United Nations TD/B/EX(50)/3

United Nations Conference on Trade and Development

Distr.: General
28 April 2010

Original: English

Trade and Development Board
Fiftieth executive session
Geneva, 8 July 2010
Item 2 of the provisional agenda –
Activities undertaken by UNCTAD in favour of Africa

The financial crisis, macroeconomic policy and the challenge of development in Africa

Note by the UNCTAD secretariat

Executive summary

The global financial and economic crisis has had a negative impact on African economies. It has also generated and renewed debate on the conduct of macroeconomic policy in developing countries. The main challenge facing African countries now is how to position themselves for post-crisis recovery as well as ensure that policy responses to the crisis do not lead to medium- and long-term problems of debt sustainability. An effective response to this challenge requires that African countries build robust regional markets, unleash the potential of local business and entrepreneurs for development, and build resilience to shocks.

Introduction

1. The global financial and economic crisis triggered by the decline of house prices in the United States in the second half of 2007 poses significant challenges for African countries and policymakers. It has led to a significant reduction in growth rates and is slowly reversing the progress in economic performance made by the region since 2000 (see table below). The crisis is also jeopardizing efforts by African countries to meet the Millennium Development Goals (MDGs) by the 2015 target date. The scale as well as nature of the impact of the crisis differs across countries, depending on their export structure, degree of dependence on external capital, and availability of domestic resources to conduct counter-cyclical policies and protect vulnerable groups.

2. Before the current crisis, the conventional wisdom was that countries experiencing economic turmoil should adopt austerity measures in the form of restrictive monetary and fiscal policies to maintain macroeconomic stability. The result has been that macroeconomic policies in Africa tend to be pro-cyclical, rather than counter-cyclical as in developed countries, with dire consequences for growth and poverty reduction efforts. The current crisis has exposed the limitations of this approach to macroeconomic policy and renewed interest in the use of fiscal and monetary policies for economic stabilization. It has also raised questions about the role of capital account liberalization in developing countries.

3. Unlike in previous crises, some African countries responded decisively to the current economic turmoil through counter-cyclical monetary, fiscal and financial policies. They also adopted measures at the regional level such as the establishment of a financing facility by the African Development Bank and the setting up of the Committee of Ten Ministers of Finance and Central Bank Governors to monitor the crisis and suggest ways to cushion its impact in the region. These national and regional actions have helped in limiting the adverse effects of the crisis in the region. The challenge facing African countries now is how to position themselves for post-crisis recovery as well as ensure that policy responses to the crisis do not lead to medium and long term problems of debt sustainability. In this regard, there is the need for African countries to rebuild their economies and lay the foundation for revival of strong and robust economic growth. There is also the need to strengthen social safety nets as well as reduce vulnerability to shocks.

Africa’s recent economic performance

Variable	**2000–2007 (annual average)**	**2008**	**2009**
Real growth rate (%)	5.6	5.18	1.69
Inflation (%)	8.3	10.25	9.05
External debt (% of GDP)	46.2	22.37	25.37

Source: World Economic Outlook database, International Monetary Fund (IMF), October 2009.

4. Against this backdrop, this paper examines the past conduct of macroeconomic policies in Africa. It also identifies some policy lessons from the financial and economic crisis and how African countries should position themselves in the post-crisis (recovery) phase in order to revive economic growth and reduce susceptibility to shocks. The paper is organized as follows. Chapter I provides explanations for the pro-cyclicality of macroeconomic policies in Africa while chapter II discusses key lessons from the current crisis. Chapter III focuses on policy actions needed to rebuild the economic foundations of African countries and set the stage for high and robust economic growth. The final section contains concluding remarks.

I. Understanding the pro-cyclicality of macroeconomic policies in Africa

5. African countries experience significant fluctuations in economic growth. This is due to various reasons, including their dependence on primary commodity exports with volatile prices, instability of both private and official capital flows, and vulnerability to climate change. In principle, counter-cyclical macroeconomic policies could be used to cushion the effects of these shocks on output. However, macroeconomic policies in Africa have historically been pro-cyclical. For example, fiscal policy tends to be expansionary during booms and tight during downturns, thereby amplifying and exacerbating the adverse effects of shocks on output.[1] There are several reasons why African countries and developing countries in general adopt pro-cyclical macroeconomic policies rather than counter-cyclical policies that would support their development efforts.

6. Until the onset of the current financial and economic crisis, the conventional wisdom was that the primary objective of monetary policy should be the maintenance of low and stable inflation.[2] Given this mindset, central banks in the region were more concerned about the impact of their policy actions on inflation than the implications for output. Consequently, they are often hesitant to follow expansionary monetary policy during downturns for fear that it would create inflation and undermine macroeconomic stability. Furthermore, in the 1980s and 1990s, African countries that participated in the Enhanced Structural Adjustment Facility (ESAF) of the IMF were required to adopt restrictive monetary policies in response to economic turmoil with severe economic and social costs.[3] These conditions effectively limit the ability of African countries to conduct

[1] Thornton J (2008). Explaining pro-cyclical fiscal policy in African countries. *Journal of African Economies*. Vol. 17, No. 3.

[2] Blanchard O, Dell'Ariccia G and Mauro P (2010). Rethinking macroeconomic policy. International Monetary Fund Staff Position Note, SPN/10/13.

[3] Naiman R and Watkins N (1999). A survey of the impact of IMF structural adjustment in Africa: growth, social spending, and debt relief. Report of the Center for Economic and Policy Research, Washington DC; and Bird G (2001). Conducting macroeconomic policy in developing countries: piece of cake or mission impossible? *Third World Quarterly*. Vol. 22, No. 1.

counter-cyclical monetary policies and contribute to macroeconomic instability in the region.

7. Regarding fiscal policy, one of the main reasons for its pro-cyclicality in Africa is the fact that financing (supply of credit) to African countries is pro-cyclical. During economic downturns African countries either cannot obtain credit or can do so at very high interest rates, making it difficult to run deficits. Consequently, the typical fiscal response of African countries during economic crises has been to cut government spending, with potentially adverse consequences for macroeconomic stability and growth. Fiscal policy in most developing countries is pro-cyclical because of political economy factors. For example, in countries with weak institutions, voters often try to reduce political rents (unproductive public consumption) by demanding more public goods and lower taxes during booms.[4] This forces the government to run pro-cyclical fiscal policies even though it is suboptimal. Policy conditions imposed by international financial institutions also restrict government spending, forces African governments to impart a pro-cyclical bias to fiscal policy, and amplify economic fluctuations. Another factor contributing to fiscal policy pro-cyclicality in Africa is the existence of fiscal rules designed to achieve debt sustainability or meet convergence criteria established by regional economic groups. These rules often take the form of limits on government borrowing, spending or debt accumulation that give governments less room to conduct discretionary fiscal policy.

8. As a result of the current crisis, economists, policymakers and international financial institutions are slowly changing their views on the role of macroeconomic policy and now recognize the need for discretionary policies to reduce economic fluctuations and support the development efforts of developing countries. However, it is important to stress that the effective use of macroeconomic policies for stabilization in Africa requires reduction of policy conditions attached to lending by international financial institutions. It also requires building strong institutions of accountability as well as improving access to credit, particularly during downturns. African countries can also create fiscal space for counter-cyclical policy responses in the future by managing revenue from commodity booms more effectively.

II. Policy lessons from the crisis

9. There are important policy lessons from the current crisis for Africa as well as for the international community. In the 1980s and 1990s, many countries in Africa adopted sweeping economic reforms that reduced the role of the State in the economy. This was rationalized on the grounds that the public sector was inefficient compared to the private sector and that markets were self-regulating and could ensure that output growth was close to potential. The current crisis has shown that these assertions have serious limitations and that the State has an important role to play in economic development. In particular, it has shown that, although the market mechanism provides a vital framework for economic activities, governments

[4] Alesina A and Tabellini G (2005). Why is fiscal policy often pro-cyclical? National Bureau of Economic Research Working Paper 11600.

must provide appropriate oversight. Consequently, there is the need for policymakers to find the right balance between state and markets for better development results.

10. Another lesson from the crisis is that monetary policy is not an end in itself. It is useful to the extent that it supports the development efforts of countries. In this regard, the focus of monetary policy should not be on inflation alone. It should also explicitly take into account growth and financial stability issues in order to minimize the impact of shocks to the economy. One way to accomplish this is to alter existing mandates of central banks to include growth and financial stability objectives.

11. The crisis has also shed light on the need for African countries to have policy space to respond to adverse shocks. In particular, it has shown that an active fiscal policy is necessary to cushion the effects of shocks on output. In this regard, there is the need to reform the current international financial architecture, particularly the way in which international financial institutions support countries facing external payments problems and economic crises. Furthermore, international financial institutions should consider reducing policy conditions attached to loan facilities so as to enhance the ability of developing countries to respond appropriately to shocks. There is also the need for African countries to exercise prudence in the management of commodity revenues during booms to create room for counter-cyclical fiscal policy responses in the future. They should also build resilience to external shocks through the development of productive capacity. This can be accomplished through infrastructure development, providing targeted incentives to promote technology transfer by foreign investors, and improving manufacturing export competitiveness through improving the business environment.

12. Another lesson from the crisis is that developed countries are not immune to financial crises and disruptions arising from imperfections of the market economy. In the past, the IMF focused its surveillance activities mostly on developing countries on the assumption that the systems in place in developed countries functioned well. This led to the neglect of systemic risks arising from the policy actions of developed countries. There is the need for the IMF to exercise its oversight responsibilities more effectively and in an even-handed manner. For this to happen, however, there is the need to change the governance structure of the IMF to better reflect the composition of its members and allow for more voice and representation of developing countries.

13. The need for a cautious approach to capital account liberalization is another key lesson from the current crisis. The timing and pace of such liberalization should depend on each country’s degree of financial market development as well as strength and quality of regulatory institutions. Each country should also have the policy flexibility to impose capital market restrictions if and when capital flows threaten the stability of the domestic financial system and economy.

14. The crisis has also shown that global problems require comprehensive, coordinated and timely responses. In the early months of the crisis, response by the advanced countries was basically at the national level with very little coordination across countries. The negative reaction of financial markets to this approach led to the realization that there was the need for a coordinated response. Consequently, since the last quarter of

2008, policy actions by the major advanced countries have been increasingly coordinated with an expansionary bias.

15. These lessons indicate that policymakers should desist from conducting business as usual if they are to reduce the likelihood of another crisis in the future. This calls for the adoption of a pragmatic approach to macroeconomic policy that recognizes the strengths as well as limitations of both markets and state in economic development. It also calls for reform of the current international financial architecture.

III. Reviving post-crisis growth in African economies

16. There are indications that the global economy is entering the recovery phase.[5] In the advanced countries, interest rate spreads have decreased significantly relative to the last quarter of 2008 and the major stock markets have regained a large part of the losses sustained since the onset of the crisis. Despite these positive developments in the financial sector, the real economy is yet to recover from the crisis and it may take several months, perhaps years, before the situation improves. Notwithstanding this uncertainty, it is likely that the post-crisis global economy will be marked by slower trade, costlier capital and more regulation. Furthermore, emerging economies are likely to play more roles in the post-crisis global economy because of their increasing share of world output. To the extent that their increasing roles and activities result in an increase in commodity prices, it could help jump-start growth in Africa. In this regard, African countries need to position themselves to take advantage of the recovery phase of the crisis and should consider adopting the following policy actions:

(a) *Build robust regional markets:* The development of regional markets is necessary for African countries to exploit economies of scale, enhance export competitiveness and integrate effectively into the global economy. Despite the long history of regional integration in Africa, intraregional trade and investment remain very low. It is estimated that intra-African trade accounts for about 9 per cent of Africa's trade while intra-African foreign direct investment (FDI) represents about 13 per cent of inward FDI to Africa.[6] Boosting intra-African trade and investment requires that African governments strengthen efforts to develop regional infrastructure and reduce barriers to trade and investment within African regional economic communities;

(b) *Unleash the potential of private entrepreneurs for development:* The private sector has a role to play in the recovery process and every effort should be made by African governments to address barriers to private sector development. There is also the need for government intervention to boost public investments and increase access by entrepreneurs to reliable and cost-effective sources of finance. The financial crisis has shown that African countries are highly vulnerable to external finance. In this context, there is the need for African governments to scale up

[5] United Nations (2010). *World Economic Situation and Prospects 2010*. New York: United Nations.

[6] UNCTAD (2009). *Economic Development in Africa 2009: Strengthening regional economic integration for Africa's development.* United Nations publication. Sales No. E-96.II.D.3. New York and Geneva.

efforts to mobilize domestic resources as a sustainable basis for financing public investments needed to boost growth and engender development. Improving public revenue collection, increasing efficiency in use of public resources, stemming capital flight and improving the functioning of the financial sector are necessary to boost domestic resource mobilization in the region.[7] The potential role of new types of industrial policy also needs to be explored, alongside the renewed focus which both African governments and donors have now in agricultural development;

(c) *Build resilience to shocks:* Africa's vulnerability to internal and external shocks has adverse consequences for macroeconomic stability and growth. Consequently, policymakers in the region should seize the opportunity of the crisis to build resilience to shocks through developing productive capacities, avoiding currency and maturity mismatches associated with borrowing, and managing revenue from commodity booms in a manner that creates room for conduct of counter-cyclical policies in the future.

17. Africa also needs assistance from its development partners to weather the global slowdown and revive post-crisis growth. The crisis has increased Africa's financing needs and it is estimated that the region would need $50 billion to achieve pre-crisis growth rates and $117 billion to attain the 7 per cent average growth rate required to meet the MDGs.[8] In this regard, an increase in official development assistance is necessary to reignite economic activities and enhance growth in the region. Such an increase in aid will be most effectively used if domestic ownership of the design and implementation of national development strategies is enhanced rather than constrained. There is also the need for development partners to ensure coherence between their aid, trade and investment policies in the region. Furthermore, the crisis presents an opportunity for the international community to reform the international financial architecture to enhance its ability to deal with the challenges of the twenty-first century and also respond more appropriately to the development needs and concerns of developing countries.

IV. Conclusion

18. The global financial and economic crisis has had significant adverse effect on African economies, reducing economic growth for the region in 2009 by about 4 percentage points compared to the annual average growth rate for the period 2000–2007. Admittedly, some African countries responded effectively to the current crisis, thereby minimizing the potential adverse effects on the region. The crisis is also altering views about the conduct of macroeconomic policies and has led to calls for reform of the international financial architecture. The main challenge facing African countries now is how to position themselves for post-crisis recovery as well as ensure that policy responses to the crisis do not lead to medium- and long-

[7] UNCTAD (2009). Enhancing the Role of Domestic Financial Resources in Africa's Development: a Policy Handbook. Geneva: UNCTAD.

[8] Kaberuka D (2009). Start this engine: Africa's policymakers should prepare for global recovery by priming their private sectors. *Finance and Development.* June: 54-55.

term problems of debt sustainability. An effective response to this challenge requires that African countries build robust regional markets, unleash the potential of local business and entrepreneurs for development, and build resilience to shocks. It also requires support by Africa's development partners.

Issues for discussion

19. Issues for discussion include the following:

(a) What are the lessons for Africa from the global financial and economic crisis?

(b) How can African countries make more effective use of macroeconomic policies for development?

(c) What is the role of the State in Africa's economic development? What should be the focus of Africa's agricultural and industrial policies in the post-crisis period?

(d) How should African countries prepare themselves for post-crisis recovery and how can development partners and the international community contribute to this effort?