CHAPTER 6
AFRICA'S FRAGILE STATES HIT HARD BY THE GLOBAL FINANCIAL CRISIS

When the current economic crisis broke in the summer of 2007, there was a widespread perception that Sub-Saharan Africa was going to be affected only to a limited extent, with fragile countries no exception.[1] The low integration of shallow financial systems with the European and the US capital markets appeared at first to shelter them from its worst effects. But as events continued to unfold, this perception proved wrong. Even if the wealth effects of the crisis are less pronounced than for other developing countries, Sub-Saharan Africa, especially its fragile countries, proved particularly vulnerable to trade links and to disruptions of trade finance.[2]

The reliance of Sub-Saharan African countries on international trade, and thus their exposure to shocks from abroad, have increased in the last 10 years. African economies have become more sensitive to falling international demand, especially in an unprecedented synchronisation of economic cycles, which limits the benefits from diverse trading partners. Moreover, because funds devoted to official development assistance tend to follow donor country economic cycles, despite the commitments to maintain and even increase aid, fragile Sub-Saharan African countries are likely to face a decline in aid, at least in the short to medium run. Despite repeated calls in international meetings to respect aid commitments, and even if donors do live up to their promises and keep aid as a share of GDP constant, aid could fall substantially, because of the drop in donor countries' GDP and possibly because of unfavourable exchange rate movements (such as the recent devaluation of the pound against the dollar). Remittances are also expected to decline after a long period of steady growth.

1. THE DAUNTING CHALLENGES OF THE CRISIS: BRINGING TO A HALT YEARS OF CONTINUED PROGRESS

The 2008-09 crisis ends a prolonged period of world economic growth and globalisation during which world trade grew twice as fast as world GDP. The growth of GDP started to decline in 2008, and the contraction spread to all regions. Indeed, the pattern of decline, the worst in decades, resembles the collapse in 1929-30. The current crisis undermined the drivers of the recent globalisation phase: open markets, globally integrated production chains and many more footloose international companies.

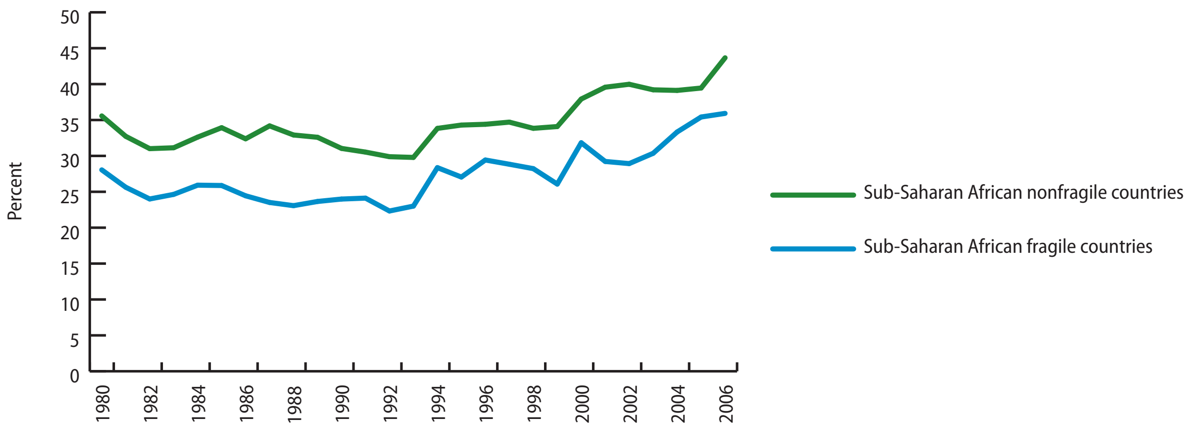
The slowdown of world trade was much sharper than that of GDP, even sharper than during the Great Depression.[3] This effect could be due to the general synchronisation of cycles among countries. It could also be traced to the larger weight of intermediate goods in trade, in turn due to the fragmentation of production – which, after stimulating rapid growth over the last 10 years, magnified the decline.

The economic and financial crisis came on top of a period of highly volatile commodity prices and exchange rates, which increased uncertainty and strengthened a vicious circle of falling trade flows and investments. It occurred when Sub-Saharan Africa had built a solid momentum for growth.[4] Before July 2008, Sub-Saharan Africa recorded strong growth, and fragile countries – whatever the definition – were no exception. The current crisis threatens to interrupt this positive trend, even though the region is more equipped to cope than in previous downturns.[5]

During the recent period of growth, Sub-Saharan Africa became more integrated with the rest of the world, as reflected in its rising (but still low) share in global exports and in GDP (figure 6.1).[6] Fragile countries, on average less integrated than other Sub-Saharan African countries, followed the same trend. The increasing international integration has exposed Sub-Saharan African fragile countries much more to disruptions in trade and to other shocks. It also had a marked effect on tax revenues (and in some countries on tax policy), with reduced receipts from trade taxes. The challenges of globalisation for resource mobilisation are exacerbated by the recent crisis, which has lowered the tax base.

1 See IDS 2008 and IMF 2008.
2 Berman and Martin 2009.
3 Eichengreen and O'Rourke 2009. The estimated elasticity of world trade to world GDP is around 2. This has supported the globalisation and is likely now to backfire.
4 Arbache and Page 2008.
5 Fosu and Naudé 2009.
6 The ratio of exports to GDP for some countries, particularly for the oil exporters in Central Africa, is probably inflated by the high prices for raw materials.

Figure 6.1: Exports rising as a share of GDP



Source: World Bank (2009c).

2. THREE "F's" (FOOD, FUEL, FINANCE) AND A FOURTH (FRAGILITY)

Food and fuel price spikes through mid-2008 put food and oil-importing Sub-Saharan African fragile countries under severe stress, pushing down their foreign exchange reserves and making it difficult to pay for imports and sustain growth. Conversely, oil-exporting countries have benefited from increased revenues, and several have been able to strengthen their foreign reserve position. However, the boom and bust contributed to output volatility, discouraging investments in long-term productive capacity.

As emphasised by IMF (2009a), most Sub-Saharan African countries have almost consecutively suffered fuel, food and financial shocks. Most recent estimates put real Sub-Saharan Africa GDP growth for 2009 at around 1.5%, down from an estimated 5.5% in October 2008. These numbers would make 2009 the first year in a decade in which most fragile Sub-Saharan African countries recorded negative growth in real GDP per capita, threatening the progress towards the Millennium Development Goals and undermining political stability.[7] Slower growth does not always threaten to reverse human development, but it produces setbacks, especially through cuts in education and health expenditures, which have serious long-term consequences.

3. THE FOUR CHANNELS OF TRANSMISSION TO FRAGILE COUNTRIES

Given the low financial development in the region and fragile countries' limited links to the global financial system, the main channels of transmission for the crisis are in the real sectors of the economy. Most Sub-Saharan African fragile countries have small domestic banking systems and thin to nonexistent equity markets. Moreover, foreign investors and sovereign wealth funds invest in just a few oil-exporting countries.

Sub-Saharan African countries are exposed to the crisis mainly through trade: the reduction in export earnings is accompanied by an adverse terms of trade effect reinforced by the excessive dependence on commodity exports of fragile Sub-Saharan African countries and the polarisation of their exports.[8] These countries are also exposed through lower migrant remittances, lower inflows of foreign direct investment (FDI) and possibly lower inflows of foreign aid.

The direct financial channels of transmission have been at work only in such countries as Kenya and Nigeria (and two important nonfragile countries, Ghana and South Africa), which have deeper and more integrated financial markets (box 6.1). Nigeria, for example, suffered stocks market falls similar to, or even greater than, those in developed countries.[9] Its Nigerian Stock Exchange-20 Index fell by 55% from July 2008 to February 2009, after a fall of 45% the previous year.[10] This decline and the corresponding lack of

7 Sub-Saharan Africa has on average a negative rate of growth of real GDP per capita (-0.6%). Fragile Sub-Saharan African countries record a positive 0.2% rate of growth, but this figure masks a high degree of heterogeneity (chapter 2).

8 Most fragile countries rely on exports of a single product. On average the three top exports account for around 90% of total exports, as emphasised in chapter 2.

9 AfDB 2009a; ODI 2009a.

10 Kasekende et al. 2009; ODI 2009a.

confidence make it even more difficult to borrow from capital markets. The repercussions of the crisis in some important destination markets for intraregional migrants – such as Nigeria, South Africa, Uganda and Zambia – have strong spillovers to neighbouring fragile countries (especially through a fall in employment opportunities for migrants and a decline in remittances).

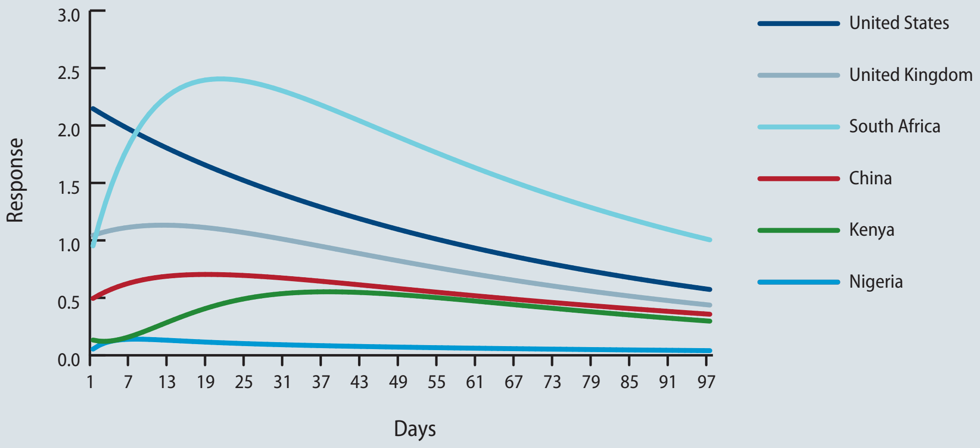
Box 6.1: African financial markets – spillovers of shocks

Since the beginning of the 1990s a number of developing countries have established stock exchanges, partly to satisfy their quest for new capital and partly to incorporate elements of market capitalism in their economies. Sub-Saharan Africa has also participated in this trend, with South Africa rising into the ranks of the leading destinations of emerging markets and with a number of regional funds specifically targeting the continent. At the behest of national governments, and with donor support, Africa has expanded its domestic stock exchanges from 6 in the late 1980s to more than 20 today, though not all are equally developed. Among fragile countries, Kenya and Nigeria have the most developed stock markets.

How did the developments of larger financial markets (China, UK and the US) affect African markets (Kenya, Nigeria and South Africa) over 2004-09? Analysing volatility of different financial markets through an econometric model, Giovannetti and Velucchi (2009) find that, on average, positive shocks in South Africa and negative shocks in China and the UK affect all markets considered. All African markets are influenced by U.S. negative shocks except Kenya, influenced only by positive shocks in the United States. South Africa affects the United States while it is influenced only by the Nigerian market. There is no evidence of a significant relationship between Kenya and Nigeria. China has strong links with African markets. Further results show that also South Africa has a key role in all African markets and that the influence of the UK and United States is weaker. China is independent of the UK and United States.

Box figure 1 graphically represents (impulse-response functions) the volatility shock propagation; on the horizontal axis, we report time (days) and, in the vertical axis, we read the volatility response. When a shock hits market *i*, the graph shows the responses on all markets; on average, market *i* response at time 0 will be higher than other markets' response. The figure shows how the collapse of Lehman Brothers propagates to all markets. On September 15, 2008 Lehman Brothers went bankrupt, and international financial markets suffered large losses. China and the UK react strongly to the US shock, while Kenya and Nigeria does not. South Africa is very US sensitive, but the effect is cumulative and the shocks reach the maximum effect after 20 days.

Box figure 1: South Africa responds to the Lehman Brothers collapse – Kenya and Nigeria do not



Note: This box uses a Multiplicative Error Model approach to describe and forecast the interactions and spillover effects among these countries (Engle, Gallo and Velucchi 2008). The model exploits the dynamics of the expected volatility of one market, including interactions with the past squared returns of the other markets; the impulse response function is used to suggest a buildup in the spillover effects.

Source: Giovannetti and Velucchi (2009).

Exporters of minerals and agricultural products have seen declines in revenues which, in turn, have negatively affected government revenues. In Nigeria, for instance, the volatile price of oil, which constitutes around 90% of Nigerian exports (see table 2.3 in chapter 2) and 90% of government revenues,[11] created considerable uncertainty, as did the drop in metal prices for the Democratic Republic of Congo. Against this background, the crisis could have a positive impact, by stimulating the redirection of interest to revive the potential of sectors different from oil and fuels (or more generally raw materials), thus strengthening the economies for possible future shocks.

3.1 FEWER RESOURCES FOR FOREIGN DIRECT INVESTMENT

FDI has been an important source of resources for some (few) Sub-Saharan African fragile countries and a powerful engine of growth, depending on which sectors it was targeted. Investments in to the oil industry generate little domestic employment, given the small number of employees and high skills required, while those in tourism or some traditional manufacturing stimulate domestic employment, consumption and growth.[12]

FDI as a share of GDP has been lower in Sub-Saharan Africa than in other developing countries, unevenly distributed across countries and often related to natural resource endowment. FDI had been increasing in absolute terms and as a share of GDP since 2000, but the economic crisis has reduced the total amount of funds or delayed some projects. The crisis tightened credit and lowered profits for firms in developed and emerging economies, leading them to revise their investment plans downward and assume a wait-and-see attitude.[13] The high and increasing uncertainty linked to the concurrent fuel, food and financial crises explains the general decline in FDI, particularly damaging because of its persistent effects,[14] perhaps even beyond those warranted by a country's fundamentals.

In the first half of 2008 Angola and Nigeria, as well as the Democratic Republic of Congo and Guinea, each received more than $1 billion in FDI inflows.[15] But in the second half of 2008 and the first half of 2009, a number of investments in natural resources and manufacturing were put on hold or cancelled. The Democratic Republic of Congo and Zambia have had mining projects cancelled, Sudan has had a refinery postponed, and Botswana and Tanzania have had mining projects postponed.

But in one sector FDI has kept increasing: land (chapter 4). Foreign countries, looking for food security or wanting to increase their production of biofuels without jeopardising their water resources, are buying land in Sub-Saharan Africa. Deals may be unfavourable for Sub-Saharan African countries, especially where state institutions are involved, because they are characterized by a weak law enforcement which could be exploited by foreign countries involved in the deals. The effects of these inflows on receiving countries are highly controversial.[16] Short-term money to cushion the worst effects of the crisis can turn out to be a predation of important resources. But if well-managed, it could increase agricultural productivity and even have some positive effects on growth.

3.2 TRADE DECLINES

Many Sub-Saharan African countries, including fragile raw material exporters, have relied heavily on export markets to grow. The crisis has been transmitted to them mainly through declining demand for exports and declining export prices.

It takes time to assess the effects of the crisis on trade flows, but early signals are not reassuring: the demand from China, Europe and the United States for Sub-Saharan African fragile country products has fallen sharply, even more than for products from other areas (figure 6.2). This is due partly to the fact that their exports are mainly raw materials. But even for manufacturers, concentrated on low-technology products, the group suffers more than other developing areas.[17] Moreover, many Sub-Saharan African fragile countries have suffered from increased exchange rate volatility, which induced high uncertainty and high costs for international trade. Many countries in the CFA franc zone have an exchange rate pegged to the euro and have experienced a real exchange rate depreciation. This makes imports from these countries cheaper to an extent, but because fragile states have little capacity to increase exports, they cannot exploit this opportunity.[18]

11 ODI 2009a.

12 See Bonassi et al. 2006.

13 Theoretical models of investment under uncertainty (Dixit 1989) have used option theory to explain investors' attitude when the environment is perceived as risky. For the same values of the fundamentals, firms' behaviour is different, depending on the history of the firms: if a firm is already investing in a country, it goes on, but new investments are postponed. Firms' behaviour could explain the current situation: what is a discontinuity in individual behaviour (firms may decide to invest or not to invest in the same situation, depending on their history and multiple equilibria are possible) makes the aggregate investment function highly nonlinear.

14 It takes time for investments to be realised, and a decline in a year produces a long-lasting impact over the years to come

15 See UNCTAD 2009, p. 42.

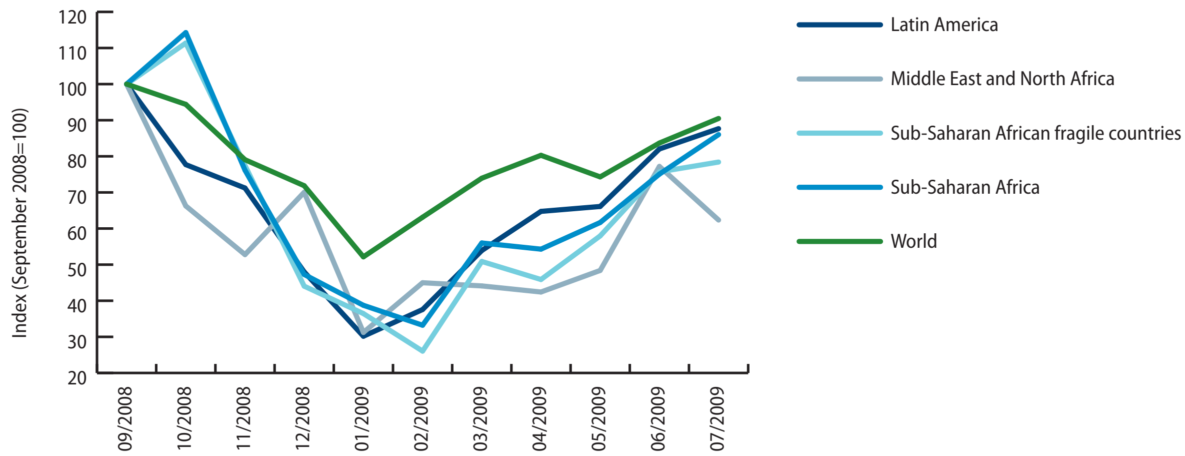
16 For a discussion of this issue, see chapter 4.

17 See UNCTAD 2009; this sharper fall in export is true also for Sub-Saharan Africa as a whole.

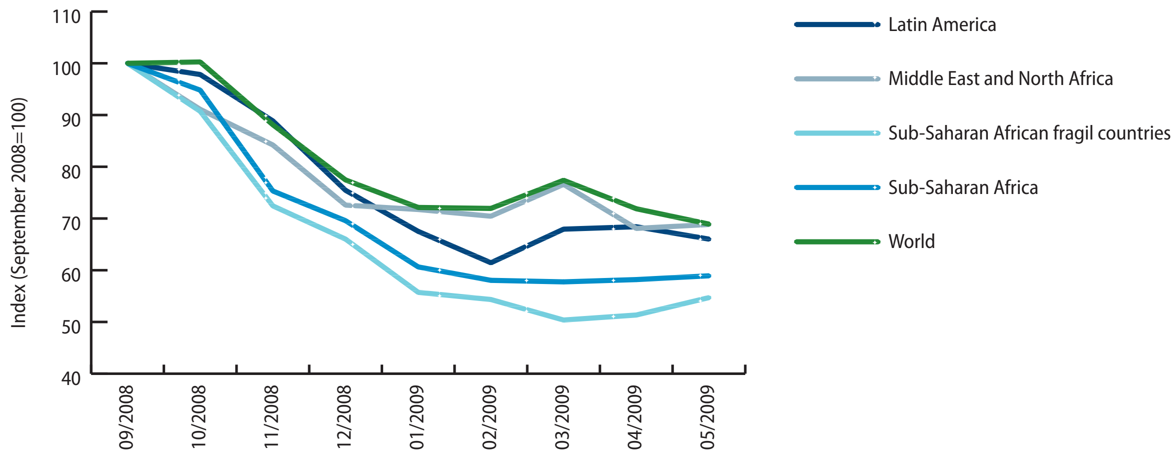
18 AfDB 2009b.

Figure 6.2: Exports down most for Sub-Saharan Africa

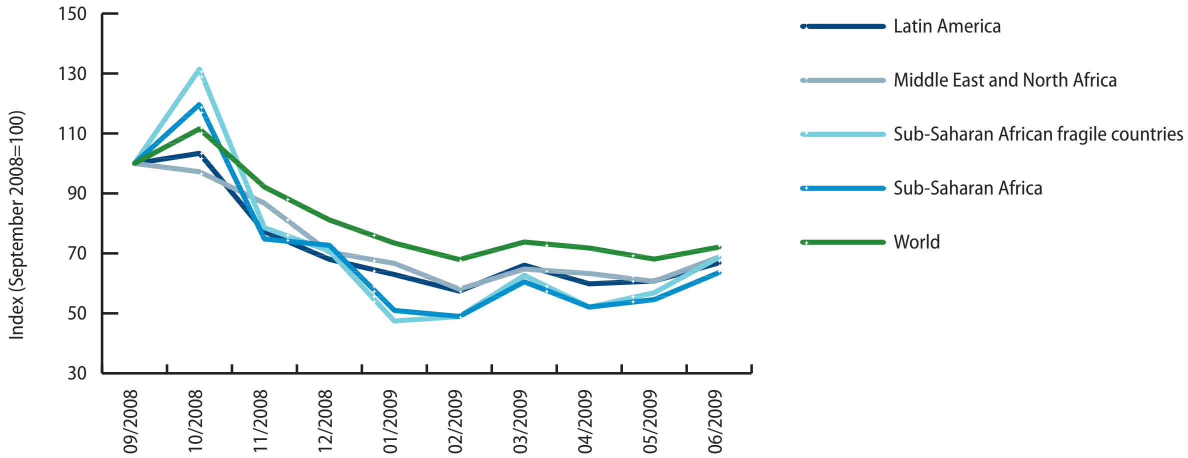
CHINESE IMPORTS



EU IMPORTS



US IMPORTS

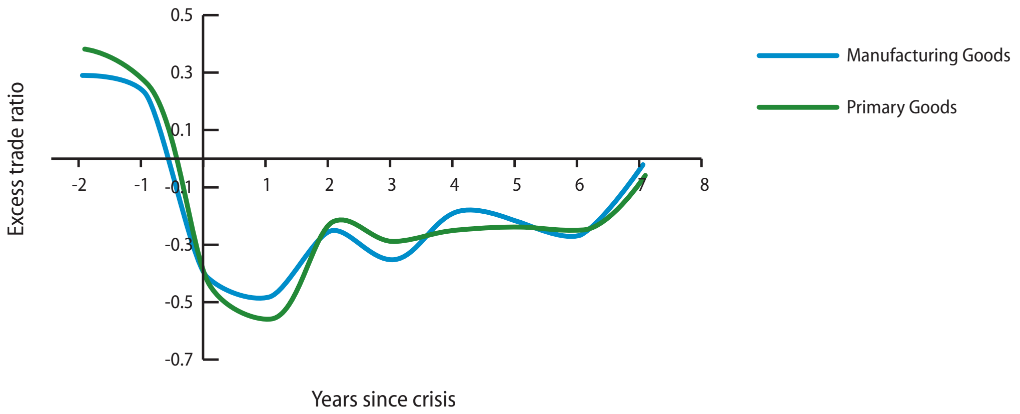


Source: Global Trade Atlas.

The financial crisis is also likely to have reduced the capacity to finance world trade. Sub-Saharan African firms, especially in fragile countries, on trade financing more than others do. Most Sub-Saharan African firms rely on letters of credit from destination countries, mainly because of an underdeveloped domestic financial system and the scarcity of self-financing. These providers, in a situation of high uncertainty and lack of trust, have reduced their risk exposure and credit. Firms and countries that suffer more are those considered more at risk. So, credit rationing, which increases trading costs, has dampened exports of fragile Sub-Saharan African countries.

Analyses[19] based on 117 systemic crises[20] and bilateral trade data suggest that exports of Sub-Saharan African countries may be hit hard by the current crisis. First, the impact of past financial crises and recessions on Sub-Saharan African exports has been stronger and more persistent when the trading partner is an industrial country. Second, Sub-Saharan African countries have been hit harder and longer than other regions by crises affecting their destination markets. This is not just a composition effect due to the overrepresentation of primary products in their export baskets, but it is also a consequence of the lower competitiveness of Sub-Saharan African manufacturing exports, which are more concentrated on lower value-added products. Indeed, Sub-Saharan African manufacturing and raw materials exports have both been hit hard (figure 6.3). Also poor infrastructure that increases the costs (duties, red tape, border crossings) add to their vulnerability. On the contrary, to exploit the opportunities offered by an economic crisis, firms have to find niches, develop higher quality products or move up the value chain. But this requires the right human capital, in short supply in fragile countries.

Figure 6.3: Sub-Saharan Africa primary and manufacturing exports after financial crisis in partner country



Note: The figure shows the deviation of Sub-Saharan African exports after a financial crisis that takes place in year $t = 0$, with respect to the average disruption effect. The excess trade ratio in the y-axis represents the deviation of bilateral exports generated by a financial crisis in the partner country, relative to the average deviation: a positive (negative) excess trade ratio means that the effect of a financial crisis in the partner country on African exports is more positive (negative) than the average effect on exports.

Source: Berman and Martin 2009.

3.3 FADING AID FLOWS: A SCENARIO TO BE AVOIDED

The G8 summit at Gleneagles in 2005 pledged to scale up aid to African countries, and this promise has been repeatedly restated and confirmed in international meetings. Still, the global recession induced by the 2008-09 global crisis casts doubts on the actual evolution of aid efforts on the side of Organisation for Economic Co-operation and Development (OECD) Development Assistance Committee (DAC) donors. Aid budgets may be reduced with respect to the historical high in 2008, to finance fiscal stimulus packages aimed at sustaining internal demand in donor countries. Early signals from some OECD DAC member countries are not reassuring. The Irish government announced a reduction of its aid budget by 22% from what was initially planned for the current year. And Italy could halve its aid budget in 2009, hitting a historical low.[21] In the short to medium run, most aid budgets of developed countries will be affected because of the recent budget deficits. So spending cuts or high interest rates are likely in the near future.

19 Berman and Martin (2009) use a gravity model to compute impulse responses; the analysis here is on Sub-Saharan Africa as a whole because of the lack of reliable time series for the group of fragile countries. See their background paper in volume 1B for details.

20 Systemic crisis defined as events possibly lasting several years where much or all bank capital was exhausted. The dataset of bilateral trade and financial crisis is on the period 1972-2002.

21 One 2009.

Past crises – which were not as global – reveal that donors tend to cut their aid budgets significantly when facing a major recession. For instance, the Nordic banking crisis in 1991 was followed by a substantial reduction in aid disbursements by Finland, Norway and Sweden.

Even keeping earlier commitments does not shelter recipient countries from a sizeable reduction in aid flows, because commitments are expressed as a share of gross national income, and because of swings in bilateral exchange rates with the dollar.

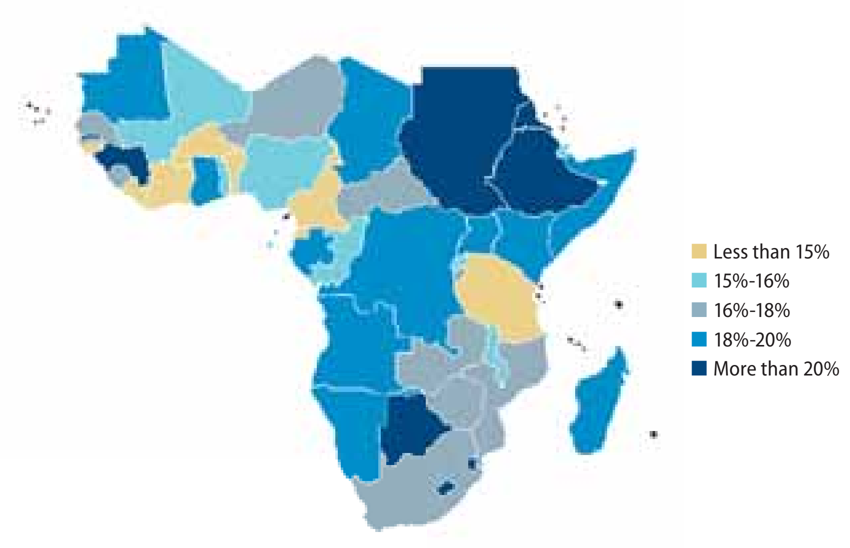
In order to gain a better understanding of the possible effects of the crisis on aid budget, we draw on the econometric analysis by Bertoli et al. (2007), who model the economic, institutional and political determinants of the aid effort – defined as the aid to GDP ratio – by the 22 members of the OECD DAC over 1970-2004. Here, we extend the analysis up to 2008, and use a modified specification of the model that allows for a non linear relationship between recessions and aid effort. Such a specification reflects the intuition that major recessions could produce a severe – and more than proportional – impact on the aid effort of the donors.[22]

Our estimates suggest that countries with a larger budget deficit do not necessarily reduce their aid disbursements, because the primary budget deficit is a poor measure of a country's fiscal stance. This finding, in line with Round and Odedokun (2004), is not reassuring. The analysis shows that aid falls with a larger debt overhang – and it falls more than proportionally in response to a larger output gap, which measures the severity of the recession. The estimates are then used to predict the aid budgets for 2009 for each donor country on the basis of macroeconomic forecasts of the OECD *Economic Outlook*.

According to our predictions, aid flows from OECD DAC countries could fall $22 billion in 2009, down from $119 billion in 2008, if donors behave as they did during past recessions.[23] The aggregate variation of total aid flows is radically different from the picture that emerges from the projections made on the basis of public announcements by member countries of the OECD DAC,[24] which are in line with earlier commitments. Our predictions represent what the evolution of aid budgets in response to the fluctuations of the business cycles suggests that could happen, but – needless to say – his is just a scenario, which could be avoided provided that most donor countries assign the due priority to aid.

To strengthen the case that this is a scenario to be avoided, we try to get a sense of the size of the impact upon recipient countries in Sub-Saharan Africa, assuming that donors keep their bilateral allocations unchanged from 2003-07,[25] gives an idea of the possible effects on individual countries. This back-of-the-envelope exercise shows that most Sub-Saharan African countries are exposed to a reduction in aid flows of between 15% and 20% (map 6.1). This cut may particularly affect countries with a high share of aid in their balance of payments.[26] Fluctuations in aid are particularly devastating for fragile countries.[27]

Map 6.1: Estimated reduction of aid flows to Sub-Saharan Africa in 2009



Source: ERD elaboration.

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22 See Bertoli et al. (2007) for a description of the underlying econometric model, and the background paper by Allen and Giovannetti (2009) available in volume 1B for the results of the extended econometric model.

23 See Allen and Giovannetti (2009) for country-specific projections.

24 OECD, 2009a

25 Bilateral aid data are not yet available for 2008.

26 Chapter 2 provides data on the dependence of fragile countries on official development assistance (ODA), compared with remittances and FDI. According to OECD (2009b), in a different context and with different estimates, Chad, Eritrea and Guinea are expected to face a decline in aid of more than $20 million.

27 OECD (2009b) maintains that Burundi, the Democratic Republic of Congo, Eritrea, Guinea-Bissau, Liberia and Sierra Leone had aid fluctuations in excess of 5% of GDP during 1990-2005.

Needless to say, European donors should avoid cutting down aid to Sub-Saharan African countries in general, and to fragile countries in particular, as the aid channel would then add to the adverse effects that go through the three channels that we have previously described. Still, the fear that donor countries, which have incurred high domestic costs to cope with the crisis, may reduce their flows cannot be easily dismissed, given the historical experience and some worrying early signals. IMF (2009c) argues that "notwithstanding international commitments to scale up aid, projections do not suggest such scaling-up in the pipeline for 2009",[28] and suggests that low-income countries could suffer from a 25% reduction with respect to the previous year.

China, which has a surplus in its budget (and in its balance of payments), could fill the gap left by OECD countries (box 6.2).

Box 6.2: Is China filling the gap?

The Forum on China-Africa Cooperation, launched in 2000 by China and its African partners (except the three countries that still recognize Taiwan as an autonomous province), is the platform for China to signal its plans for international development assistance to Africa.[29] China provides international aid to African countries through economic cooperation, mainly on a project basis, often linked to FDI and trade. By the end of 2006, China had launched around 800 aid projects in Africa: 137 in agriculture, 133 in infrastructure, 19 in schools and 38 in hospitals. China has also sent 16,000 medical personnel to 43 African countries, trained 15,000 people and cancelled African debt for about $1.2 billion[30].

China had disbursed $5.6 billion in aid to Africa by the end of 2006. China's Exim Bank, one of the country's key actors in development cooperation, announced that it has disbursed $12.3 billion in loans and export credits to Africa over 1995-2006. The Centre for Chinese Studies[31] adds that Exim Bank had 259 projects in 39 African countries by September 2006, 80% in infrastructure (dams, railways, oil facilities and mines). Jacoby (2007) includes grants and other credits to the previous figures and estimates $19 billion in financial assistance from China to Africa by 2006.

The forms of assistance to African countries are grants (mainly in kind), zero interest loans and concessional loans. Recently, China started providing African countries with more debt relief. Chinese officials are said to prefer providing aid in the form of grants in kind because this reduces considerably the transaction costs related to the delivery of aid and increase its effectiveness[32].

OECD (2008b) reports that a number of African fragile countries (such as Angola, Cameroon, the Democratic Republic of Congo, Côte d'Ivoire, Eritrea, Liberia, Nigeria, Sudan and Togo) have already received concessional loans from China's Exim Bank. Pehnelt (2007) finds that almost all of China's most important partners in the continent perform poorly on political freedom and the quality of governance, while Alves and Draper (2007) highlight the low scores on Foreign Policy's Failed States Index. Woods (2008) and Brautigam (2008) stress the rising Chinese engagement in "rogue states" such as Sudan and Zimbabwe, though this support goes beyond the sole provision of aid, while Shinn (2008) focuses on the strong military ties of China with these two countries.

Box figure 1 compares DAC aid with Chinese economic cooperation[33] for a group of African fragile countries.[34] ODA from DAC countries has been cyclical since 2000, with a downward trend over the latest years. By contrast, flows of Chinese economic cooperation to fragile countries have been growing steady and, in 2006, were almost equal to DAC countries' aid outflows.

The trend is even stronger for some individual African countries, especially where the financial support from western donors has weakened since the mid-1990s (Angola, Equatorial Guinea, Eritrea and Sudan) – when a long series of episodes of violence and general instability spread over the continent[35] – and that nowadays receive the bulk of financial assistance from China.

28 IMF 2009c, p. 30.
29 Burkina Faso, The Gambia and São Tomé and Príncipe.
30 MOFCOM 2007.
31 CCS 2008.
32 Lancaster 2007.
33 As by the definition provided by the National Bureau of Statistics of China, data on economic cooperation with foreign countries or region cover either projects financed by China's aid programmes and contracted projects undertaken by Chinese contractors. It is therefore important to put a word of caution about the comparison between outflows of Chinese economic cooperation, which, according to OECD (2008a), includes Chinese ODA but certainly overestimates it, and ODA from developed countries, which is a more focused and self-explaining category.
34 Fragile countries have been selected according to the operational definition proposed by OECD (2009b) and adopted in chapter 2 of this report.
35 Tull 2008.

Box figure 1: China's economic cooperation with African fragile countries and DAC aid, 1998-2007

Source: ERD elaboration based on OECD DAC database National Bureau of Statistics of China (various editions), China Statistical Yearbook.

According to some observers, China is going to profit from a possible withdrawal of Western countries from Africa,[36] though this will become clearer only after the fourth Forum on China-Africa Cooperation summit in November 2009. At the beginning of 2009, Chinese leaders restated their commitments towards Africa, announcing billions of dollars for new projects and other forms of assistance, including a further reduction of debt.[37] Before President Hu Jintao's tour of a group of Eastern African countries in February 2009, Chinese officials pledged that China would maintain its aid to Africa, "regardless of the financial crisis" and that it planned a 200% increase over 2006 in its foreign aid to Africa.[38]

3.4 REMITTANCES SLOW

Migrant remittances to Sub-Saharan Africa reach countries where other private flows, such as FDI, are limited or nonexistent, sometimes even exceeding ODA.[39] And many Sub-Saharan African migrants from fragile countries (as well as refugees) move nearby, because they cannot afford the high cost of migrating to high-income countries (map 6.2).[40]

Map 6.2: Many migrants reside within Sub-Saharan Africa

Source: ERD elaboration based on data from the University of Sussex and the World Bank reported in Ratha and Shaw (2007).

36 Cook and Lam 2009.
37 Brown and Chun 2009.
38 China View 2009.
39 OECD 2008.
40 Sander and Maimbo 2005.

Remittances for recipient countries matter not just for their size but also because they tend to be stable or even move countercyclically along the business cycles of recipient countries, thus reducing the likelihood of a balance of payment crisis[41]. So, how have remittances to fragile African countries responded to the present downturn?

Different forecasts exist. Ratha and Mohapatra (2009), after initial optimism, predict that remittances to Sub-Saharan Africa will fall 7% in 2009 to $18-19 billion, down from the $20 billion officially recorded in 2008 (this excludes informal channels, commonly used by intraregional migrants). IMF (2009b) asserts that a 1 percentage point reduction in the rate of economic growth in migrant-sending countries reduces outgoing remittances by up to 4%. Calí and Dell'Erba (2009) maintain that, compared with Latin America and the Caribbean or East Asia and the Pacific, Sub-Saharan Africa will experience a moderate drop in official flows of around 6-9% in 2009, given that its share of remittances from high-income countries was fairly low in 2008[42].

Remittances through official channels and from traditional receiving countries are, however, only part of the story, with intraregional migration an important channel of transmission from emerging African countries to fragile Sub-Saharan African countries. A detailed country-specific assessment would require reasonable forecasts about the flows of remittances and the evolution of bilateral exchange rates of the migrants' destination countries against the dollar, because this is the single most relevant factor in shaping the dollar value of the incoming migrants' remittances. But without such forecasts, an assessment is not feasible.

A decline in remittances can affect the composition of expenditure, if remittances are more likely than income from domestic sources to be invested in education and housing.[43]

Thus, Sub-Saharan African fragile countries will suffer from a steep fall in revenues from trade, due both to a fall in international demand and to deteriorating terms of trade. Furthermore, they are also exposed to a decline in remittances originating from developed and emerging Sub-Saharan African countries, which are the main destinations of migrants from fragile countries, and to shrinking FDI inflows. These adverse effects could also be matched by a decline in aid flows from DAC countries, if these fail to live up to their commitments towards Africa, and they react – as past experiences suggest – to the recession with cut in aid budgets.

4. CAN FRAGILE STATES COPE WITH THE CRISIS?

Fragile countries will suffer from the steep fall in international trade. But they will also suffer from deteriorating terms of trade and shrinking remittances because of higher unemployment in developed countries and in emerging Sub-Saharan African countries, declining FDI and disinvestments and possibly a reduction in aid flows, at least in the short to medium run. To understand how they can cope with the recession or other negative shocks, we propose and apply an overall resilience index.

Resilience is a multifaceted characteristic of a socio-economic system, which is only partly understood, and whose measurement is controversial. Following Naudé (2009), we focus here just on its macroeconomic dimension, which relates to the state's ability to implement adequate policies in reaction to a shock, such as the 2008-09 crisis. Hence, additional dimensions of resilience – at the household or community level – are not considered; their relevance should not be downplayed, but state institutions still represent a pillar of resilience. With this caveat in mind, we build an index of the resilience of each Sub-Saharan African country examining four separate dimensions:[44]

- Macroeconomic management, reflected in balance of payments and fiscal balances and levels of currency reserves.
- Good governance.
- Market efficiency, measured by the Doing Business 2009 indicators.
- Social cohesion, measured by using the ethnolinguistic fractionalisation index and the political instability index.

We then aggregate these four components of the resilience index and rank Sub-Saharan African countries according to their capacity to cope with external shocks, in three main categories: low, medium and high. The subgroup of fragile countries is mainly classified as low resilience (table 6.1).

[41] See Ratha (2006) for evidence on countercyclical movements of remittances and Bugamelli and Paternó (2006) for a discussion of the role of remittances in Balance of Payments crises.

[42] ODI (2009b) reports that remittances in Kenya, largely from the United States, fell 12% in the first half of 2009, compared with the first half of 2008.

[43] Maimbo and Ratha 2005.

[44] See the background paper by Naudé (2009) in volume 1B with additional details on the index.

Table 6.1: Resilience rank – from low to high

Low		Medium		High	
Congo, Dem. Rep. of	1	Ethiopia	16	Burkina Faso	31
Chad	3	Sierra Leone	17	Togo	32
Burundi	4	Zambia	18	Madagascar	33
Central African Republic	5	Malawi	19	Benin	34
Eritrea	6	São Tomé and Príncipe	20	Tanzania	35
Congo, Rep. of	7	Cameroon	21	Mozambique	36
Guinea-Bissau	8	Mali	22	Lesotho	37
Côte d'Ivoire	9	Uganda	23	Swaziland	38
Guinea	10	Nigeria	24	Seychelles, The	39
Niger	11	Ghana	25	Gabon	40
Kenya	12	Senegal	26	Namibia	41
Liberia	13	Cape Verde	27	South Africa	42
Angola	14	Rwanda	28	Mauritius	43
Comoros	15	Equatorial Guinea	29	Botswana	44
		Gambia, The	30		

Source: Naudé 2009.

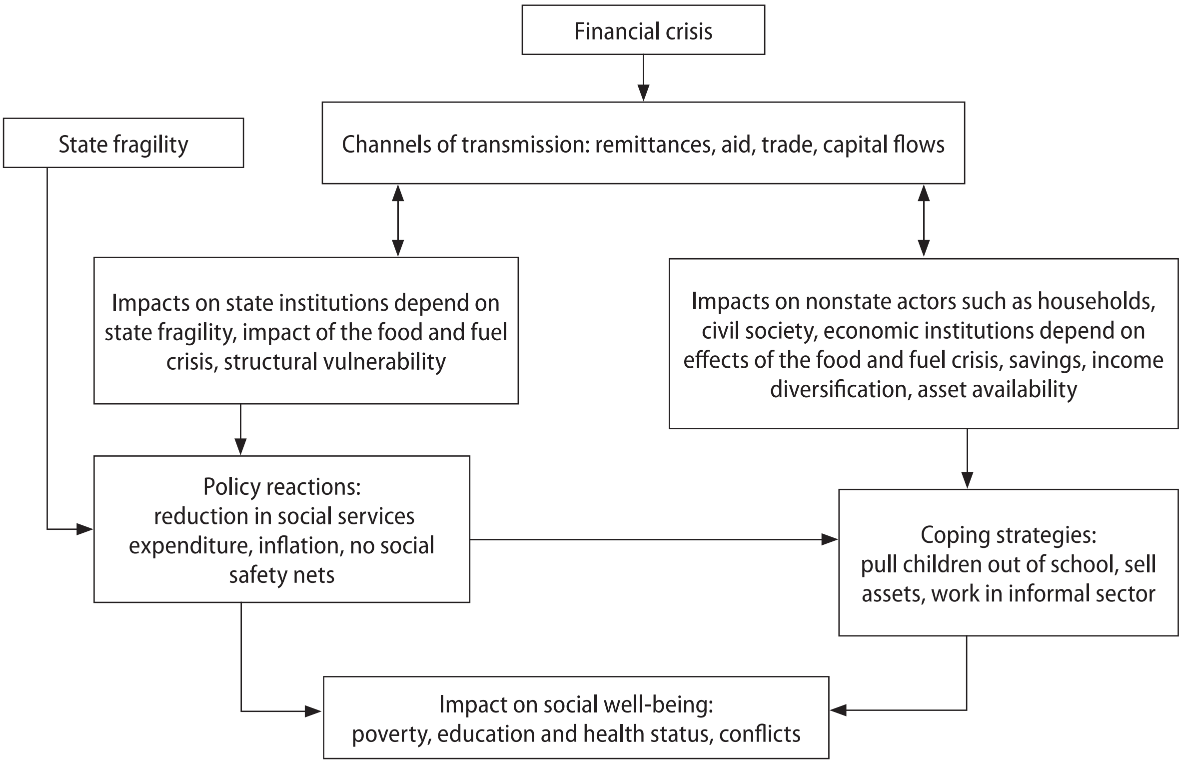
We note that the most fragile countries are in the group of low resilience countries. It is likely in each country that those most affected will be the poorest, those less resilient than average (at a community and household level).

The ability of fragile countries to react to the crisis was impaired not only by fragility itself, but also by the previous food and fuel crises: food- and oil-importing fragile countries suffered from the transmission of the real effects of the 2008-09 crisis when most of them were already in a highly stressed situation, which further added to their limited ability to react to the crisis due to the fragility of their state institutions.

4.1 SEVERE SOCIAL IMPACT OF THE CRISIS

The impact of the 2008-09 crisis in Sub-Saharan Africa varies between and within countries, even though its magnitude is difficult to assess because of the scarcity of data and lag. Figure 6.4 provides a snapshot of the impact of the crisis and of how it is aggravated by the fragility of state institutions. The 2008-09 crisis directly influences state institutions and nonstate actors. The combined effect of the coping strategies of state institutions and nonstate actors determines the impact of the crisis on social well-being.

Figure 6.4: The impact of the crisis on social well-being



According to Chen and Ravaillon (2009), the financial crisis together with the spikes of food and fuels prices will increase the number of poor people by 53-64 million in 2009, based on estimates of those living with less than $2 a day and $1.25 respectively. Sub-Saharan African countries are expected to lose at least $50 billion in income in 2009. Infant and child mortality rates are also projected to rise. Friedman and Schady (2009) estimate that the crisis could induce 30,000-50,000 excess infant deaths in Sub-Saharan Africa. The International Food Policy Research Institute projects that the prevalence of undernourishment among children in Sub-Saharan Africa will rise from a fifth in 2005 to a fourth in 2020.

Poor women – heads of households, farmers, factory workers, informal service providers, internally displaced persons and refugees – caught up in wars are the most vulnerable to shocks. Research from United Nations Research Institute for Social Development[45] points out that women as heads of household increase their workload and have less time to rest and care for the family's health and the sick.

Obiageli Ezekwesili, the World Bank vice president for the Africa Region, said in May 2009 that "the global economic crisis will drastically reduce African women's individual incomes as well as the budgets they manage on behalf of their households, with particularly damaging consequences for girls [. . .] Poverty has a female face, and the global economic downturn will have a significant impact on women as more of them lose jobs and are forced to manage shrinking household incomes".[46] World Bank research already shows household income declines in Uganda and falling income from agriculture in Madagascar, where girls are the first to be pulled out of schools. Ezekwesili also observes that "the crisis in Africa is leaving women with ever fewer job choices. In many export-oriented industries [. . .] it is women, not men, across Africa who are losing jobs because of the crisis. Declining remittances and a tightening of microfinance lending are restricting the funds available to women to run their households."

45 UNRISD 2006.
46 World Bank 2009d.

The global collapse in demand led to job losses in many industries. AfDB (2009c) reports that in Sub-Saharan Africa there will be 27 million new poor, 28 million more vulnerable jobs (mainly in mining but also in manufacturing) and 3 million more unemployed following the crisis. Recent assessments indicate high work-hour reductions, which force workers to move to lower productivity activities or to the informal sector, with its high unemployment rate and income insecurity[47].

The direct impact on households also depends on assets availability, income diversification, savings and local safety nets, such as funeral associations. Price changes affect both net producers and consumers. Lower global demand of commodities pushes prices down, reducing producer incomes. A price fall is good for net consumers, but unfortunately the transmission of the reduction is never complete and takes a long time to reach final consumers.[48] Food-price inflation is very high and in time will challenge food security and reduce what the poor can spend on nonfood items such as education and health.

The combination of assets and insurance mechanisms shapes coping strategies of the households in fragile countries. Families are likely to sell assets to cope with the crisis, to withdraw children from school, to reduce reliance on health care and to cut food expenditure, shifting to lower quality products with fewer calories. This situation produces a vicious circle that undermines the chances of younger generations to move out of poverty. Indeed, there is a bad chance that children will not go back to school once the crisis is over – or will not recover the learning gaps from their lack of attendance. And the declines in food consumption among children can lead to irreversible effects (box 6.3).[49]

Box 6.3: Adverse shocks and social protection – what role for formal and informal financial institutions?

By Abena D. Oduro, University of Ghana

Objective indicators of risk in Sub-Saharan Africa include the variability of rainfall, the seasonality in crop prices and the proportion of households without access to safe drinking water and safe sanitation. The incidence of self-reported shocks is another indicator of the extent and nature of risk and shocks facing Sub-Saharan African households. In Tanzania, for example, about two-thirds of rural households surveyed in Kilimanjaro and Ruvuma reported shocks that affected their livelihoods during a five-year period.[50]

Households tend to be hit by more than one shock. In Tema, a largely urban district of Ghana, the majority of households reported one or two shocks over a two-year period. This finding contrasts with Builsa, a largely rural district, where more than half the households reported more than four shocks in the two years. The current global crisis and its impact on African economies add an additional layer of risk and uncertainty to communities and households already risk prone.

Adverse shocks have impacts in the short and long term. For example, school enrolment of both boys and girls in Côte d'Ivoire declined after an adverse weather shock. There was an increase in malnutrition among children in areas that experienced the shock.[51]

The decline in investments in the education and health of children in the aftermath of a shock can have long-run negative impacts. The decline in consumption means that some households or individuals could become poor or, if already poor, remain poor. In some countries the number of transient poor, who move in or out of poverty, can be substantial.

In responding to an adverse shock households balance consumption reduction and asset depletion. Households use a wide variety of measures to manage risk and respond to adverse shocks. These coping mechanisms depend largely on family (nuclear and extended) and other networks and self-insurance (for example, the sale of assets). There is limited recourse to public social protection and formal credit and insurance instruments.

47 World Bank 2009a.
48 ODI 2009b.
49 World Bank 2009b.
50 Sango et al., 2007
51 Jensen, 2000

The prevalence of informal finance arrangements can be explained by supply and demand. The geographical coverage of banks and other formal financial institutions is limited. Rural and remote communities are poorly served by these institutions. Microfinance programmes have much broader coverage. Formal financial institutions are unlikely to expand coverage in the rural economy until they can adequately address adverse selection and moral hazard. The demand for informal credit and insurance persists because transaction costs for informal loans may be lower than those for formal loans. The cost of defaulting on an informal loan can be lower than for a formal loan. In a high-risk environment this may push demand for credit and insurance towards the informal sector. Some examples of informal financial institutions are funeral associations and revolving savings and credit associations, which are not designed to provide insurance against adverse shocks.

Empirical evidence suggests that households cannot fully insure against risk. Risk-sharing arrangements are more likely to provide insurance against idiosyncratic shocks than against covariate shocks. For example, funeral associations normally provide insurance against idiosyncratic shocks. But the poor are more likely to be left out of these arrangements.[52]

The high risk in African economies and the evidence that households cannot protect consumption when they are hit by adverse shocks suggest that there must be a large demand for insurance. A study of rural households in Tanzania finds that there is a demand for insurance against price fluctuations and rainfall shocks. The willingness to pay for insurance depends on the availability of cash to pay for the insurance.[53]

4.2 THE RISK OF POLITICAL INSTABILITY AND RESURGING CONFLICTS

The fragility of state institutions blunts political processes for state capacity and citizen expectations to reach an equilibrium. The global financial and economic crisis further jeopardises the chances that such an equilibrium is maintained in fragile Sub-Saharan African countries. Armed conflict is a possible outcome of the divergence between state capacity and citizens' expectations. This concern was voiced by Dominique Strauss-Kahn, the managing director of the International Monetary Fund, who argued that for low-income countries "we don't just care about growth for growth's sake, we also want to safeguard peace and prevent war. Indeed, when low-income countries were doing well over the past decade or so, the incidence of war declined significantly. The great fear is that this trend could be reversed".[54]

Miguel et al. (2004) analysed the determinants of a civil war in 41 African countries, showing that a 5% reduction in the rate of economic growth increases by half the risk of a conflict. Brückner and Ciccone (2007) find that a crash in the price of an export commodity increases the likelihood of an armed conflict. And Ciccone (2008) shows that a drought-induced fall in incomes produces a similar effect.

Such a tragic outcome of the crisis in Sub-Saharan African fragile countries increases the human and social costs of the global financial and economic crisis. While Sub-Saharan African countries need not suffer more from a higher macroeconomic shock than other countries in the region, the consequences could be much more severe, due to their limited capacity to implement adequate policy responses to the shocks. That is why protecting fragile countries from the fallout of the crisis should rank high among the donor priorities.

52 Harrower and Hoddinnot 2005; Hoogeveen 2003; de Weerdt 2009; the risk-sharing arrangements may provide partial but not full insurance. Contributions may not be large enough to cover the full cost of the shock. Households are less likely to insure fully against covariate risks (Harrower and Hoddinnot, 2005; Hoogeveen 2003). The movement of households in and out of poverty over time suggests the absence of or weakness in risk management mechanisms that can adequately protect households from falling into poverty when there are shocks.

53 Sarris et al. 2007.

54 Strauss-Kahn 2009.