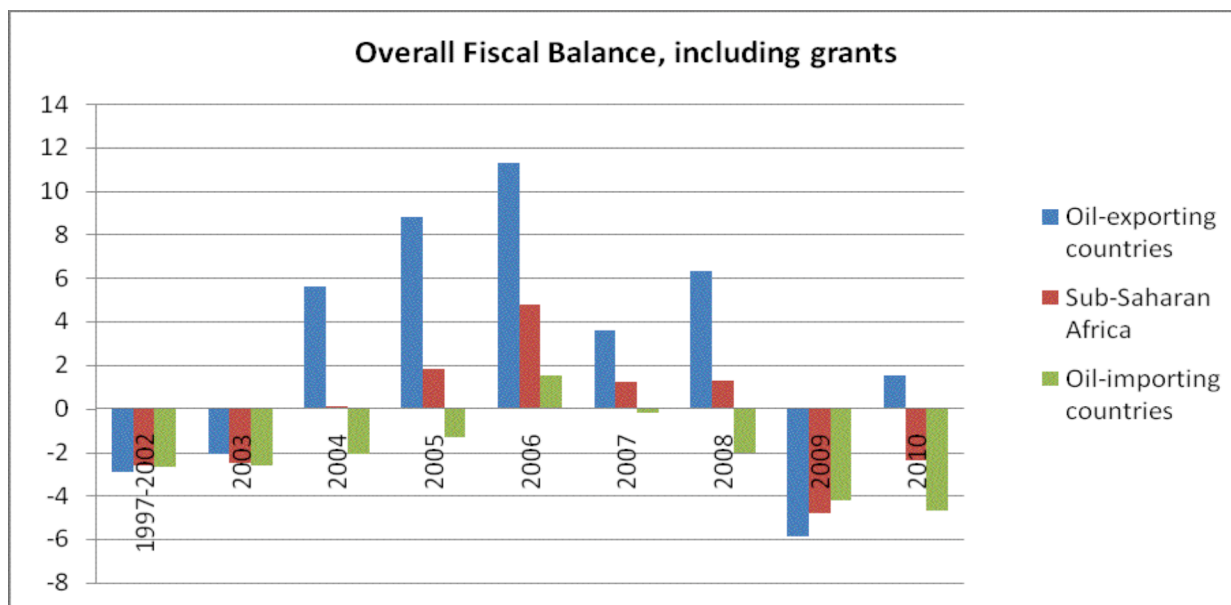
Implications for Government Fiscal Balances

The global economic meltdown has slashed the exports of many sub-Saharan African countries and disrupted capital flows, putting serious pressure on spending patterns and revenue generating channels of many African governments. Fiscal deficits are expected to widen. The overall fiscal balances of sub-Saharan African countries are projected to deteriorate from a surplus of about 1.3 percent of GDP in 2008 to a deficit of nearly 5 percent of GDP in 2009 before recovering to a deficit of about 2.4 percent of GDP in 2010. The outlook varies substantially across countries. Oil exporters are expected to experience some of the largest negative shifts in fiscal positions - due to significant revenue declines (Figure 7).

Moreover, government revenues have been dampened due to the possible decline in corporate taxes since the global financial crisis is lowering private economic activities. Declining royalties and mining taxes will be realized and this will affect a number of fiscal balances. The global financial crisis has come at a time when Zambia appeared poised to collect significant tax revenue from the mining sector for the first time. Having never exceeded 10 percent of total tax revenue, the IMF was projecting mining tax of 4.6 percent of GDP in 2009. This has now been cut to 0.5 percent of GDP. The loss of revenue from the mines as a result of the crisis reduces the government's fiscal space to finance social sector expenditure programmes such as education, health and infrastructure for poverty reduction.

Import taxes will also decline because import values decline with lower commodity prices leading to lower import volumes because of lower total final expenditure. Also capital income and grants are on the lower side. It is therefore likely that the government balance will weaken. Tax revenues in Uganda declined in the third quarter of 2009 over the same period in the previous year. The main reason was the realization of lower domestic taxes as value added taxes were lower because of lower domestic consumption (ODI, 2009). Reduced revenue and expanding debt are increasing pressure on government budgets resulting in government squeezing social services that were introduced recently. Kenya has seen a reduction in core poverty programme funding from an approved Ksh78 billion in 2007/2008 to Ksh62.9 billion in 2008/2009. The proportion of Zambia's marginal social protection budget allocated to non-pension activities has shrunk from 24.5 percent in 2008 to 19.2 percent in 2009. Again, the Federal Government of Nigeria intends to reduce public expenditure on the social services sector significantly, with the 2009 budget indicating a 16 percent cut in education allocations and 29 percent cut in health (Ibid).

Figure 7: Central Government Overall Fiscal Balances (% of GDP), 1997-2010



Source: IMF, *Global Economic Outlook*, October 2009.

4. EXPLAINING IMPACT IN AFRICA

In sum, African economies have been affected by the current global economic crisis in diverse ways and these effects have been influenced largely by their own conditions at the onset of the crisis. It is important to observe that before the crisis, a number of them had been pursuing economic reforms, with varying scope and speed. In the more extensive programmes, attention was being paid to both policy and institutional reforms. There were countries that had gone much further than others in the pursuit of these changes and this was reflected by the ability to engage with programmes for longer term growth and development. The manner in which they were affected by the crisis was determined by their state of ‘preparedness’ conditioned by their reform programmes.

Financial Sector Reforms and Improved Regulatory Environment

As earlier observed, in the last decade or more, many African countries have pursued financial sector reforms in order to strengthen their financial systems for delivering the necessary financial resources that could be utilized to enhance investments and facilitate employment creation. The reforms were largely designed to enhance the policy environment for financial institutions and provide incentives for them to become more competitive. They have also been intended to build the institutional capacity to handle the growing demand for different types of financial services coming from a more diversified clientele. They have sought to create a larger set of regulatory agencies to reflect the growing variety of financial institutions. Having different regulators for the capital markets for example has been a major development in some countries. Strengthening central banks for a greater supervisory role has been pursued with a lot of commitment in some countries. Cooperating with central banks in other countries in the region in order to keep an eye on cross-border activities has become important to countries with such banks.

These improvements have generally been seen as helping to protect the operations of the emerging financial systems and ensure unnecessary risk-taking that could endanger the investments and assets of customers. A number of observers have suggested that in countries where the regulatory environment has been adequate, the soundness of the banking system and other financial activities has been reasonable, and the institutions have not been unduly exposed.

Macroeconomic Mangement

A distinction can be made between countries that had fairly decent macroeconomic environments and those that were in trouble. These had decent growth rates, as seen earlier, and also fairly low inflation rates and fairly high foreign reserves. A good example of that category of countries is Tanzania that had achieved a fiscal surplus before the crisis hit. Since 2000, Tanzania has managed a per capita growth rate of 3.8 percent, way above the African average of 2 percent. Despite significant aid dependence, it had implemented a good fiscal programme that ensured that at the onset of the crisis it had enough fiscal space that allowed it to provide some stimulus to some productive activities and support additional social programmes in a counter-cyclical manner. Aside from good macro management Tanzania had invested significantly in trying to diversify its export base even if this was yet to yield very robust results. The counter-cyclical domestic spending programme is reckoned to have lightened the impact of the crisis on specific groups, especially the poor (ODI 2009). Tanzania expects to grow at 8 percent in 2010.

In contrast, Ghana did not have the fiscal space to engage in counter-cyclical domestic spending to offset the effect of the crisis. Even though Ghana's economic performance had been comparable to that of Tanzania until one and a half years before the crisis, it had managed to accumulate a fiscal deficit of 14.9 percent of GDP by the end of 2008 with inflation rising to over 20 percent at the beginning of 2009. The newly elected government was forced to initiate cuts in social spending in its desire to reduce the deficit to 9.5 percent of GDP within a year. This is generally assessed to have affected the poor adversely (ISSER 2009). Planned expenditures for the Savannah Agricultural Development Initiative of GHC200 million for 2010 has been reduced to GHC25 million in the latest budget. Despite a GDP growth achievement of 7.3 percent in 2008, only about 5.5 percent is expected in 2009 and this is projected to drop further in 2010.

A major outcome of the financial and economic crisis has been that it has forced a number of countries to put on hold major reforms that had been underway. Many governments have indicated the need to carry on with reforms and a strong desire to do so, but it is obvious that they are battling with more current challenges that threaten those reforms.

5. CONCLUSION

The global financial and economic crisis is affecting African economies in a significant way, mostly indirectly through the harm they cause to the real sectors of the economies. In aggregate terms the impact has been quite strong as shown by the sharp drop in aggregate output around the region. The financial crisis is shrinking economies and affecting the capacity of the state to deliver on social protection. The crisis is also affecting households access to resources and this is likely to worsen.

Even though there are both direct and indirect channels for transmitting the crisis to African economies from the rest of the world, the indirect channels have been more pronounced in their effects largely on account of the structures of these economies. The integration of the economies into the global economy has been largely on account of trade in goods and also the consequence of migration, and hence the effects on the real sectors and in remittance flows. Financial integration has been more muted.

The paper has noted that there have significant variations in the impact of the crisis across countries, and this has been influenced largely by the quality of institutions, particularly for regulation, and initial conditions prevailing in the countries. Hence, the effect on banks, for example, has not been uniform. Neither has it been for export earnings and tax revenue mobilization. It is interesting that with the crisis affecting the capacity of some financial institutions to provide credit, it is mainly credit to small enterprises and households that has been most affected in the countries where this has occurred. There is growing evidence that the impact on the poor has been more acute than for the non-poor. It is also the poor who suffer most from cuts in social spending.

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