Macroeconomic Policy and Financing for Africa's Economic transformation under Agenda 2063

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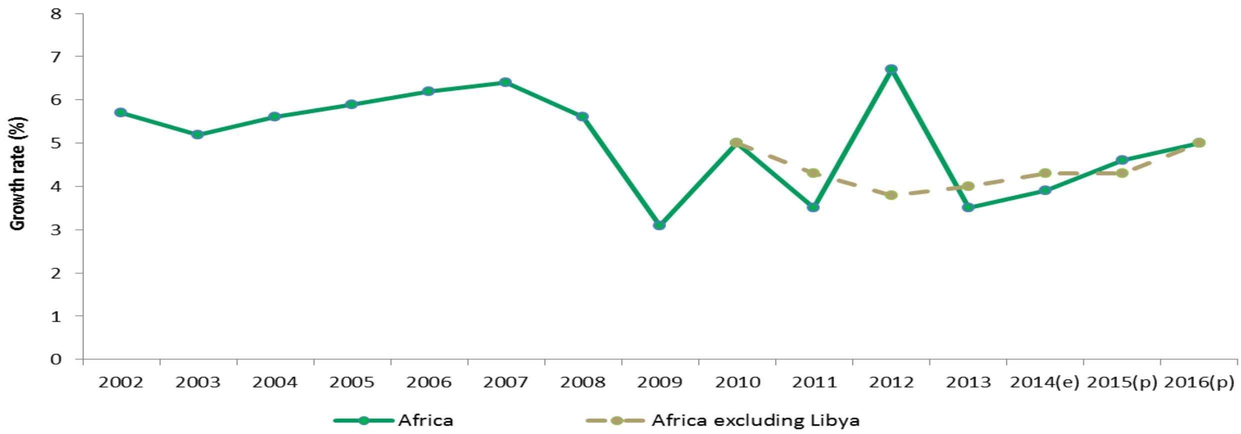
I. Introduction

1. Over the 2000s decade, Africa's impressive economic performance saw its average gross domestic product (GDP) growth more than double form just above 2% during the 1980s and 1990s to above 5% between 2001 and 2014. This performance was higher than general world growth, just above 4%, and higher than Latin America and Caribbean, just above 3%. But it was lower than for emerging and developing Asia at about 8%.
2. Despite this remarkable economic performance, assessment of the quality of Africa's growth shows that it has not been inclusive and broad-based enough to have a significant impact on widespread inequalities, poverty levels and economic structures. In this perspective, one of the daunting challenges facing African policy makers is that of economic and social planning to catalyze inclusiveness and economic transformation.
3. Prior to 2013, Africa's growth prospects were strong, bolstered by relatively high commodity prices; increasing domestic demand; easing infrastructural constraints; ever-tighter trade and investment ties with emerging economies; and improving global economic and regional business environments.
4. Since 2014, Africa's growth has been held back by the hesitant global economy and political and social factors. Export markets, notably in Europe but also in China, remained weaker than expected since 2013. The unforeseen drop of oil and other commodity prices reduced revenues for Africa's commodity exporters and the Ebola virus outbreak killed thousands at a high economic cost. Furthermore, in some countries, improvements in the business environment have stalled or even reversed while in many others framework conditions for doing business made new progress.

Figure 1: Africa's economic growth, 2002-2016



Source: Statistics Department, African Development Bank

5. As a result of these adverse factors, growth has remained strong in some countries and moderate in others. Africa's overall GDP grew 3.9% in 2014, up from 3.5% the previous year. It should accelerate to 4.5% in 2015 and 5% in 2016, approaching levels seen before the 2008/09 global financial crisis. In sub-Saharan Africa growth was 5.2% in 2014. It is projected to weaken to 4.6% in 2015 and to strengthen again to 5.4% in 2016. Relatively low growth in South Africa is reducing overall growth in sub-Saharan Africa by about three-quarters of a percentage point. Excluding South Africa, sub-Saharan Africa's economy will grow by 5.2% in 2015 and 6.2% in 2016. This projection depends on the world economy improving, oil prices gradually recovering and the Ebola epidemic in West Africa being contained.

If the virus spreads, if commodity prices fall further or if political and security conflicts become more serious, Africa's growth would be lower than projected. The fragility of export markets, notably in Europe, and of global financial markets also remains a risk.

A- Impact of declining commodity prices on Africa's macroeconomic stability

6. Africa is endowed with abundant natural resources in the world, many of which are the sources of its recent economic performance. These resources include not just minerals and oil, but also bountiful possibilities for clean energy.

7. The decline of commodity prices had started in 2013 due to weak demand from industrialized countries and emerging countries such as China. Some commodity prices are now 40-60% down from their peak level, slightly lower than before the commodity price boom started. Oil prices have lost more than half the price of over USD 100 a barrel in mid-2014 to go below USD 50 at the beginning of 2016. The higher supply of oil with the appreciation of the US dollar met with lower demand due to subdued global growth.

8. The lower oil price affects economies through a number of channels. First it puts downward pressure on other fuel prices, particularly natural gas. The lower prices reduce costs for heating, transport and energy intensive sectors including agriculture. As a result household purchasing power increases, and – if spent on domestic products – GDP increases. Model simulations indicate that the fall in oil prices – if sustained – could have a significant positive impact on world GDP. African countries benefit from lower oil prices, which ease inflation, increases real incomes and strengthen export markets. However, Africa's oil exporters have to cope with lower government revenues. As oil profits decline, investment and exploration could be cut which would reduce production in the longer-term. The oil price decline has also weakened the currencies of oil-exporting countries, putting upward pressure on inflation and reducing countries' capacity to borrow. Monetary authorities in countries with strong foreign reserves can mitigate currency depreciation by intervening in exchange markets, although there are limits as foreign reserves are depleted.

9. Given these various transmission channels from oil prices to economic activity it is difficult to quantify the overall impact of the lower oil price on economic growth in Africa's oil-exporting countries. Model scenarios produced by the African Development Bank suggest that a permanent oil price decline of 25% causes GDP growth shortfalls of between 0.6% and 2.7% for Africa's main oil exporters. As the AEO 2015 projections are based on a larger oil price decline, the impact could be more significant. However, such simulations illustrate long-term effects on growth using general *ceteris paribus* assumptions. So far, most African oil-producing countries have been relatively resilient to the price decline and achieved relatively high growth in 2014. Oil production often increased and growth was also boosted by non-oil sectors. The main adverse effect has so far been on government revenues. If oil prices remain low this will reduce growth in coming years, as governments will have to cut spending.

10. Prices of non-oil commodities such as copper and gold and the export prices of some agricultural products such as cotton also weakened. While lower prices are affecting revenues in the exporting countries, most of them recorded relatively high growth in 2014 and prospects for 2015 remain favorable. The reason for this

resilience is that agriculture and mining production increased and that other sectors, notably services, boosted growth. As a result, in many countries growth remained relatively strong, such as in Benin, an exporter of cotton, in Burkina Faso, a producer of gold and cotton, and in Zambia, a main producer of copper.

B. Implications for the monetary policy towards strong economic growth

11. With higher commodity prices and high trend growth during the past decade and a remarkable resilience to global shocks, Africa has also become more attractive for foreign investors. This has enabled more and more African countries to tap international markets by issuing bonds denominated in foreign currencies. With the recent decline of the commodity prices since early 2014, African countries are managing to improve monetary policy transmission mechanisms so that monetary policy can better combat inflation and stimulate their economies. To this end, countries have taken measures to improve links between monetary policy, financial markets and the real sectors. Africa's monetary and exchange rate policies continued in 2014 to be geared toward maintaining or achieving price stability. In countries where inflationary pressures have eased and exchange rates have remained relatively stable, policy interest rates have been reduced to stimulate growth. Central banks in countries where exchange rates came under pressure responded by tightening policies. Central banks also adopted a more restrictive policy stance, which should ease inflation in 2015/16. But risks remain if exchange rate pressures continue and fiscal deficits remain high.

B.1. Impact on fiscal positions and current accounts

12. Falling commodity prices have had a significant impact on government budgets in resource-rich countries. More solid public finances in recent years have helped many African countries to improve macroeconomic stability and make them more resilient to external shocks. But the commodity price decline has shown again how vulnerable budgets are in some countries to those shocks. The global recession in 2008/09 caused Africa's average fiscal balance to deteriorate from a surplus to a deficit of around 5% of GDP. The average deficit gradually declined to around 3%, helped by the economic recovery and prudent policies. But in 2014 deficits started to increase again to an average above 4% and they are expected to rise to the levels of the global recession. The main reason is the deterioration of budget balances in oil-exporting countries. Lower oil prices have caused a sharp fall in government revenues in these countries.

B.2. Impact on debt sustainability

13. Given the increased budgetary pressures, keeping debt at sustainable levels remains a priority in many countries. According to a debt sustainability analysis by the World Bank and the International Monetary Fund, two-thirds of countries assessed since 2012 are at a low or moderate risk of debt distress and around a third are a low risk. Despite the debt risks, governments also face spending pressures, in particular to reduce the large bottlenecks in economic and social infrastructure. With the limited space to increase spending, it is vital to make spending more geared to boost growth and human development. This can be done by improving the composition of spending and by making individual spending programmes more effective.

B.3. Impact on current accounts

14. The fall in oil prices has also adversely affected current accounts for exporting countries. Most of them will record current account deficits in 2015 after having achieved surpluses in recent years. Among the large oil exporters, only Libya and Nigeria are expected to record current account surpluses. Botswana will continue to run significant current account surpluses. Oil-importing countries will on average register current account deficits of 7-8% of GDP, and this despite relief from lower international oil and food prices. Lower export prices and export volumes outweigh the effect of lower import prices on the current account. Some countries saw import prices pushed up through currency depreciation.

B.4. Bridging Africa's financing gap

15. Scaling up both domestic and external financial resources is central to Africa's economic and social transformation under Agenda 2063. Despite improved recent economic growth, domestic savings have consistently fallen short of the continent's investment needs (see *ERA 2012* and *ERA 2013*), whereas ODA for example is expected to continue to decline in the near future. Africa thus needs to focus on more innovative approaches to mobilize domestic resources and external private capital.

C. Sources of finance to support Africa's growth and transformation

16. The financing of Africa's economic transformation has to be increasingly based on domestic public and private resources (ECA and AUC, 2013) and for that to happen Africa needs to explore new approaches to raising capital to meet its development agenda. In addition to traditional domestic sources of finance such as taxes and levies and private savings (extensively discussed in *ERA 2012* and *ERA 2013*), Africa needs to adopt a broader and more diversified set of instruments and mechanisms as well as financial products, and an enabling environment for mobilizing resources from non-traditional sources. Fresh approaches to development financing revolve around sovereign wealth funds (SWFs), pension funds, insurance savings, private equity funds, diaspora and sovereign bonds, remittances, public–private partnerships (PPPs) — as well as the curtailment of illicit financial flows.

C.1. Sovereign Wealth Funds

17. The availability of long-term financing is a particular problem for Africa. SWFs are some of the non-traditional forms of savings that could fund development projects or, in some cases, be used as savings for future generations. Only 10 African countries have SWFs, including the recently established Nigerian SWF. Sovereign wealth enterprises and strategic development sovereign wealth funds could contribute to the financing of national and cross-border projects in the context of the Programme for Infrastructure (PIDA) and the Comprehensive Africa Agriculture Development Programme (CAADP) under the African Union Commission (AUC) and the New Partnership for Africa's Development (NEPAD).

C.2. Pension Funds

18. Pension funds are a potentially reliable source of financing for development projects that generally struggle to attract long-term financing. The pension market in Africa is underdeveloped (apart from Botswana, Kenya, Mauritius and South Africa) and is dominated by state-owned schemes. Only 7 per cent of such schemes are privately managed, against 16 per cent worldwide (Beck et al., 2011). Still, these new markets highlight the growing sources of new capital for the continent's development (ECA and NPCA, 2013). Yet, owing to the infancy of capital market development and lack of regulation in Africa, channelling pension funds into productive investment is not risk free. Improvements in the regulatory and investment framework for domestic and foreign capital are a necessary condition for unlocking productive investments.

C.3. Insurance Sector

19. Long-term funds can also be channelled into capital markets through the insurance sector. Insurance companies across Africa are generally small, selling shorter-term non-life products rather than longer-term life and savings products. Nevertheless, the sector has the potential to provide capital for longer-term projects given the fact that insurance growth on the continent outstripped economic growth between 2000 and 2011 when total premiums reached US$8.8 billion (Karl, 2012). Moreover, insurance premiums could exceed US$16 billion by 2017 and US$25 billion by 2022, particularly if the middle class grows rapidly and innovative micro-insurance products emerge to serve low-income individuals and businesses (Karl, 2012).

C.4. Private Equity

20. Private equity has grown strongly since 2007 with the market valued at between US$25billion to US$30billion in 2013 (NEPAD, 2013), with countries such as Kenya, Nigeria and South Africa being the major beneficiaries. Although FDI through private equity has been rising in Africa, the continent still only attracts a small share of global equity funds and they are relatively small and concentrated in a few sectors and countries, such as South Africa (53 per cent), Egypt, Mauritius and Morocco (8 per cent) and Nigeria (5 per cent), and a few sectors in 2011 (UNCTAD, 2013).
21. Trends in private equity demonstrate the persistent attractiveness of extractive industries, infrastructure and energy, where extractive industries alone account for nearly 46 per cent of all cross-border mergers and acquisitions by private equity firms in Africa over the since 2009 (UNCTAD, 2013). This signifies the potential role that private equity could play in Africa's transformation, but African countries need to identify constraints to private equity investment and to design appropriate regulatory, tax and other policy measures to boost private equity investments.

C.5. Diaspora Bonds

22. Approaches to mobilizing external sources include diaspora bonds, remittances and sovereign bonds such as Eurobonds. It is estimated that around 140 million Africans in the diaspora are saving up to US$53 billion in the destination countries every year (AfDB, 2010). Ethiopia was the first African country to issue a diaspora bond to finance its Renaissance Dam project in 2011. Cape Verde, Ghana and

Kenya are considering similar bonds. However, for such bonds to be successful, institutional mechanisms are needed to generate the expected revenues for a particular development project, as is an institutionalized role for the private sector.

C.6. Accessing International Markets

23. A few African countries have met part of their foreign currency needs by borrowing on international financial markets by selling Eurobonds, usually denominated in dollars or euros. Some of them have sold bonds at low interest rates owing to rapid growth, better economic policies, lower global interest rates and continued economic stress in many advanced economies (Sy, 2013). By February 2013, 10 African economies[1] had collectively raised US$8.1 billion from their maiden sovereign-bond issues (Stiglitz and Hamid, 2013). East African countries such as Kenya, Tanzania and Uganda were expected to issue Eurobonds in the near future (Sy, 2013).
24. However, African countries need to ensure that their sovereign-bond issues remain sound by putting in place a forward-looking and comprehensive debt management structure, mainly because such bonds entail significantly higher borrowing costs than concessionary debt. They need not only to invest the proceeds in the right type of high-return projects, but also to ensure that they do not have to borrow further to service their debt (Sy, 2013).

6.7. Public Private Partnerships (PPPs)

25. PPPs too remain largely unexploited. Broadly, PPPs are risk-sharing mechanisms in which a legal contract assigns public service delivery responsibilities to a private entity. Whereas private sector participation in infrastructure investment in developing countries increased from about US$30 billion in 1995 to US$140 billion in 2008/9, engaging the private sector in public service delivery and infrastructure development remains limited in Africa (World Bank, 2011; ECA, 2011). However, encouraging signs of PPP are emerging in productive sectors such as the agriculture corridor in Tanzania.
26. While identifying and preparing “bankable” projects for PPP is essential, some infrastructure projects in Africa are rendered less attractive by high and front-loaded costs, the presence of redistributive factors in pricing outputs, long pay–back periods and risks, including foreign exchange risks. In such conditions, investment projects require supplementary finance to make them bankable through public cost sharing and the use of various funding mechanisms — in India and Ghana, for example, the Viability Gap Scheme and Financial Intermediary Loans fill capital-investment funding gaps.

C.8. Tracking and recovering Illicit Financial Flows

27. Beyond the challenge of raising finance it is also important not to lose what Africa already has by stemming illicit financial flows (IFFs) from the continent. IFFs have been a huge drain on Africa, not only in denying the continent access to funds for productive investments but also through undermining economic governance. Africa should address illicit flows from the region as much as it tries to mobilize domestic

[1] Angola, Côte d'Ivoire, DRC, Gabon, Ghana, Namibia, Nigeria, Senegal, South Africa and Zambia

and external resources. Over the last 50 years, Africa is estimated to have lost in excess of $1 trillion in illicit financial flows (IFFs) (Kar and Cartwright-Smith 2010; Kar and Leblanc 2013). This sum is roughly equivalent to all of the official development assistance received by Africa during the same timeframe. Currently, Africa is estimated to be losing more than $50 billion annually in IFFs. But these estimates may well fall short of reality because accurate data do not exist for all African countries, and these estimates often exclude some forms of IFFs that by nature are secret and cannot be properly estimated, such as proceeds of bribery and trafficking of drugs, people and firearms.

Conclusion

D. Policy recommendations for macroeconomic resilience and stability

28. Achieving Agenda 2063, the economic transformation and development plan for the next fifty years, Africa need to design and implement development plans that foster social cohesion and catalyse structural changes. In that perspective, African countries should adopt reforms that improve and sustain its growth in the long term. These policy reforms include:

D1. Structural reforms to mitigate fiscal pressure and manage risks

29. In several cases, structural reforms can help mitigating fiscal pressures without harming growth and equity, thus providing a way to avoid difficult trade-offs. These structural reforms include promoting economic diversification through industrialization and upgrading skills to equip workers with the capabilities that are required for structural transformation. It also includes building high quality infrastructure to facilitate diversification and trade within the continent. The aim of this approach is to provide substantial revenues to African countries through their gradual integration in the Global Value Chains. These funds will also be used in areas such as financing of infrastructure or long-term care through greater reliance on private funds. Given uncertainty about future developments, structural reforms can also increase resilience of public finances to unexpected developments and exogenous shocks. Furthermore, these structural reforms should also contribute to the strengthening of African agriculture and food security through an integrated value chain approach that can improve the livelihoods and avoid the continental dependency on import of agricultural products.

D2. Improved economic policies

30. Lower inflation and stronger budgets due to more prudent fiscal policies, also helped by appropriate debt management will improve macroeconomic stability and support growth within the continent. Countries are promoting structural transformation from traditional towards more productive activities. This has helped some countries without resources, such as Ethiopia and Rwanda, to attain high annual growth of 8% or above. But structural transformation has remained limited in most countries and productivity growth is too slow and has not created enough jobs to lower poverty (AfDB et al., 2013).

D3. Building sustainable fiscal policies for stronger social contracts (fiscal reform)

31. As social cohesion and fiscal policies interact in multiple ways, there is a need for African countries to achieve fiscal legitimacy in a way that catalyse the engagement

of citizens as development agents. Fiscal legitimacy is especially relevant for the effectiveness of public policies in countries where citizens can influence policies through voting or other forms of civic participation. If ignored, low or no fiscal legitimacy can ultimately lead to outbreaks of violent social unrest (OECD, 2013). This fiscal reform should aim at contributing to the efficiency of the African Tax Administration. Economic growth should therefore be built on the firmest foundations of just, transparent and efficient governance and institutions administered by the capable state.

D4. Improving science-industry links

32. This will be done through increased efforts by research institutions and universities to reach out to industry and by promoting greater industry participation in the public research agenda. Enhancing human resource development: A Science and Technology Human Resource Development Fund to develop a pool of skilled and trained S&T workers in Africa by 2063. Entering into strategic alliances: Africa should participate in regional, continental and multilateral and bilateral joint S&T activities.

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