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# The European Debt Crisis: Risks for Africa?

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## 1. Introduction

At the outset of the global financial and economic crisis, Africa's immunity from negative effects was widely predicted, given its limited financial integration with the rest of the world. While the crisis hit Africa with delay, it operated through multiple channels (trade, capital flows, remittances, tourism, and others) and led to a significant slowdown of African economies. Real GDP growth fell from an average of 5.6% during 2001 – 08 to 2.5% in 2009, while working poverty and unemployment escalated, especially among the youth.

Indeed, Africa has weathered the crisis well relative to most other developing regions and relative to its own past record. Nevertheless, current global recovery has become even more fragile. Concerns over fiscal tightening and sovereign credit risks in Europe have been mounting, while the lukewarm performance of the US economy only heightened the fears of a double-dip or substantially slower recovery. In spite of the EU's massive stabilization fund of €750 billion, the financial turmoil in Europe has still not subsided, with four euro zone countries – Spain, Ireland, Portugal and Greece – having downgrades of sovereign risk rating since the beginning of 2009.

Sparked by the Greek debt crisis, the European sovereign debt turmoil has increased the fragility of Africa's recovery, given the strong economic links between the two continents. For Africa, this turmoil may have several implications as the crisis may be transmit to the continent through various channels. The extent of transmission will however depend on the degree of trade and financial linkages with Europe and on the resilience and policy space of the specific economies and sub-regions.

On a more positive note, the July 2010 Update of the IMF Financial Stability Report points out that the transmission of sovereign credit risk due to the very high public debt levels in Europe has so far been primarily financial in nature and generally contained within the region (IMF, 2010a)[1].

[1] On a less positive note, some analysts argue that the European debt crisis is likely to persist for a while as the turmoil is a confidence problem. The Greek crisis for instance primarily reflects fiscal indiscipline over several years, which was disguised by misreporting. The exposure of this misreport led to loss of credibility and confidence in the ability of the Greek government to manage its finances, and thus required not only the financial support of the rest of the EU and the IMF, but also the credibility of its economic and fiscal program.

**Mthuli Ncube**
**m.ncube@afdb.org**
**+216 7110 2062**

**Charles Leyeka Lufumpa**
**c.lufumpa@afdb.org**
**+216 7110 2175**

**Leonce Ndikumana**
**l.ndikumana@afdb.org**
**+216 7110 2076**

Prepared by the following staff: Gil Seong Kang, Abdul B. Kamara and Zuzana Brixiova.

*"North Africa is most dependent on trade with the European (EU), followed by West Africa, Southern Africa, Central Africa and East Africa."*

*"While the risk of falling demand from Europe is a cause for concern to many, some are of the view that the 14-country CFA Zone may in fact gain from Europe's debt crisis, due to the currency peg to a weakening euro."*

In that context, the July 2010 IMF Update of the World Economic Outlook has cut the baseline forecast for the EU in 2011 only marginally. It actually raised slightly its forecast of growth for Sub-Saharan Africa, driven in part by more buoyant growth in Asia (Annex). At the same time, the revised outlook underscores that the risks of a feeble global recovery have increased markedly (IMF, 2010b).

Notwithstanding the overall still positive outlook, downside risks to global as well as Africa's recovery have risen and need to be carefully monitored. This brief examines these risks from the broader perspective of Africa's economic recovery and long-term growth.

## 2. Trade Risks

As Mhango (2010) points out, while timely and effective, it is unlikely that rescue packages of the EU and the IMF will completely offset the impact of the debt crisis on European economies. Fiscal consolidation measures especially are likely to slow Europe's growth. The most immediate and direct impacts of the European crisis for Africa would thus be through trade.[2] Given the strong trade linkages with European markets, the overall negative impacts on African exports would be substantial. The severity of the impacts at regional and country levels would vary with the degree of dependency on European markets as well as offsetting linkages to other developing regions, in particular China, India and the Gulf countries (Annex).

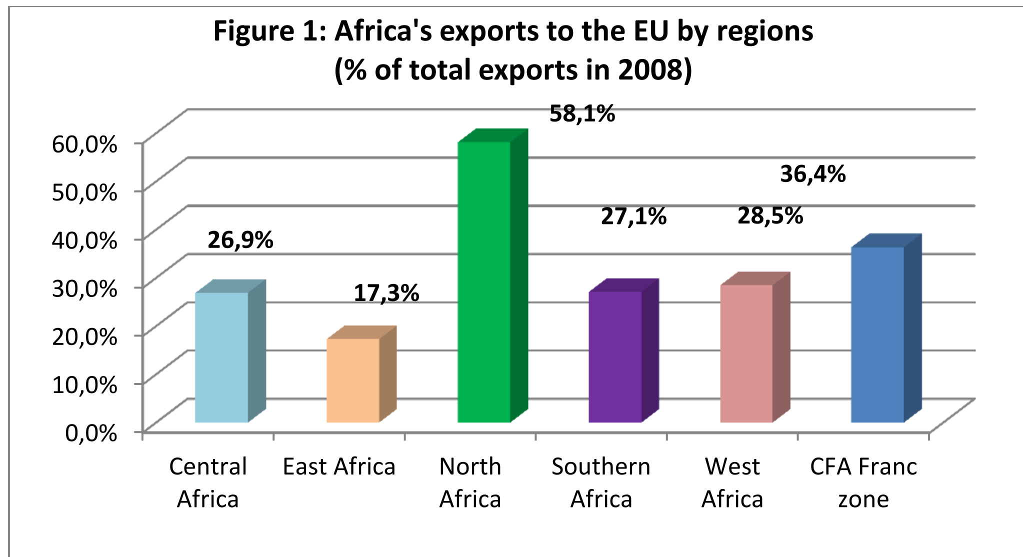
### *2.1 Regional disparities*

North Africa is most dependent on trade with the European (EU), followed by West Africa, Southern Africa, Central Africa and East Africa (Figure 1). About 60% of North Africa's export earnings come from the EU, with a few countries such as Tunisia and Libya sending over 75% of total exports to European counties. Thus, a slower-than-expected European recovery or double dip would have significant negative impact on these countries.

The second set of countries with high trade risk exposure to Europe is the CFA Zone countries. The countries in this largely West Africa Common Monetary Zone have a significant linkage with European markets, which is a destination to over 36% of the Zone's total export. While the risk of falling demand from Europe is a cause for concern to many, some are of the view that the 14-country CFA Zone may in fact gain from Europe's debt crisis, due to the currency peg to a weakening euro. This may actually make CFA Zone exports to the rest of the world more competitive, especially dollar-based exports – crude oil, cocoa, coffee and groundnuts. So far, the CFA franc has depreciated against the US dollar by about 17% since the end of 2009. The currency peg to the Euro also implies that most of the CFA Zone countries have their reserves in Euro, which could depreciate in real terms, in terms of months of import cover. In fact, the currency peg actually requires that more than 80% of the foreign reserves of these African countries are deposited in the "operations accounts" controlled by the French Treasury (Busch, G. K., 2008).

[2] The 2009 trade collapse accompanying the global financial and economic crisis hit Africa particularly hard (Kandiero and Ndikumana, 2009).

*"Ghana's primary export, gold, could continue to benefit from increasing prices as risk averse investors turn to gold as a substitute."*




## *2.2 National and sector disparities*

As depicted in Figure 2, exports destined for the EU in 2008 represented over 50% of total export earnings in 15 countries[3]. These countries also have substantial trade risks from Europe should the current turmoil lead to a significant fall in demand. Most of the remaining countries have limited exposure to trade risk from Europe, especially Zambia, Burkina Faso, Angola, Togo, Djibouti, Benin, Republic of Congo, Chad, Guinea-Bissau, Sudan, Somalia, whose exports to the EU accounts for less than 20% of total export earnings.

Besides regional and country disparities, recession in Europe could have substantial implications for the sectoral composition of African exports. For instances, the EU is the primary market of the Kenyan horticulture, which brought nearly USD 1 billion in 2009, and is a major customer of South Africa's automotive industry.

These sectors would face declines in sales if cuts in expenditures by European governments and households are realized. Crude oil exporting countries such as Equatorial Guinea, Angola and Nigeria may be substantially affected by a drop in demand for commodities and crude petroleum from Europe.

In contrast, Ghana's primary export, gold, could continue to benefit from increasing prices as risk averse investors turn to gold as a substitute. The tourism sector is also likely to be affected by the European crisis, particularly in Cape Verde and Mauritius, where tourism receipts account for more than 15% of GDP in 2008. In Mauritius, European tourists accounted for about 67% of total tourist arrivals in 2009.

*"The tourism sector is also likely to be affected by the European crisis, particularly in Cape Verde and Mauritius, where tourism receipts account for more than 15% of GDP in 2008."*

[3]Tunisia, Sao Tome and Principe, Cape Verde, Libya, Mauritius, Cameroon, Seychelles, Morocco, Cote d'Ivoire, Madagascar, Sierra Leone, Comoros, Uganda, Burundi and Mozambique.

**Figure 2: Africa's exports to the EU by countries (% of total exports in 2008)**

Somalia
Guinea-Bissau
Congo, Rep.
Djibouti
Angola
Zambia
Zimbabwe
Swaziland
Nigeria
Eritrea
Rwanda
Liberia
South Africa
Kenya
Equatorial Guinea
Central African...
Mauritania
Algeria
Ethiopia
Mozambique
Uganda
Sierra Leone
Cote d'Ivoire
Seychelles
Mauritius
Cape Verde
Tunisia

0% 20% 40% 60% 80%

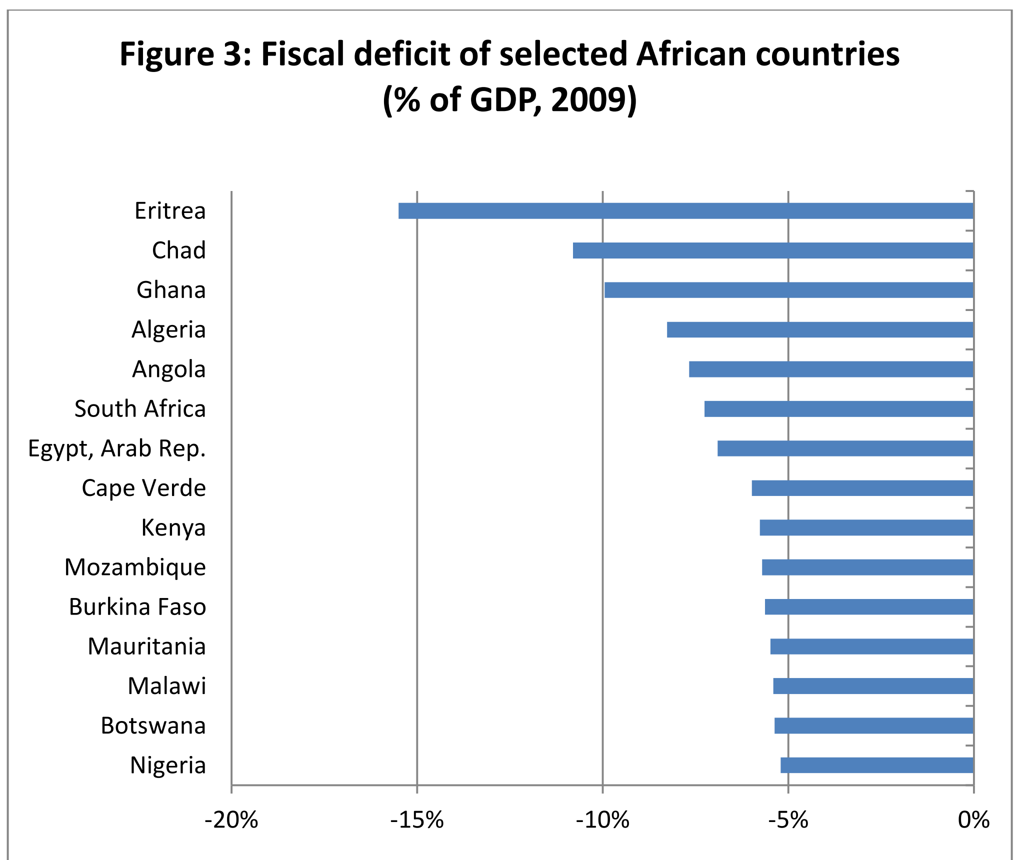
*"Declines in demand for African exports from Europe may adversely affect tax revenues..."*

## 3. Sovereign Risks

The second risk that African countries could face as a result of the European debt crisis is sovereign risk, which may arise from declines in tax revenue and ODA. There would also be a potential for increased costs of borrowing as a result of changes in sovereign risk premiums. In particular, countries with high fiscal deficits have a relatively high exposure to the risk of re-pricing of sovereign risk.

### *3.1 Potential reduction in tax revenue*

Declines in demand for African exports from Europe may adversely affect tax revenues, especially through trade and resource-related tax revenues, which could make it difficult for countries to maintain the planned levels of public expenditures including long-term infrastructure investment. In particular, countries with high fiscal deficits count among the most vulnerable to these fiscal risks. Notable among these are 15 African countries, including Eritrea, Chad, Ghana, Algeria and Angola, whose fiscal deficits were recorded at more than 5% of GDP in 2009 (Figure 3).



*"On the average, resource-related tax revenues as a share of GDP nearly tripled in Africa between the late 1990s and the start of the financial crisis before retreating back to around 15% of GDP."*

The decline in revenues could also be significant, especially among oil and mineral resource exporters. Resource-related tax revenues remain the most important financial source for several governments, accounting for as high as 66% of GDP in Libya and 39% in Angola in 2007. On the average, resource-related tax revenues as a share of GDP nearly tripled in Africa between the late 1990s and the start of the financial crisis before retreating back to around 15% of GDP.

### 3.2 Potential contraction in ODA

Should the European debt crisis continue to deepen, European governments would be increasingly forced to slash spending, which would lead to declines in aid to developing countries including Africa. For instances, Germany plans to trim Euro 81.6 billion in federal spending between 2011 and 2014 and Greece, Spain, Portugal, Ireland and Italy have all announced austerity measures.

These measures would adversely affect Africa, given the continent's relatively high dependency on the EU for ODA.

ODA inflows from the EU represent over 80% of total ODA in four countries (Algeria, Mauritius, Tunisia and Morocco), over 50% in 23 African countries, and at least 20% of total ODA inflows to all African countries (Annex 1). Declines in aid already started to increase the financial burden on some African countries. For instance, Tanzania's 2010/11 budget projects a decline in foreign aid and loans at 28% of the total budget compared with 33% in 2009/10. Uganda expects budget support grants and loans to drop to 790 billion shillings (USD 345 million) in 2010/11, from 1.06 trillion shillings in 2009/10.

*"… the European debt crisis may create opportunities in African emerging-markets…"*

### 3.3 Increased costs of borrowing

This type of risk impacts most directly the emerging market countries, such as South Africa and Egypt. These countries have also experienced reduced portfolio flows due to the reduced risk appetite of investors.

Moreover, most frontier markets such as Kenya, Uganda, Tanzania and Nigeria, which postponed the launch of sovereign bonds amid the global financial crisis, decided to postpone it further. Those that still plan to issue bonds, such as Ghana could face significantly higher costs.

The shock from such turmoil in global bond markets would be concentrated in countries with weak fiscal balances and high indebtedness. This is so especially for external indebtedness which gives a measure of exposure to volatilities of debt-service costs, which could also arise from changes in exchange and interest rates. Among the most vulnerable countries to these risks are Liberia, Guinea-Bissau, Zimbabwe, Seychelles and DR Congo, which have external debts of over 100% of GDP (Annex 2).

On the other hand, the European debt crisis may create opportunities in African emerging-markets, as the situation could lead investors to undertake portfolio reallocation from advanced country bonds into attractive emerging-market bonds.

In this context, Bloomberg in June 2010 reported that Ghana's Eurobonds have surged 93% since last November, and may continue to rise given the country's increasingly attractive fiscal position, due in part to the imminent production of oil.

*"The risk remains that the contagion of the European banking crisis could spread to African banking sector."*

## 4. Liquidity Risk

Central to European banking crisis is that Portugal, Ireland, Greece and Spain together owe hundreds of billions in Euros, mainly to banks in Europe. According to the BIS (Bank for International Settlements), France and Switzerland are most exposed to Greece's debt, at Euro 65 billion each - about twice as much as Germany. The risk remains that the contagion of the European banking crisis could spread to African banking sector.

### *4.1 Dominance of Foreign Banks*

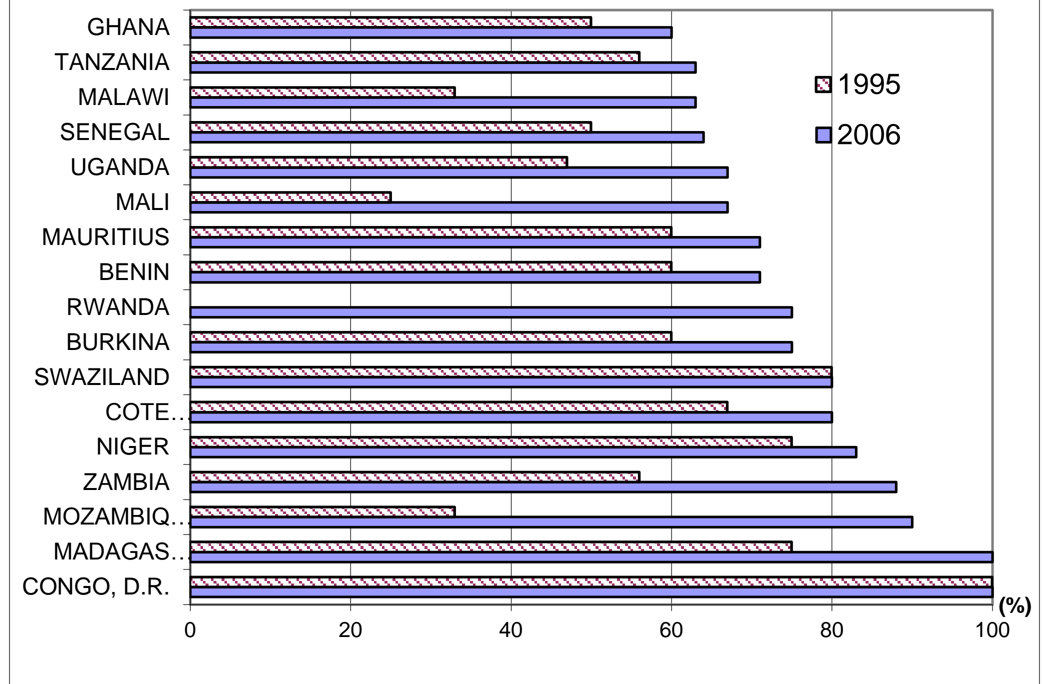
The impact of European debt and banking crisis, especially on African private sector could be worsened by the tightening of credit markets due to a shortage of bank liquidity as well as a rise in uncertainty. African banks would therefore have difficulties securing lines of credit on international markets. The impacts will vary with the degree of financial integration, such as foreign bank presence, which is a potential channel of contagion of financial distress.

Foreign bank assets represent over 70% of total bank assets in 7 countries (Annex 3), and over 70% of banks in 11 African countries are foreign (Figure 4), including 4 CFA countries (Benin, Burkina Faso, Côte d'Ivoire and Niger).

### *4.2 Other financial inflows*

The impacts of European debt crisis could also be transmitted in the continent through Foreign Direct Investment (FDI). If European banks, which are the major players in the project-finance market face liquidity shortage and start reducing their exposure to emerging countries, Africa will be affected. In addition, remittances, which have become an important source of external financing for African countries, would be affected. A recession in Europe will therefore lead to a slowdown in remittances as demand for unskilled labor declines.

*"A recession in Europe will therefore lead to a slowdown in remittances to Africa as demand for unskilled labor declines"*



*"A contraction in ODA from European countries could pose tough challenges to African governments in managing public finance…"*

*"While Africa's growth prospects remain sound, risks of the continent's exposure to the European crisis need to closely monitored and well understood, especially with regards to export and tourism receipts and financial flows."*

## 5. Impacts on macroeconomic perspective

While so far contained, the European debt crisis has a potential to negatively impact Africa's export and tourism revenues, which would lead to deteriorating current account balances that could impair the growth prospects of the continent. Contraction in demand for crude oil and other commodities could reduce jobs in mining and other sectors, with severe social consequences.

A contraction in ODA from European countries could pose tough challenges to African governments in managing public finance, especially in mobilizing resources for expanding infrastructure investments and strengthening social protection. The situation could be worsened if tax revenues substantially decrease alongside declines in exports, exacerbated by potential tightening of government borrowings from foreign markets.
In this worst case scenario, the continent's medium- to long-term growth prospects could be undermined by decreases in investments, which could weaken competitiveness of African economies in the long-term.

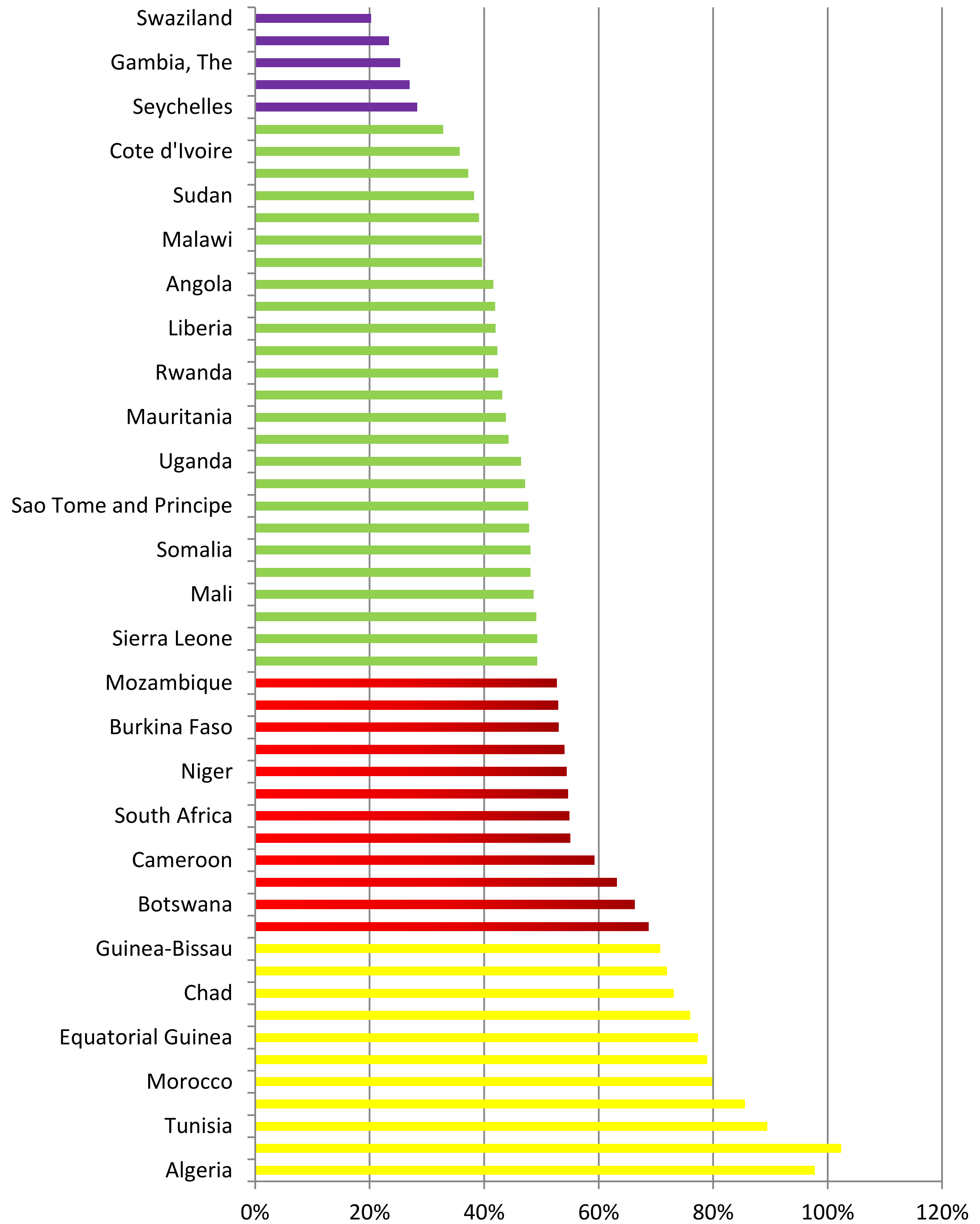
## 6. Conclusions

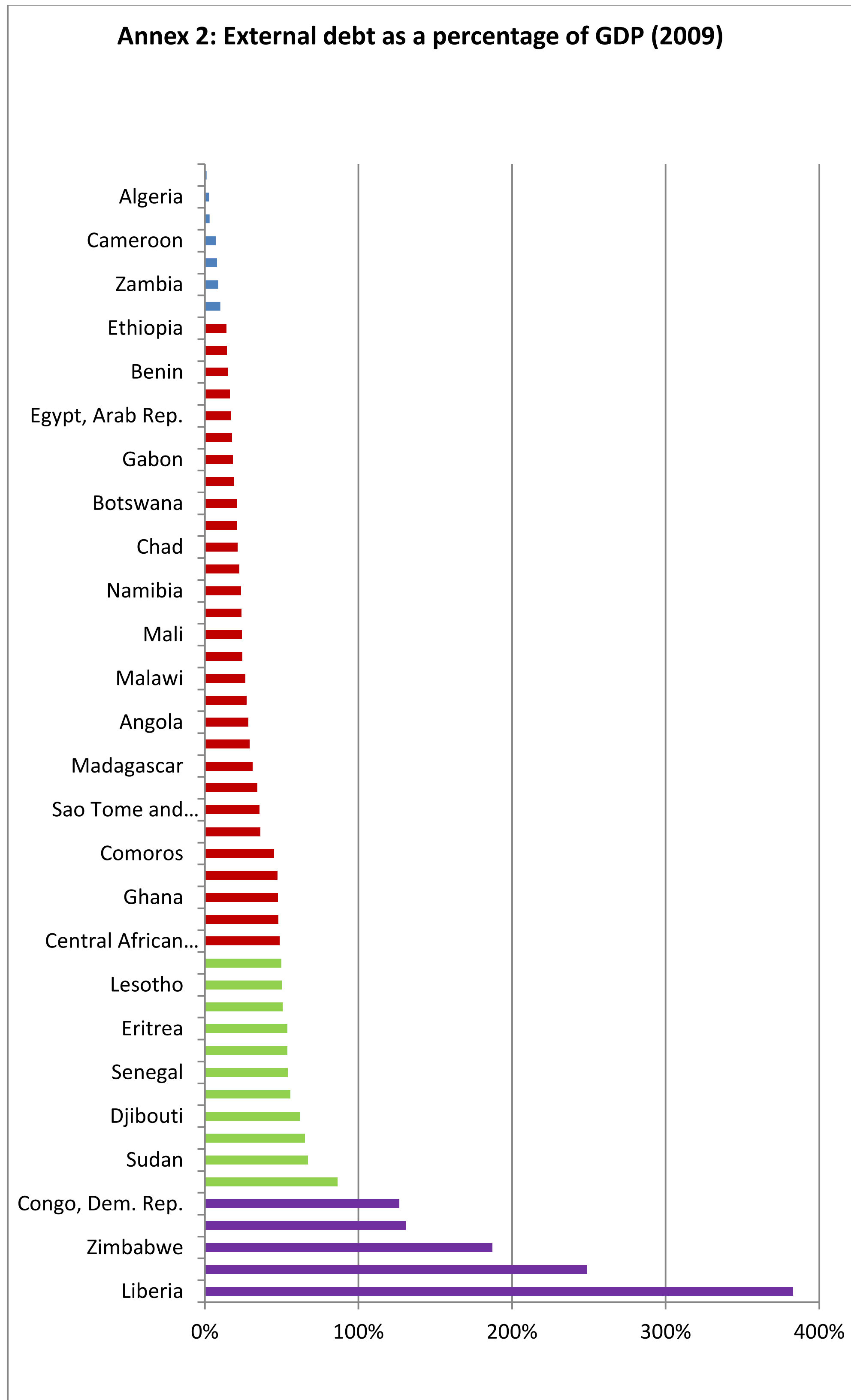
While Africa's growth prospects remain sound, risks of the continent's exposure to the European crisis need to closely monitored and well understood, especially with regards to export and tourism receipts and financial flows. It is clear that such potential impacts would vary across the continent, with North Africa being the most vulnerable to any fall in demand from the EU.

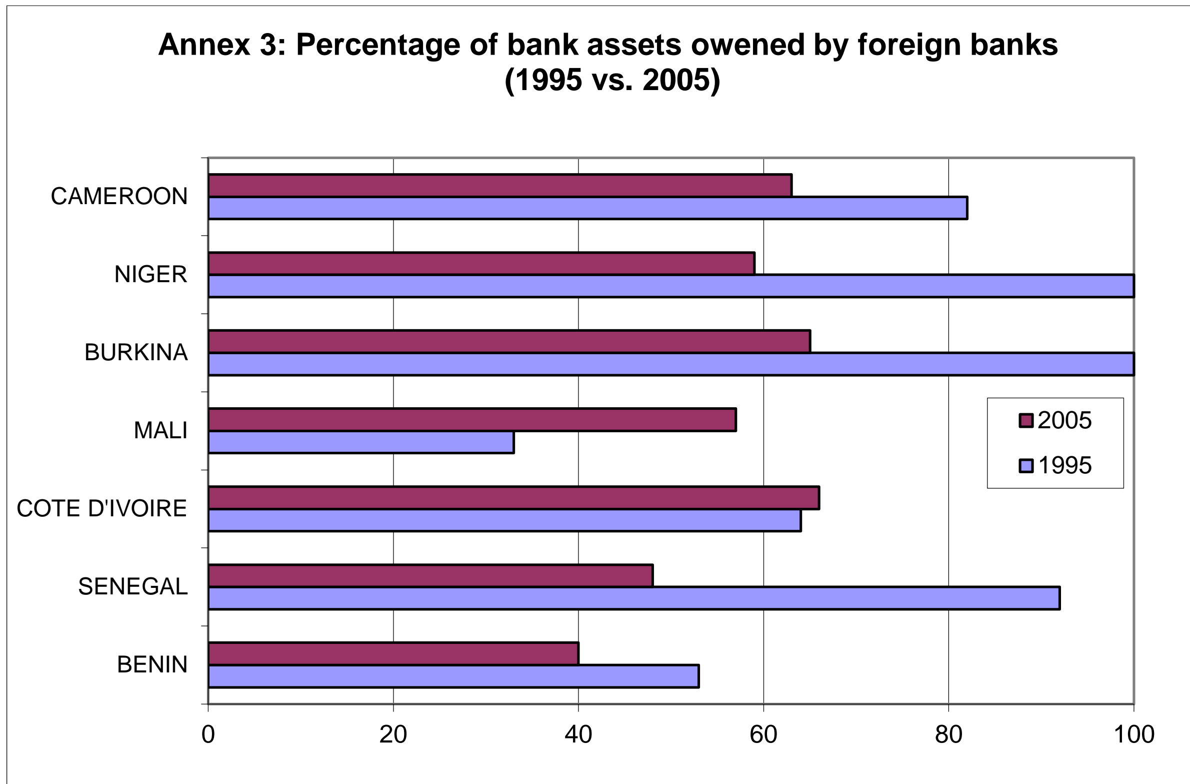
Even though fiscal risks, including declines tax revenues and contraction of ODA from the EU and re-pricing of sovereign borrowing risk, are identified and discussed, there is no clear evidence about whether they would come to bear and if so to what extent. The exposure of Africa's banking sector is real, due to the heavy presence of foreign banks, which needs to be closely watched from the perspective of liquidity and rising uncertainty from parent banks in Europe.

The global financial crisis has already triggered rethinking of development models that African countries have chosen in the past, with a renewed interest in domestic and regional drivers of growth (Brixiova, Kamara, and Ndikumana, 2010). The exposure to risks from the European debt crisis and more recently also heightened risks of slower US recovery further underscore the need for African countries to diversify into other regions such as the Middle East and Asia for trade and financial services, as well as other financial resource flows.Measures to restore or maintain fiscal soundness, which is the necessary precondition for macroeconomic stability at a time of global uncertainty, need to be prioritized. Going forward, the global financial crisis and the recent European turmoil also highlight the importance of prudent management of capital flows as Africa financial markets develop, to prevent boom-bust cycles experienced by other regions, such as emerging Europe during this global crisis and Latin America in the past.

# ANNEXES




Annex 2: External debt as a percentage of GDP (2009)
Algeria
Cameroon
Zambia
Ethiopia
Benin
Egypt, Arab Rep.
Gabon
Botswana
Chad
Namibia
Mali
Malawi
Angola
Madagascar
Sao Tome and...
Comoros
Ghana
Central African...
Lesotho
Eritrea
Senegal
Djibouti
Sudan
Congo, Dem. Rep.
Zimbabwe
Liberia
0%
100%
200%
300%
400%




**Annex 4: Real GDP growth (proj.)**

| | Update July 2010 | | April 2010 | | Difference | |
|---|---|---|---|---|---|---|
| | 2010 | 2011 | 2010 | 2011 | 2010 | 2011 |
| | | | | | | (percent) |
| **Sub-Saharan Africa** | **5.0** | **5.9** | **4.7** | **5.9** | **0.3** | **0.0** |
| World | 4.6 | 4.3 | 4.2 | 4.3 | 0.4 | 0.0 |
| Euro area | 1.0 | 1.3 | 1.0 | 1.5 | 0.0 | -0.2 |
| EMEs/Dev. Countries | 6.8 | 6.4 | 6.3 | 6.5 | 0.5 | -0.1 |

Source: IMF WEO.

## Annex 5: Africa's Exposure to the European Debt Crisis

| Country | Export (as % of GDP, 2009) | ODA (as % of total revenues, 2008) | Remittances to FDI (%, 2008) | Exports to China, India and Middle East (as % of total export) |
|---|---|---|---|---|
| Algeria | 40.01 | 0.45 | 117.16 | 2.65 |
| Angola | 58.35 | 0.86 | | 32.72 |
| Benin | 17.88 | 45.31 | 224.90 | 28.39 |
| Botswana | 34.54 | 14.40 | 29.92 | 8.54 |
| Burkina Faso | 9.95 | 70.98 | 36.47 | 18.01 |
| Burundi | 11.96 | 151.62 | 2.20 | 5.90 |
| Cameroun | 19.47 | 10.65 | 64.47 | 6.04 |
| Cape verde | 13.74 | 42.14 | 66.42 | 0.00 |
| Central African Republic | 9.51 | 85.48 | | 10.40 |
| Chad | 62.60 | 17.91 | | 3.37 |
| Comoros | 15.79 | 29.87 | 148.94 | 9.23 |
| Congo, Dem. Rep. | 49.84 | 69.96 | 0.00 | 45.14 |
| Congo, Rep. | 75.56 | 8.43 | 0.57 | 33.44 |
| Cote d'Ivoire | 37.15 | 13.01 | 60.99 | 2.54 |
| Djibouti | 35.93 | 29.39 | 12.17 | 10.35 |
| Egypt, Arab Rep. | 25.04 | 3.31 | 99.80 | 21.05 |
| Equatorial Guinea | 90.36 | 0.48 | | 16.16 |
| Eritrea | 3.34 | 43.28 | | 40.92 |
| Ethiopia | 11.47 | 77.47 | 386.87 | 17.71 |
| Gabon | 58.98 | 1.18 | 54.27 | 18.69 |
| Gambia, The | 47.17 | 55.62 | 102.33 | 43.05 |
| Ghana | 42.02 | 28.27 | 6.04 | 7.47 |
| Guinea | 27.67 | 43.54 | 11.17 | 7.63 |
| Guinea-Bissau | 31.36 | 90.30 | 200.27 | 75.40 |
| Kenya | 25.58 | 18.26 | 1750.07 | 7.39 |
| Lesotho | 54.31 | 12.71 | 222.91 | 0.47 |
| Liberia | 38.65 | 584.31 | 511.74 | 4.14 |
| Libya | 63.93 | 0.10 | 0.39 | 5.67 |
| Madagascar | 26.57 | 53.53 | 0.74 | 6.94 |
| Malawi | 25.24 | 71.04 | 3.47 | 11.08 |
| Mali | 26.34 | 58.32 | 167.21 | 33.66 |
| Mauritania | 41.75 | 40.04 | 1.94 | 40.64 |
| Mauritius | 51.12 | 5.71 | 56.17 | 5.82 |
| Morocco | 30.27 | 4.64 | 281.90 | 8.33 |
| Mozambique | 25.03 | 78.52 | 16.93 | 7.08 |
| Namibia | 53.12 | 8.13 | 2.26 | 15.41 |
| Niger | 18.40 | 37.82 | 53.16 | 0.16 |
| Nigeria | 39.91 | 1.90 | 49.21 | 0.89 |
| Rwanda | 6.37 | 77.01 | 49.64 | 9.78 |
| Sao Tome and Principe | 10.97 | 55.08 | 6.25 | 0.42 |
| Senegal | 25.90 | 36.74 | 141.71 | 7.95 |
| Seychelles | 104.98 | 3.58 | 3.29 | 2.03 |
| Sierra Leone | 13.01 | 118.01 | 506.76 | 5.36 |
| Somalia | | | | 89.26 |
| South Africa | 31.34 | 1.55 | 9.43 | 12.82 |
| Sudan | 17.15 | 18.86 | 71.14 | 60.61 |
| Swaziland | 57.22 | 6.31 | 957.50 | 4.94 |
| Tanzania | 23.48 | 49.32 | 22.11 | 25.16 |
| Togo | 28.57 | 59.17 | 8.29 | 7.85 |
| Tunisia | 57.37 | 4.44 | 237.50 | 9.60 |
| Uganda | 19.12 | 64.82 | 117.61 | 15.37 |
| Zambia | 34.97 | 33.10 | 6.32 | 19.95 |
| Zimbabwe | 50.92 | 420.37 | | 6.95 |

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