The Impact of the Financial and Economic Crisis in Low-Income African Countries

Session for Daystar University students, Kenya

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Overview of the presentation

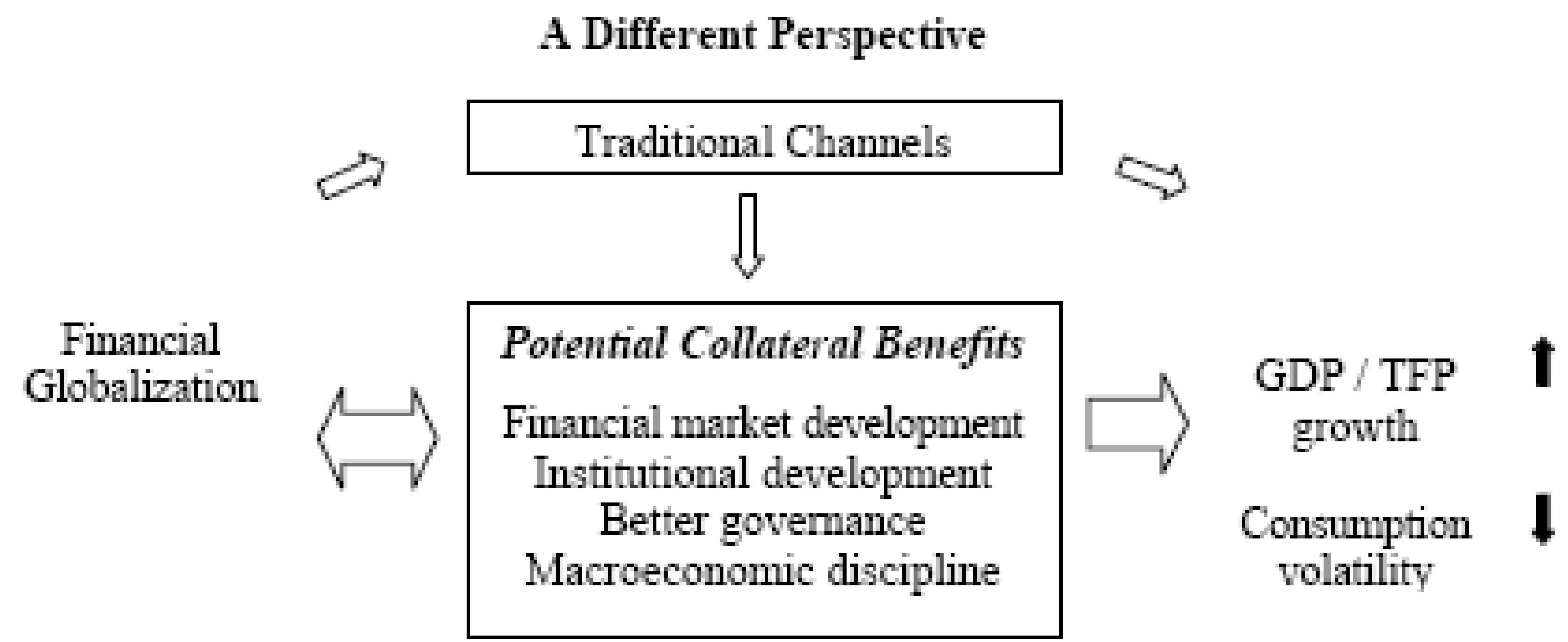
1. *prelude*: Financial globalization in low-income countries
2. The international financial and economic crisis
3. How does the crisis impact poor countries and people: a conceptual framework
4. How country authorities respond to the crisis?
5. Reaction of the international donor community

   Intermezzo on the IMF (and the World Bank)
6. Applications to country cases

1. Financial globalization in low-income countries

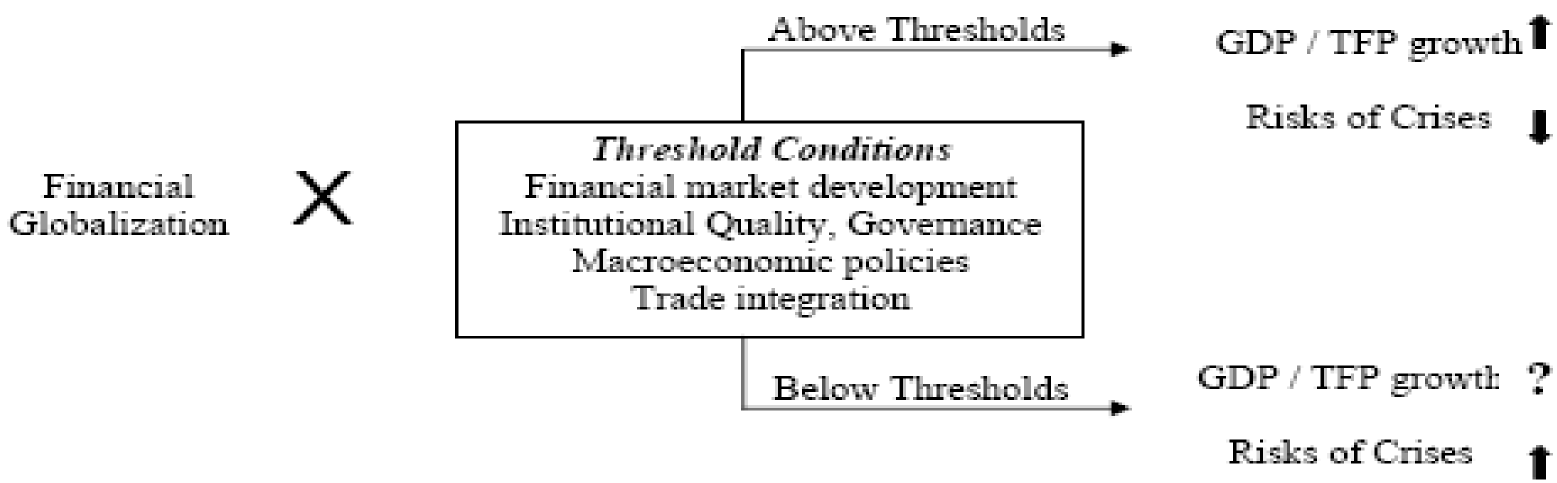
- Financial globalization (FG) is defined here broadly as the (net) inflows (or stocks) of external finance to recipient (developing) countries
- Distinction between *de jure* and *de facto* FG
- Link between FG and growth and development is uneasy, and may lead to the existence of FG *traps*
- Further evaluation requires disaggreagation of FG: aid, private capital flows (loans and equity), and remittances
- What explains the low degree of FG in LiCs?

The uneasy link between FG and growth/development



Our perspective acknowledges the relevance of the traditional channels, but argues that the role of financial globalization as a catalyst for certain collateral benefits may be more important in increasing GDP/TFP growth and reducing consumption volatility.

The uneasy link between FG and growth/development (II)

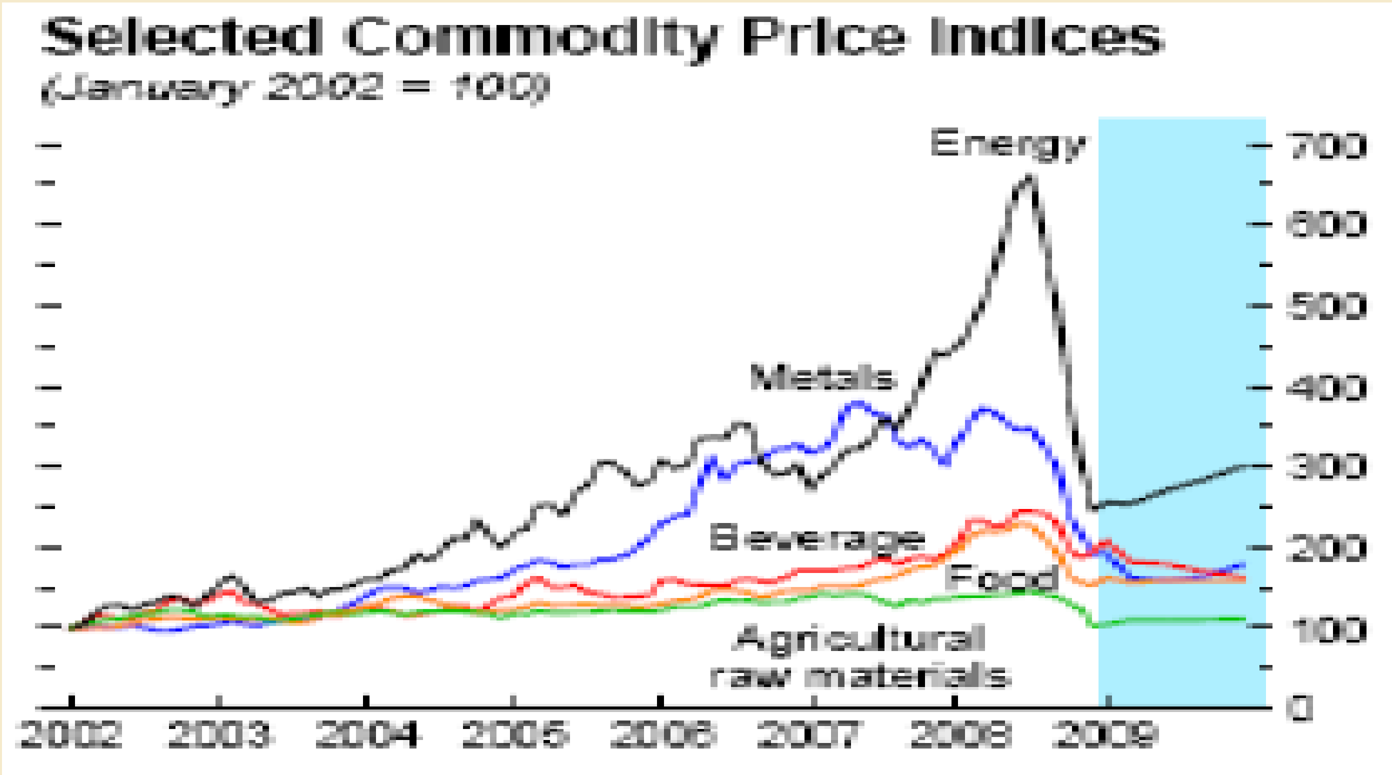


Financial globalization leads to better macroeconomic outcomes when certain threshold conditions are met. This generates a deep tension as many of the threshold conditions are also on the list of collateral benefits.

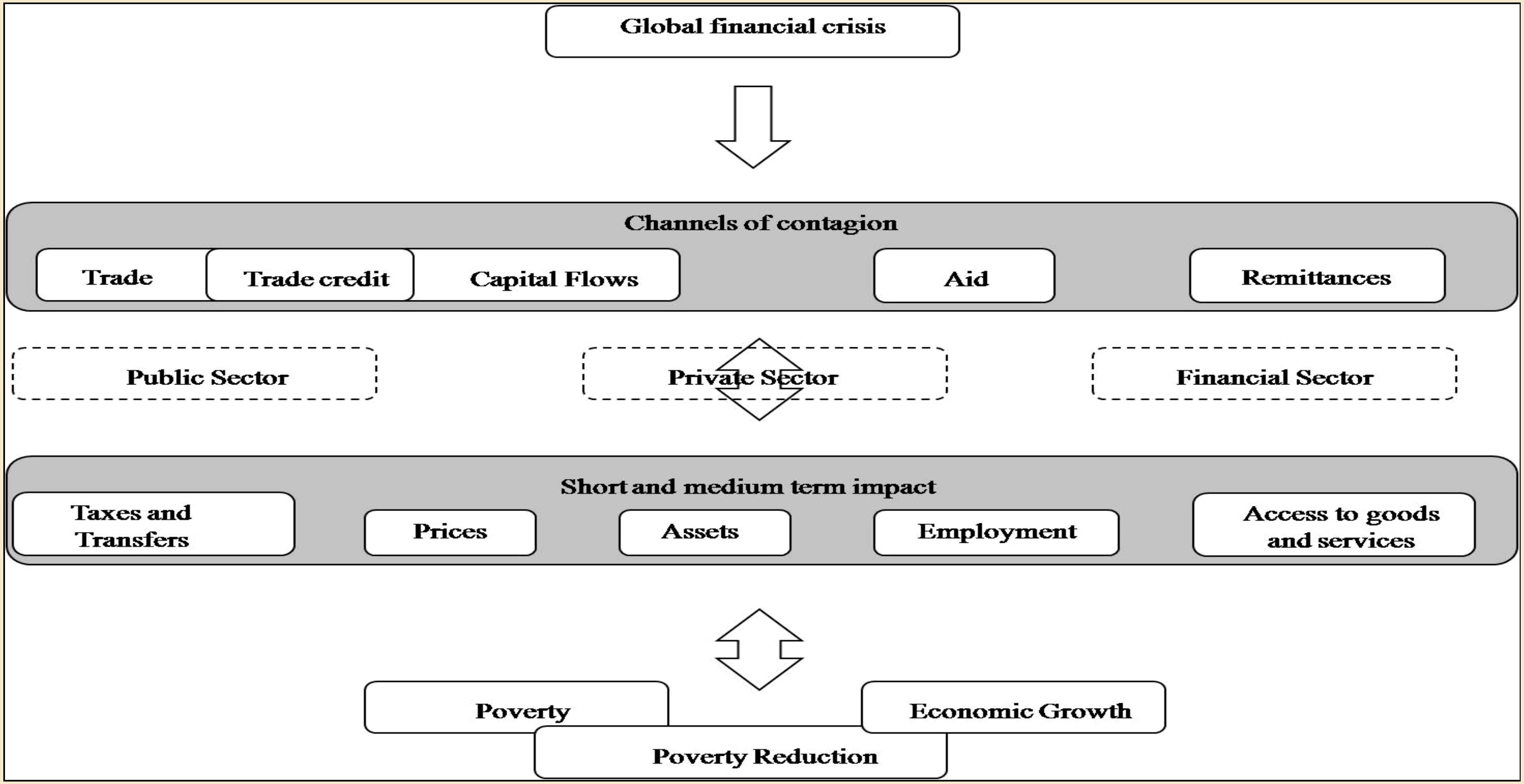
2. The international financial and economic crisis

- International financial stability is a 'Global Public Good' (GPG). Supply of the good is produced through "weakest link" technology. Cure undersupply e.g. by international cooperation, through int.organisation (IMF, see later)
- Current crisis originated in US financial system ('weakest link'), but spread as global public 'bad'
- Due to low degree FG, originally hopes of 'decoupling' for LICs (little '*direct* impact')
- Alas… :int. financial crisis developed into global economic crisis (drop of global demand, fall of booming commodity prices), which did impact LICs ('*indirect*' impact)
- We have to disentangle current crisis from recent Food and Fuel crises (**3Fs**), and potential other (internal) ones

Evolution of world commodity prices



3a. Measuring impact: a conceptual framework



Authors' adaption of ODI (2009)

3b. Defining and measuring vulnerability

- Dealing with external vulnerability
- Dealing with household level vulnerability
- Rate of decline of the growth rate, combined with the level of initial poverty
- Scope for the government to react:
  - institutional capacity, and/or
  - availabilty of fiscal resources (‘fiscal space’).
- Level of harmonization (among donors) and alignment (with country government systems and priorities

A framework for dealing with external vulnerability

	Prevention mechanisms	Insurance		Coping mechanisms
		Self-insurance	Market insurance	
(Terms of) Trade	Diversification; countercyclical aid (and remittances)	Reserves hoarding; stabilization funds, SWF	Commodity price derivatives; indexed debt	Current account and fiscal adjustment with adjustment loans and other exceptional aid
Private Capital Flows	Composition of flows, DSA, capital market development, dedollarization of flows, countercyclical aid (and remittances)	Reserves hoarding	Currency and interest rate derivatives, indexed debt, external debt in local currency	Current account and fiscal adjustment with adjustment loans and other exceptional aid
Remittances	Migration (return) policy	Reserves hoarding		Current account (macro) adjustment with adjustment loans
Aid	Predictable aid; multi-year aid; fixed-tranche aid	Reserves hoarding		Current account and fiscal adjustment

Source: authors' interpretation of Lee, Perry and Birdsall, 2008: table 1.

Dealing with household level vulnerability

	Prevention mechanisms	Insurance		Coping mechanisms
		Self-insurance	Market insurance	
Crisis impact	Formal employment; diversification of household income, in informal sector; countercyclical transfers and remittances, income in dollars	Assets hoarding (financial and real, e.g. land,cattle)	Hedging: exchange CF for dollars; micro-insurance	Adjusting to shock by reducing consumption, possibly reduced by microcredit; emergency assistance such as food-for-work programs, …

3c. Studies on the impact of the crisis

- 1) The African Development Bank has produced various papers on the impact of the crisis on Africa

  2) The IMF's webpage has also produced two papers: a) Implications of the Global Financial Crisis for Low Income Countries ; and b) Impact of Global Financial Crisis on Sub-Saharan Africa

  3) The OECD's views and information

  4) The World Bank's initiatives, including its vulnerability framework are described on its new Financial Crisis webpages. It has also published, Swimming Against the Tide: How Developing Countries are Coping with the Global Crisis; IMF/WB 'Global Monitoring Report 2009.
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  5) In preparation for its June 1-3 conference on the financial crisis, the UN General Assembly Commission led by Joseph Stiglitz has produced a preliminary report on reforms of the international monetary and financial system.

- Independent research on case studies: ODI webpage with information on its (10 country) studies about the financial crisis ; also, 3 case studies funded by Belgian DGDC (**DRC**, Senegal, Tanzania)

Overall impact on SSA

- Severity of international shock and importance of different channels of transmission country-dependent, but for SSA on average (for 2009):
  - growth to decline from projected 6.25% to 3.25% (??)
  - current account deficit from 2.75% to 6.75%
  - fiscal balance from projected surplus of 2% to a 4% deficit
  - inflation decreasing only marginally (from 9% to 6%)

- Poverty impact: destroying much of the efforts realised in recent years: World Bank estimates that 53 million more people would be trapped in poverty this year, subsisting on less than $1.25 a day, because of the crisis

4. Country policy response

- Sustain or regain macro-economic stability, through
  - fiscal policy (fiscal stimulus depends on ‘fiscal space’)
  - monetary and exchange rate policies
  - financial sector policies (enhanced supervision)
- Design targeted safety nets for those most affected by the crisis
- Continue to execute LT structural reform and PRSP and MDG agenda, including reducing vulnerability to external shocks
- In most countries, this programme relies heavily on donor funding to be executed

5. International (donor) community response

- More general, restore international financial stability (IMF), global economic growth, avoid protectionism,…

- Provide targeted emergency financing to smooth adjustment cost: multilateral institutions are best placed for this:
  - IMF Exogenous Shocks Facility (ESF), next to the PRGF
  - WB 'Vulnerability Fund' proposal, incl. IDA Financial Crisis Resoponse Fast Track Facility
  - AfDB decided on Accelerated Resource Transfer of Fund resources
  - EU also special budget lines (food crisis, now financial crisis)
  - *usually a mix of BOP and budget support*

- Bilateral donors should not reduce their planned aid interventions (and preferably scale up disbursmements)

IMF

Use of funds	Sources
• Short-term financing at market rate • De facto: for middle-income countries	Quota ↓ determines also: - voting rights - borrowing ceiling
Separate for LICs: PRGF/ESF: - Long term fin. - Concessional rates (0.5% interest)	PRGF-HIPC Trust Fund

International (donor) community response (II)

The G20 Meetings in London made some important progress on financing for development for low-income countries, by pledging US$50 billion for LICs from a US$ 1 trillion anti-crisis package. This included:

- An additional US$ 6 billion of potential IMF lending through the PRGF and ESF
- An IMF SDR allocation, of which SDR 19 billion will go to LICs;
- Pledging US$12 billion of trade finance and US$13 billion of accelerated lending by the Multilateral Development Banks

- Multilateral donors should step up the provision of macro-level *market-based insurance* mechanisms, as they have a natural comparative advantage to do so

6. Application to the DRC: boom-bust cycle

- DRC is touched by 4 shocks: 3 Fs (food, fuel, and finance), and the worsening of the security situation in the East; disentangling the effect of the financial crisis is difficult.
- Good economic performance in recent years driven by a few key sectors, such as the mineral sector, (and indirectly construction and telecom), fueled by increasing FDI, global demand and world prices for key minerals (copper, cobalt, diamond,…)…
- ...resulting in export windfall earnings, that were used mainly for extra imports (“largely absorbed”), not for ‘self-insurance’
- Boom also fueled (mining and other) *informal* activities
- Terms of trade evolution positive in recent years until mid 2008, despite food/fuel shock

Main international transmission of the shock

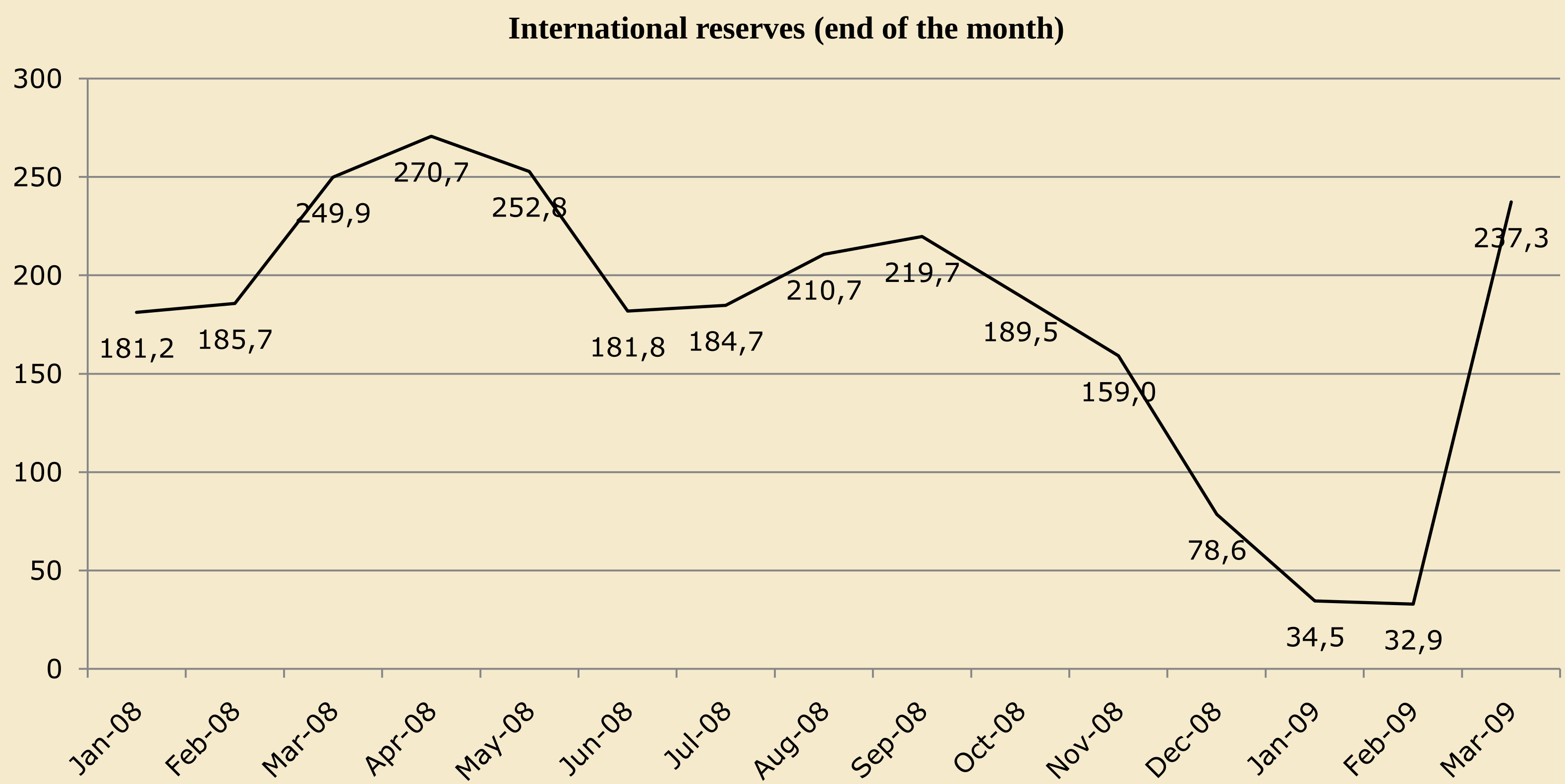
DRC is externally vulnerable economy: high degree of openness (trade + finance), low diversification of exports

- Financial and economic crisis hit DRC indirectly, especially through export and FDI channels …
- … and less through the aid and remittances channel (see BOP figures);
- …leading to a large overall BOP deficit
- Coping is the main reaction;
- W*ho pays the ferryman?:* less than proportional reduction of imports, compensated by emergency BOP assistance; remaining funding gap estimated at around 320 million $
- Low, and declining, level of international reserves (pre ESF-financing)

BOP impact of the financial crisis

	2007	2008			2009		2008 effect crisis (d)-(c)	2009 effect crisis (f)-(e)
	(Dec 08 est.) (a)	Sept 07 proj. (b)	Dec 08 ? proj. (c)	Most recent est. (d)	Sept 08 mission (e)	Most recent proj. (f)		
Current Account	-188	-1.168	-569	-1.783	-2.399	-2.927	-1.214	-528
Merchandise trade	886	-484	861	-125	-753	-2.073	-986	-1.320
Exports	6.143	3.033	7.052	6.586	6.705	2.995	-466	-3.710
o/w mining products	5.108	2.280	5.643	5.422	5.410	2.362	-221	-3.048
Imports	-5.257	-3.517	-6.191	-6.711	-7.457	-5.067	520	-2.390
Current Transfers	787	462	573	1.231	434	1.078	658	644
of which official aid	740	429	540	1.019	415	954	479	539
Capital and Financial account	477	733	131	1.154	2.574	1.568	1.023	-1.006
o/w FDI	374	966	1.616	1.713	2.449	621	97	-1.828
Overall Balance	-307	-434	-438	-628	175	-1.359	-190	-1.534

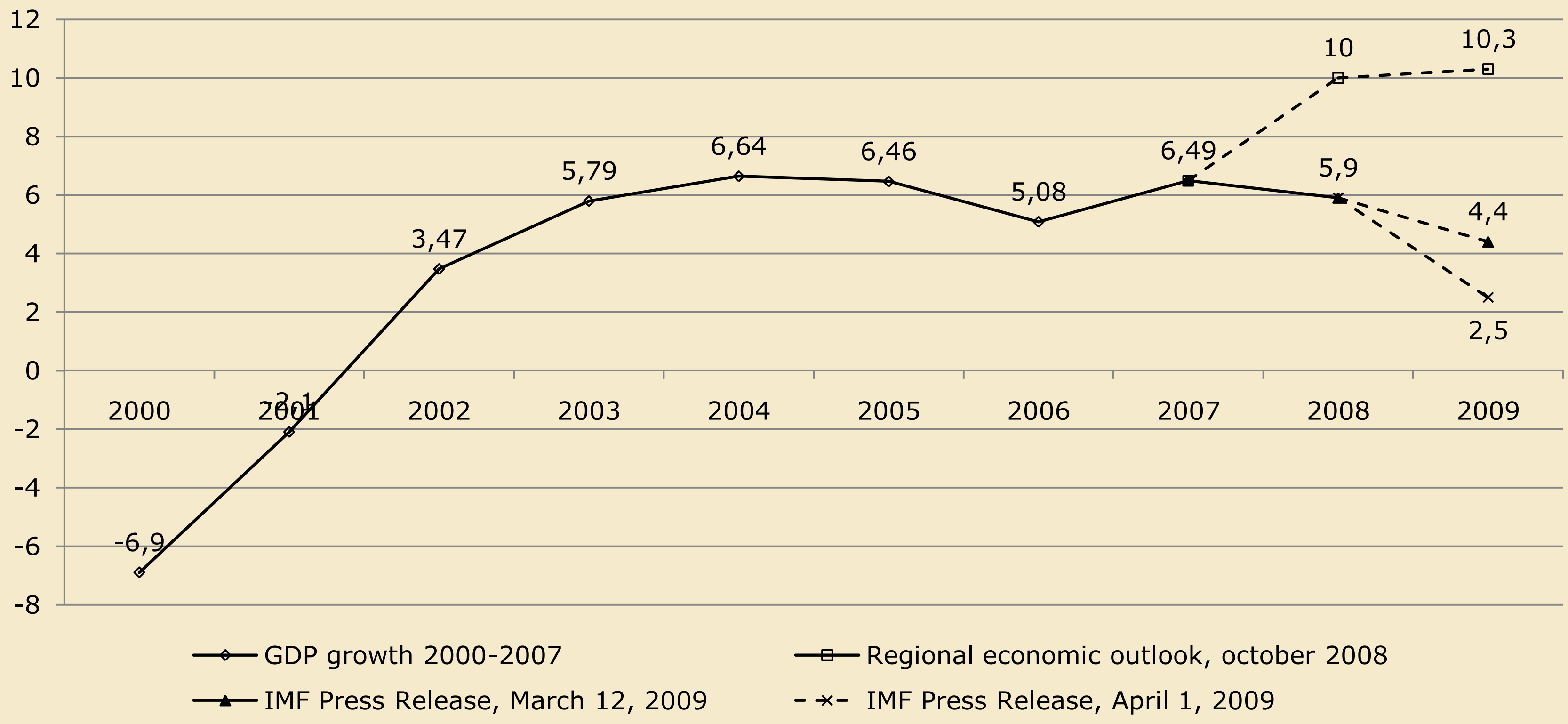
Evolution of foreign reserves: no self-insurance



3b. Impact on economic sectors

- Severe negative impact on key productive sectors, especially those responsible for pre-crisis growth, and their derived activities
- Rescaling, postponing major investment projects, rescaling or halting production in operational projects; reduction of informal activities
- Economic growth turned negative in third and fourth quarter of 2008: “recession”
- Economic growth revised downward in from 10% to 5.9% in 2008 and from 10.3% to 2.7% in 2009

Growth performance and projections



Growth decomposition by sector and quarter

		Overall growth		Sector Growth				
		quarterly growth rate	Cumulative	Mines and hydrocarbon	Manu-facturing	Construction	Energy	Others
2008	1st quarter	2,5	2,5	18,3	0,1	10,8	3,2	14,5
	2nd quarter	6,7	9,4	3,2	5,5	8,4	-9,6	-5,4
	3rd quarter	-1,8	7,5	0,7	-6,6	-4,7	2,4	18,1
	4th quarter	-1,4	5,9	-12,2	-3,0	-1,4	-2,4	0,3
1st quarter 2009		-1,3	-1,3					

Fiscal impact

- Structurally low fiscal space, despite improvements in recent years
- Windfall earnings of boom did not majorly impact budget…
- … but crisis did severely negatively impact certain revenues (crude oil, and mining), …
- Compounded by increased security expenditures…
- … leading to a substantial deficit end of 2008, that was covered mainly by monetary financing (BCC avances)
- Cash-based budgeting improved situation a little bit in 2009, and impacted revenues recovered a bit, but situation remains very fragile…
- Again coping is dominant strategy,with latest projections indicating a remaining funding gap of about 280 million $ after current identified emergency assistance

Central government budget impact 2008 (mln $)

	Cumul Jan-June 2008	July 2008	Aug 2008	Sept 2008	Oct 2008	Nov 2008	Dec 2008	**Cumul 2008**
Revenues	**1006,50**	**217,00**	**197,86**	**187,93**	**199,68**	**221,38**	**128,76**	**2159,11**
o/w oil revenues	201,23	35,19	62,22	35,45	52,53	29,55	1,99	**418,17**
o/w mineral revenues	85,85	24,65	9,32	7,89	6,28	13,06	1,37	**148,42**
Expenditure	**923,99**	**217,14**	**186,86**	**192,24**	**202,44**	**257,94**	**219,07**	**2199,69**
Salaries	367,29	78,66	70,74	40,32	85,89	109,04	81,82	**833,75**
Retrocession	142,15	21,88	38,70	33,58	44,87	39,93	34,02	**355,13**
Public debt service	50,51	11,68	11,22	10,80	6,35	15,39	1,78	**107,72**
Other operational	266,53	70,97	50,25	91,93	47,03	62,47	27,51	**616,69**
Investment	55,35	31,21	14,38	10,48	15,33	17,57	9,56	**153,87**
Other urgent expenditures	20,99	0,00	0,00	0,00	0,00	9,29	60,01	**90,29**
Other expenditures	21,17	2,74	1,58	5,13	2,97	4,25	4,38	**42,23**
Balance	82,51	**-0,14**	11,00	**-4,31**	**-2,75**	**-36,56**	**-90,31**	**-40,57**

Impact on domestic financial sector

- Financial sector is heavily underdeveloped, and unsophisticated; very little *direct* impact of the crisis; boom has attracted some new banks
- Banking system is largely dollarized
- Impact of the crisis largely felt through reduction of (dollar) deposits and international ST credit lines, and decrease of value of credit portfolio (NPL), increasing fragility of the system
- Windfall foreign assets collected by the financila sector during boom provide a cushion

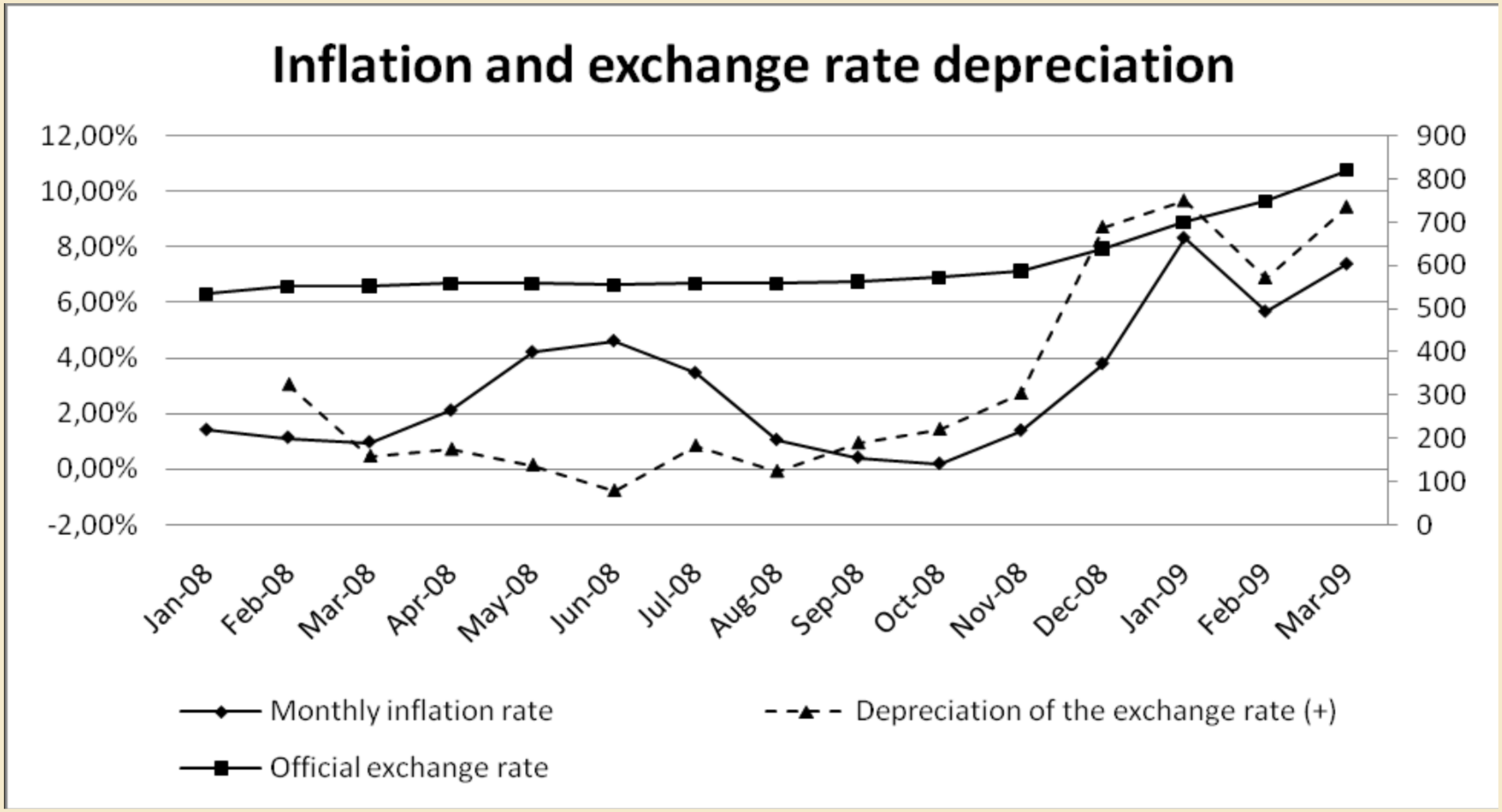
3c. National transmission channels

- Main transmission channels to household income and poverty level are through *price* mechanisms, of which:
  - Exchange rate depreciation: by reduction of supply of dollars, and high demand for dollars, with limited intervention capacity of BCC, …
  - …fuelling inflation (e.g. increasing domestic fuel prices), which is furthermore increased by monetary financing of the budget deficit

  Inflation is hurting everyone whose income is not dollar-based/indexed, especially the poor

  DANGER OF SEVERE MACROECONOMIC and SOCIAL INSTABILITY
- loss of formal employment, or temporary unemployment (limited); loss of opportunities for activities in the informal sector, e.g. mining sector and derived activities
- Danger of further degradation of access to (public/donor) services
- Coping is again dominant strategy; importance of emergency assistance strategies
- No detailed studies, only anecdotal evidence

Impact on (Kinshasa) inflation: twin peaks



4. Government response to the crisis

Institutional (national) response: inter-ministry commission (Nov.2008, not fully operational), crisis cell (Prime Minister), adopted plan (PUAICF,March 2009),focusing on (a.o.):

- Short-term: re-establishing macro-economic stability:
  - Fiscal interventions: revised budget using cash-based budgeting, to avoid further monetary financing;
  - Monetary interv.(BCC): reducing liquidity, intervening in forex markets
  - Some other short-term measures taken outside the plan, such as new taxes, are counterproductive
- Safeguarding minimal public service delivery (‘ringfencing’ pro-poor expenditure?)
- Securing access to formal IMF program (PRGF, June 09, retroactive April 09) and HIPC/MDRI debt relief (end 2009?), triggering also additonal donor flows

Government response to the crisis (II)

Medium-term:

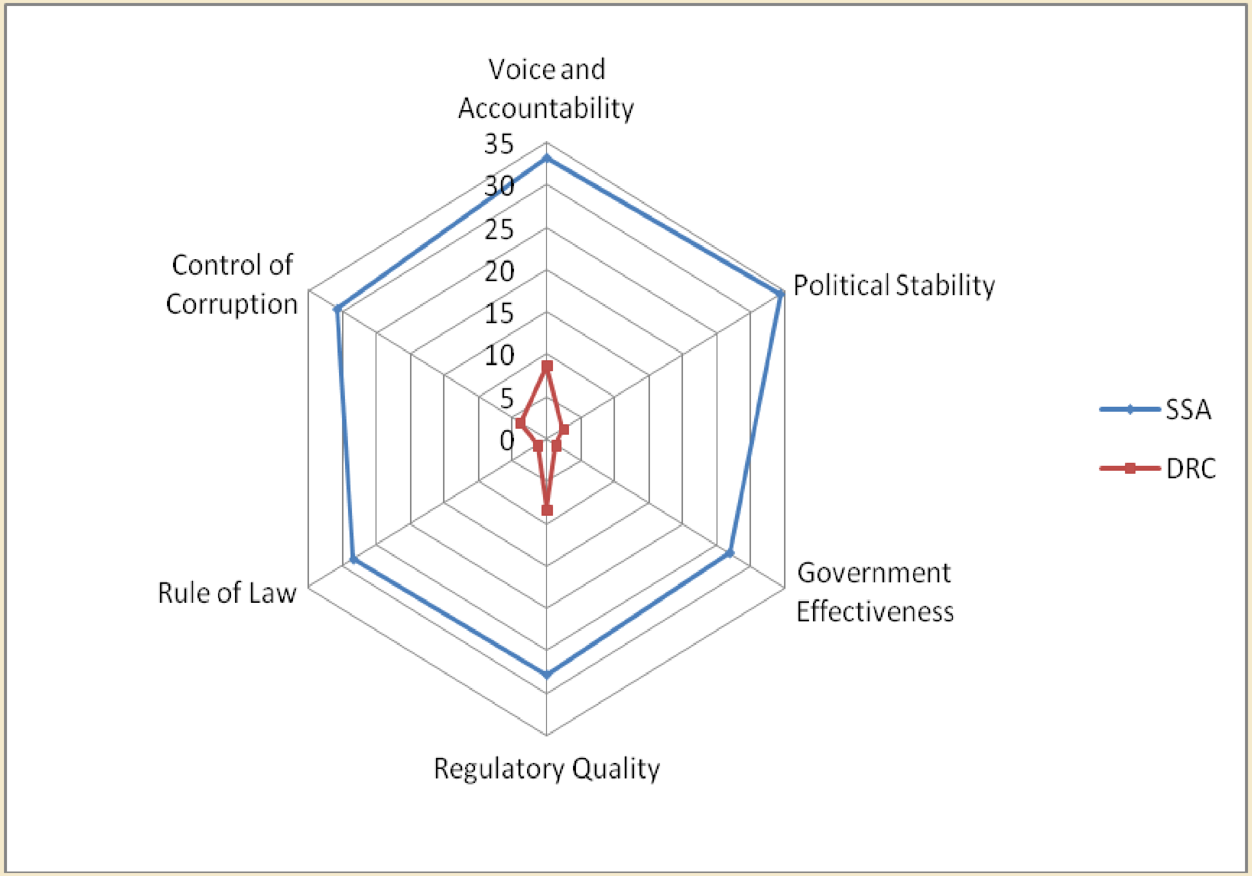
- Design and execute a (2nd) PRSP
- Execute the huge structural reform agenda; should focus on *prevention* and *self-insurance mechanisms*
- Crucial precondition: sustainable solution for conflict in the East

National policy supplemented by some provincial efforts (e.g. in Katanga)

Executing the reform agenda poses huge challenges, as quality of governance and institutional capacity is very low, leading to low development output of efforts, and low levels of donor commitments and especially, of disbursements:

Government should credible commit itself to execute a reduced list of low-cost, high impact structural interventions

Governance indicators (World Bank KKM)



5. Reaction of the international donor community

- Low level of H&A in Paris declaration terms (project aid modality only)…
- …but high degree of de facto alignment with respect to current crisis response of the donor community
  - Mix of macro-level emergency BOP support and budgetary support to ensure macroeconomic stability, the import of necessary goods and the functioning of minimal public services.
  - Earmarked micro-level support to ensure safety nets for the population, mainly highly labour-intensive public works, such as road building, that tackle at the same time the pressing infrastructural constraints of the Congolese economy.

Reaction of the international community (II)

- Globally-designed instruments of emergency mixed BOP and budgetary support applied fast in DRC:
  - IMF rapid access component of ESF,
  - WB (IDA) Financial Crisis Response Fast Track Facility
  - EC and AFDB about to follow
- Exceptional financing in the form of interim HIPC debt relief is provided by the WB and the AfDB, as well as by Paris Club bilateral donors (even topping up HIPC interim relief)
- No additional coordinated bilateral response so far: Belgian initiative to provide 20 million euro of macro-support, might trigger other responses
- More fundamental question is whether multilateral donors are not most appropriate donors to provide emergency crisis support

Reaction of the international community (III)

How to further optimize future donor reaction?

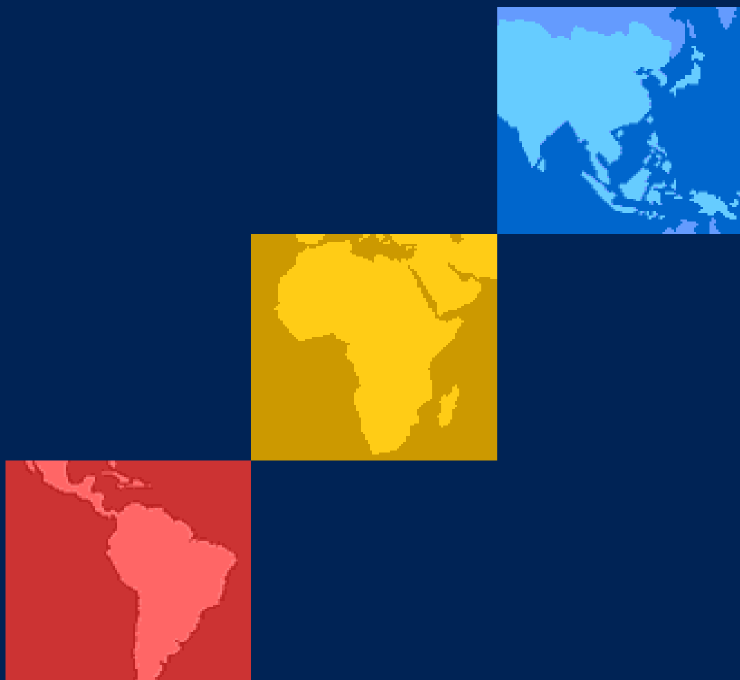
- Basic problem is low rate of disbursements of projects; a case could be made to relax conditions (only) if this is due to:
  - Administrative bottlenecks at the donor level
  - Lack of counterpart, or matching, funds by government; in this case, one could waive this requirement
- Longer-term: next to providing emergency asisstance, (multilateral) donors have natural advantage in supporting the provision of macro-level *market-based insurance* mechanisms

7. What about Kenya? (Mwega, 2009)

- Interference with food crisis (due to drought) and internl stability (post election violence)
- Direct impact likely limited: banking system not very much linked to global events, and has strenghtened in recent years; capital markets (NSE) adversely affected (but worst is over?)
- Indirect effects: external transmission mechanisms
  - main sectors affected: tourism and commercially-oriented agriculture such as horticulture, tea and coffee
  - remittances relatively important, but no clear signs of severe hit?
  - Aid likely to be affected, but not very important
  - other capital flows: sovereign bond issue to be stalled

What about Kenya? (Mwega, 2009) (II)

- Leading to increased fiscal gap, also because of stalling sovereign bond issue
- Depreciation of Kenyan shilling and depletion of reserves (still 3.2 months of reserves cover at Jan.15, 2009)
- Hope that inflation, fueled by high oil prices in 2008, will go down due to lower world prices of oil, and other imported materials (e.g. fertilizers)
- Resulted in downscaling projected growth for 2009 at 3%
- Government response: taske force established
- Kenya has requested emergency BOP financing from the IMF



Thank you!

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