Caleb M Fundanga: Africa and the global financial and economic crisis – an opportunity or a curse?

Speech by Dr Caleb M Fundanga, Governor of the Bank of Zambia, at the Forum "Developing Africa – an opportunity for Europe, Italy and Sicily", Taormina, Sicily, 1-2 October 2009.

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Chairperson,

Distinguished Participants,

Today we gather at a time when the world economy has gone through a tremendous economic and financial shock, which may well have long lasting social consequences. When we met last year, we were on the eve of disaster although we did not, and perhaps could not, appreciate the depth and severity of the crisis that we faced. In many ways we were in the calm before the storm. What subsequently transpired in September and October 2008, when financial markets froze and stock markets collapsed, was the greatest macroeconomic challenge that many of us, as practicing economists, are likely to face in our lifetime. As we all know, trade and output contracted sharply across the globe particularly in the fourth quarter of 2008 and first quarter of 2009, the downward trend in commodity prices witnessed since the historic highs of July 2008 accelerated, and perhaps most significantly confidence and trust in the market economy was severely impaired. In this regard, estimates from the International Monetary Fund (IMF) are that in the fourth quarter of 2008 global exports contracted by an average of 15.1%, whilst global output contracted by 6.5%.[1] This broad based deterioration in the global economy was carried through into the first and second quarters of 2009.

The most recent projections by the IMF suggest that global growth will contract by 1.4% in 2009 before recovering to a growth rate of 2.5% in 2010. For the United States of America and the Euro Area, growth in 2009 is projected to contract by 2.6% and 4.8%, respectively; whilst in Japan and the United Kingdom, growth is projected to contract by 6.0% and 4.2%, respectively. Although emerging and developing economies are projected to perform much better, with a projected growth rate of 1.5%, this rate of growth is significantly below the estimate of 6.0% growth in 2008. Further, growth in Sub-Saharan Africa is projected to decelerate sharply to 1.5% from 5.5% in 2008.

Thankfully, as we meet today there is growing evidence that in many parts of the world, the worst of the crisis may be over. At the epicenter of the crisis, i.e. the United States of America (USA) and Europe, the collapse in output has decelerated – with the most recent evidence pointing to some increase in growth both in terms of actual output as well as some of the leading indicators of output. In the USA, second quarter GDP growth figures of -1% indicate a deceleration in the pace of contraction. Further, in the second quarter of 2009, important Euro areas economies such as Germany and France actually posted positive rate of GDP growth. More broadly industrial production, exports, and retail sales figures appear to have improved, although they remain sharply negative on an annual basis. In addition the broad-based recovery in commodity prices also suggests that the global economy is on a path to recovery.

However, despite this more positive outlook for the global economy, it is not clear that Africa has seen its worst days. For many countries in Sub-Saharan Africa, the ramifications of the

[1] Source: IMF World Economic Outlook (WEO) update July, 2009. Figures for exports reflect annualized percent change of 3 month moving average over previous 3-month moving average.

crisis are still working themselves through the system. Initially, financial markets rather than the financial system bore the initial brunt of the crisis in Africa, as economies experienced a sharp reversal of financial flows, and exchange rates depreciated sharply, and capital markets registered sharp declines in market capitalization and trading volumes. Thankfully there are clear signs that financial markets have now stabilized, with exchange rates appreciating and inflows of portfolio flows and FDI showing tentative signs of recovery. In Zambia, for example, between September 2008 and April 2009, the country experienced a negative portfolio inflow. Non-resident holdings of Treasury bills declined from around 16% of outstanding bills in September 2008 to zero by end March 2009. During this period the exchange rate of the Kwacha against the US dollar depreciated by around 60%.

Whilst non-performing loans in the banking sector rose from around 5% in July 2008 to their current levels of around 10%, they remain within the prudential ceilings above which concerns of systemic risks would be warranted. The increase in non-performing loans thus reflects the deterioration in the real sector of the economy. It is in this sense, i.e. the absence of a significant volume of impaired assets in the financial system, that I describe “financial markets” rather than the “financial system” as bearing the brunt of the crisis. The weight of adjustment was reflected in exchange rates and the Balance of Payments – reflected in a marked draw down of international reserves. However, the ramifications of the crisis on the real sector of many sub-Saharan African economies are real and potentially far reaching, and it is to these that I now turn.

In my reflections on the impact and implications of the global economic crisis on Africa, I wish to emphasize four key points: The first and perhaps the most significant effect of the global financial and economic crisis has been the marked slow-down in real GDP growth in SSA, to a projected 1.5% in 2009 from an estimated 5.5% in 2008. This slow-down in growth has occurred after a significant period of strong economic growth and investment that had laid the platform for sustained and significant reductions in poverty across the continent. Further, whilst real GDP growth is anticipated to recover to 4.1% in 2010, this is significantly below the minimum annual growth rate of 7% that is thought necessary to move SSA towards a significant achievement of its Millennium Development Goals (MDGs) by 2015.[2] There is thus a strong possibility that without an appropriate policy response, SSA may be caught in a period of much lower growth rates over the coming years than is necessary to reduce poverty on a sustainable basis – reversing the important gains that have been made this decade. Africa, with 30% of the global population, still contains a large proportion of the world’s poor. Africa’s share of global trade and investment inflows also remains small in absolute terms and relative to Africa’s vast potential.

The second point I wish to make is that prior to the crisis, many Governments in SSA registered improvements in fiscal space which reflected not only the broad commodity price boom that began at the turn of the current decade, but also painful structural reforms aimed at expanding the market economy and implementation of greater fiscal discipline. In this regard, the impact of the crisis for many Governments in SSA is lower growth, the sharp contraction in imports as the external sector adjusted, and lower trade volumes in general, have led to a sharp reduction in Government revenues and a contraction in fiscal space. This contraction in fiscal space represents a grave challenge to the implementation of critical investment expenditures in the education and health sectors and in building infrastructure that supports the proper functioning of the market economy and expands its reach, particularly into the rural areas, where the majority of the poor live. With deteriorating fiscal positions in the donor Government, there also remains a real risk of cuts in donor flows to

[2] The MDGs are to: Eradicate extreme poverty and hunger; achieve universal primary education; promote gender equality and empower women; reduce child mortality; improve maternal health; combat HIV/AIDS, malaria and other diseases; ensure environmental sustainability; and develop a global partnership for development.

developing countries. In Zambia for example, Government revenues during the first half of 2009 were 25% below the projections in the 2009 Budget, largely reflecting lower trade taxes as well as lower donor inflows. For Africa, as a whole, recent estimates by the IMF are that budget deficits will drop from a surplus of 2.8% of GDP in 2008 to a deficit of 5.4% of GDP in 2009 – with fiscal outturns deteriorating across both oil and non-oil commodity exporters.

The global financial and economic crisis has also impacted Foreign Direct Investment (FDI) and credit flows in Africa, with serious consequences on the ability of African economies to build their productive capacities. For many countries in SSA, FDI flows as well as commercial lines of credit have been an important source of finance for growth, particularly because of insufficient domestic savings and the shallowness of domestic capital markets. In Zambia, for example, over the past 5 years FDI flows have averaged over US$ 900 million per annum, particularly in the mining, agriculture, manufacturing, construction, and tourism sectors. I believe this is an important part of the reason why Zambia's real GDP growth in 2009 is estimated at 4.5%, well above the 1.5% forecast for SSA. As indicated earlier, FDI flows to Africa are projected to fall by 18% in 2009, relative to 2008 inflows of US$ 30 million. In addition trade credits have been impaired as has the access of Government's to the international capital markets. Efforts, for example, by several African countries to raise long-term financing in international markets through sovereign bond issues have either failed, been cancelled (for example the Ghana Telecom bond issue for US$ 300 million) or have been delayed (for example the Eurobond issues for Kenya, Nigeria, Tanzania, and Uganda).

My fourth point is related to the actual, as well as imagined, failures of the market mechanism at the heart of the advanced economies, and the inevitable institutional reforms that need to be undertaken, as the relative boundaries of the public and private sector are reassessed. This is really a point of caution for SSA, because there have been calls for the Governments in Africa to emulate the actions taken by developed economies to support private sector companies and the financial sector in general in a manner that expands the reach of government. This course of action needs to be avoided in Africa because it risks undermining both public and private institutions, whose development has been an important part of the success of African economies in generating high rates of growth during this decade. Whilst greater fiscal discipline has led to lower and more sustainable budget deficits, real yield rates on long-term government bonds remain high in many African economies, suggesting that investors have not yet fully priced in the significant improvement in macroeconomic fundamentals and that their inflation expectations remain high. Central banks in Africa are also constrained in their ability to inject liquidity into the financial system by purchasing available government or any other type of securities in the market. This constraint is at two levels: first the financial systems in Africa have not been impaired and the money markets have continued to function regularly, without a significant and prolonged liquidity crisis – largely due to the absence of any impaired or toxic assets in the banking system. Second, credit expansion to the non-Government sector remains strong. Both of these facts suggest that any rapid expansion of Central Bank balance sheets or government deficits may be viewed as inappropriate and would therefore undermine the credibility of these institutions and their ability to anchor inflation expectations, which remain fragile.

It is with these four points in mind that I pose the question: **Is the global financial and economic crisis an opportunity or a curse for Africa?** I do not see the global crisis as a curse on Africa – some unknown force guiding us to our inevitable doom. Rather I see the global crisis as presenting a set of circumstances to which Africa is capable of responding proactively – to the great benefit of its people and indeed to the global economy. My reading of the current debates on the state of economics is that the poor predictive power of most macroeconomists in calling the financial crisis has bred the widespread belief that it is not so much that economists failed in their duties, this they certainly did; but that the science of economics itself has been found to be severely wanting. I myself have a more balanced view. There were certainly ample signs that trouble was brewing in the global economy – best reflected in the growing financial imbalances across the globe, for example between the

United States and China, in an ever more interconnected financial landscape. Economists understood the broad problem, but somehow failed to draw or contemplate the correct conclusions, despite our knowledge of previous episodes of financial collapse. However, the charge against the economics profession also has merit in that ultimately these global imbalances gave rise to or produced perverse economic incentives in financial markets which existing models did not or could not contemplate. This was compounded by a lack of regulatory oversight of key sectors of the financial market.

But let me return now to the question of Africa and the global financial and economic crisis. **How does Africa respond to the real prospect of lower growth than is necessary to reduce poverty on a sustainable basis?** I believe that Africa needs to retain open economies, expand regional markets and integration; and expand the reach and benefits of the market economy. Zambia has been an active and founder member of the Southern African Development Community (SADC) as well as the Common Market for Eastern and Southern Africa (COMESA). Through these bodies Zambia is looking to leverage its own potential through projects such as the North-South Corridor under COMESA, which seeks to open up efficient transport routes for the flow of goods, service, and people, from the south to the north of Africa. Further, under SADC Zambia is looking to develop its vast hydro-electric power potential, estimated at around 6,000MW, as well as transmission infrastructure to enable Zambia to supply countries in the East African Community which face severe power deficits. Zambia already trades power within the SADC region, through the Southern African Power Pool (SAPP). In the mining sector, Zambia is already seeing investment in value addition to raw materials being driven by the opportunities available in regional markets as close as the Democratic Republic of Congo (DRC) and as far away as Egypt.

How does Africa respond to the loss of fiscal space that has robbed the Government of critical resources needed to build their economies by investing in human capital and physical infrastructure projects such as roads, irrigation schemes, and power plants? First of all it is important to recognize the extraordinary response of the international community, especially through the G20 group of countries, in mobilizing resources to address both the liquidity needs of financial markets and the fiscal challenges faced by Governments. A significant amount of this support has been channeled through the multilateral financial institutions such as the IMF, World Bank, and the various Regional Development Banks, including our own African Development Bank (AfDB). The operating procedures and practices of these institutions have also been reformed to a significant degree – although it is true to say that it will take more time to change the organizational mindset and attitude of staff.

In this regard, at the end of August and the beginning of September, Zambia received an SDR allocation amounting to US$ 625 million that has augmented our reserves and provided a boost of confidence in our financial markets. Zambia has also benefitted from increased support from bi-lateral donors, with the prospect of additional resources being made available in the current calendar year from the European Union amounting to around 13% of all the grants that were scheduled to be received in 2009 from the EU and individual donors. Institutions such as the African Development Bank have also made changes to their procedures aimed at fast tracking the disbursement of critical development finance resources, against already approved projects.

However, there are serious concerns that Africa has been disadvantaged in the allocation of resources made available by the international community – particularly to key institutions such as the AfDB. There is also concern that whilst the principle of increased resource flows through Institutions such as the IMF should be targeted beyond the traditional BoP needs has generally been accepted at a political level, there is some reluctance at the institutional level for institutions such as the IMF to venture outside of their traditional confines of their support. In Zambia, the Government has engaged our cooperating partners to ensure that the additional resource provided to help African countries deal with the global crisis can be utilized to do just that – and not be simply kept for a rainy day that ignores the current monsoon. In my own personal interaction with the IMF, I believe that in Zambia we do have a good common understanding on this issue. The Government has in fact been able to draw on its PRGF resources to compensate for the shortfalls in Government revenues over the first half of 2009 that I have alluded to earlier. However, when all is said and done, Africa still needs to mobilize both foreign and domestic sources of finance that provide sustainable sources of investment.

How can Africa best arrest the recent reversal of FDI inflows generated by the global financial and economic crisis and encourage domestic resource mobilization i.e. boost domestic savings rates? In my view, ensuring that we retain our focus on consolidating macroeconomic stability is a critical element of Africa's response to the current crisis. For many of our economies, inflation has been pushed beyond the single digit level, and we must all therefore work hard to re-establish low levels of inflation as soon as possible. The ability to attract FDI inflows is also a function of the supporting infrastructure and the existence of a business environment that supports innovation, initiative, and hard work. In this regard Africa must not relent on efforts to improve infrastructure development, and lower the cost of doing business. This is a process which is being actively pursued in Zambia, where great strides have been made to reduce the number of business licenses required and to streamline licensing procedures, in addition to the establishment of an organisation, the Zambia Development Agency, to spearhead and support FDI flows and domestically financed investment. We do see increased interest in cross border investments from within our region, particularly in the financial sector.

With respect to the need to mobilize domestic savings, Africa certainly needs to expand the reach of the financial sector and to make the financial sector more efficient. In Zambia, the majority of the population does not have access to financial products. The Bank of Zambia has therefore made advancing financial inclusion as one of its strategic objectives. Zambia has a very low population density and there are many areas that are currently not served by any financial institution. Reaching these areas will require the application of technology and the concept of branchless banking. To facilitate such innovation, a robust regulatory regime governing the payment system has been implemented with the enactment of the National Payment Systems Act in 2007. In this regard, Zambia is learning a lot from the advances made in countries such as Uganda and Kenya, where cell phone technology has expanded the reach of financial services and products. On its part the Zambian Government is also taking concrete steps to enhance the application of Information and Communication Technology across the broad spread of Government services and the private sector.

How can we build better and more resilient institutions that boost confidence in the benefits of a market economy and can act as strong anchors of inflation expectations? Earlier in my remarks I did make reference to the fact that one of the greatest dangers facing African economies is the risks that the current crisis might trigger significant policy reversals that undermine important institutions such as the Government as well as the central bank. It is important that in Africa, the critical work of consolidating fiscal positions and improving the Governance arrangements and financial management of public resources is sustained. In many ways, fiscal sector reform reflected in the curtailment of fiscal dominance, have been the central platform upon which macroeconomic stability has been built and achieved in Zambia. From the central bank perspective, the Bank of Zambia has worked to improve its own credibility by working with commercial banks and other financial institutions to improve Governance arrangements in the financial sector, improve the frequency and level of communication between the bank and the institutions that it supervises, as well as the general public. Much of this work has been done under the framework of a comprehensive Financial Sector Development Plan (FSDP) that has had broad support from our cooperating partners. At the regional level, a new SADC Model Central Bank Act has also been approved by the Ministers of Finance in SADC that enshrines important principles of independence and good corporate governance as a yardstick to be followed by all central banks in the region.

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In conclusion, let me simply state that I believe that we in Africa have an opportunity and an obligation to consolidate reform and ensure that we can return to and surpass the high growth rates, of above 5%, witnessed in the new millennium. This is important not just for Africa and the challenge of reducing poverty, but also the world, as demographic changes shift the burden of production onto the younger generation – which is concentrated in the developing economies, including Africa. I am happy to note that my invitation for colleagues to visit Zambia and see the wonderful opportunities for investment and progress that exist have been heeded as I did receive a delegation from Italy early this year. I cannot therefore end without encouraging all of you to visit Zambia when you have the opportunity – I can assure you that you will not be disappointed.

I thank you for your kind attention.