Emmanuel Tumusiime-Mutebile: The Eurozone crisis and its impact on Africa's economy

Presentation by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the COMESA (Common Market for Eastern and Southern Africa) Policy Organisation Meeting, Kampala, 20 November 2012.

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1. Introduction

The Eurozone crisis is part of a much broader economic and financial crisis that has afflicted the global economy since 2008. The global crisis is manifested primarily in slow economic growth and the fragility of financial systems. Global economic growth has fallen by about two percentage points in the five years since the crisis began in 2008 compared to the preceding five years (table 1). The need to reduce very high levels of debt in both the public and private sectors has impeded economy recovery in the advanced economies.

Table 1

Real output growth in the world and growth in world trade (percent) 2004–2013

	2004	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
									proj	**proj**
World	4.9	4.6	5.3	5.4	2.8	–0.7	5.1	3.8	3.3	3.6
Advanced Economies	3.1	2.7	3.1	2.8	0.1	–3.7	3.0	1.6	1.3	1.5
ow Euro Area	2.2	1.7	3.2	3.0	0.4	–1.8	2.0	1.4	–0.4	0.2
Emerging and Developing Economies	7.5	7.3	8.2	8.9	6.0	2.8	7.4	6.2	5.3	5.6
Sub-Saharan Africa	7.1	6.2	6.4	7.1	5.6	2.8	5.3	5.1	5.0	5.7
Uganda	6.5	6.3	10.8	8.4	8.7	7.3	5.9	6.7	3.4	5.0
World Trade	11.2	8.0	9.1	7.7	3.0	–10.7	12.6	5.8	3.2	4.5

2012 and 2013 are projections

Uganda data pertains to the fiscal year

Sources: IMF World Economic Outlook, except for Uganda where it is the Uganda Bureau of Statistics

Although all regions of the world have suffered a slowdown in economic growth as a result of the economic and financial crisis, the Eurozone is one of the regions hardest hit; its economy has gone back into recession this year, its banking system is very fragile and countries on the periphery of the Eurozone have unsustainable levels of public debt. The slower economic growth has also affected world trade. In the five years prior to the start of the economic crisis, world trade volumes expanded at an average of 8 percent per annum, but this growth fell to only 3 percent per annum in the last five years. The slowdown in the growth of world trade is one of the main channels through which the economic problems of advanced economies are transmitted to developing economies.

The short term prognosis for the global economy is not propitious. The October 2012 edition of the World Economic Outlook, published by the International Monetary Fund (IMF), forecasts only a very modest recovery in global economic growth in 2013, to 3.6 percent compared to 3.3 percent in 2012. The IMF warns that the outlook is very uncertain and that the risks for a serious global slowdown are alarmingly high. The continued difficulties facing the advanced economies are not especially surprising, given that the economic crisis had its genesis in a systemic financial crisis. Historically, major financial crises have had large and long lasting negative effects on economic growth.

The medium to long term prospects for the global economy are also very uncertain. A report released last week by the Conference Board, one of the leading economic forecasters in the United States, forecasts that economic growth in both advanced and developing economies will be weak through to the middle of the 2020s. The Conference Board forecasts global growth of only 3 percent per annum during 2013–2018 and then only 2.5 percent per annum during 2019–2025.

2. What are the implications of the global economic crisis for African economies?

The health of the global economy matters profoundly for African economies, especially because of its impact on their balance of payments. The weaknesses in the global economy and especially the slowdown in the growth of world trade have constrained Africa's export growth while inflows of donor grants have stagnated and private capital flows have become more volatile. The current account balances of sub-Saharan African (SSA) economies have worsened markedly since the onset of the global crisis, from an average surplus of 0.7 percent of GDP during 2004–08 to a projected average deficit of 3.3 percent of GDP during 2012–13.[1] The deterioration of the current account affects both oil exporters and oil importers alike. The IMF forecasts a further rise in the average current account deficit of SSA economies to 3.9 percent of GDP by 2017.

Slower growth of exports and larger current account deficits will be detrimental to the development of SSA economies for two reasons. First, exports are an engine of economic growth and economic transformation. Fast growing developing economies almost always have successful export sectors. Secondly, larger current account deficits must be financed with capital account surpluses. Given that official finance (such as concessional loans from international financial institutions) is projected to be flat over the medium term, larger capital account surpluses will only be possible if there are substantial increases in net private capital flows, increases which are at best uncertain because of the difficulties facing the advanced economies from where most of these flows originate. Moreover, even if larger net inflows of private capital can be attracted to SSA countries to finance current account deficits, private capital flows are likely to be volatile because of the fragility and turbulence on global financial markets, which itself will be a source of instability for the macroeconomy.

3. The policy implications for African economies

To thrive in a much more difficult global economic environment, SSA economies will have to prioritise measures to promote stronger export growth and to diversify their export markets away from the traditional markets in advanced economies which face a prolonged period of slow growth. I want to highlight three sets of strategic policy reforms which I believe can contribute to these objectives across a broad range of SSA economies, if not necessarily in all of them. These reforms pertain to the real exchange rate, regional trade and agricultural modernisation.

The real exchange rate

Many empirical studies have established a robust relationship between economic growth and export growth in developing countries and their real exchange rates. Overvalued and volatile

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1 These data and forecasts are from the IMF's World Economic Outlook, October 2012.

real exchange rates are very damaging for export industries and thus for private investment in these industries. Hence macroeconomic policy in Africa should aim to achieve stable real exchange rates which are, at the very least, not overvalued, and preferably are undervalued, to shift incentives in favour of private investment in traded goods industries.

Sustaining more depreciated real exchange rates over the long term will only be possible if domestic absorption falls relative to GDP (so that trade deficits are reduced). This requires increased domestic savings rates. Because private savings rates are very difficult to influence in the short term through public policy, the burden of raising domestic savings rates will initially fall on the public sector. Public savings must rise which means that public consumption, and especially spending on public administration, which is not usually very productive, must be curtailed.

Intra-regional trade

To achieve sustained export growth over the long term, African exporters will have to diversify away from the slow growing traditional export markets in advanced economies. Regional trade offers promising prospects for diversification. Although Africa's intra-regional exports have expanded more than four-fold since the turn of the century, they still comprise only 9.6 percent of the continent's total exports, which is much lower than the corresponding share in other developing regions such as Latin America; hence there should be considerable scope for expanding intra-regional trade over the long term.

Regional economic integration is a goal of many countries in Africa, including those in East Africa which have established the East African Community (EAC) and a broader group of countries which are members of the Common Market for Eastern and Southern Africa (COMESA). The EAC has implemented a customs union, removing tariffs on intra-EAC trade and imposing a common external tariff. However, non tariff barriers (NTBs) to intra-regional trade remain pervasive in the region, some of which have been retained for protectionist reasons, despite the fact that the removal of all NTBs that are applied in a manner which restricts trade is an objective of the EAC Customs Union Protocol. NTBs include restrictions pertaining to the "rules of origin" of imports, sanitary and phyto-sanitary measures and technical barriers to trade involving the application of product standards and regulations in a discretionary manner. A forthcoming World Bank report, which examines how to harness the potential of regional trade and integration, found that Uganda and Kenya impose significantly more NTBs on their imports than many other SSA countries.[2] NTBs are a particularly serious obstacle to the expansion of food exports within Africa, with the consequence that agricultural development is stymied and the continent is becoming ever more dependent on food imports from outside Africa. Hence the removal of NTBs should be a priority for African governments.

Agricultural development and food trade

Africa's trade balance in agricultural products has deteriorated alarmingly over the last three decades. In the 1980s, Africa had a small trade surplus with the rest of the world in agricultural products, but it now has a trade deficit of approximately $22 billion. The main reason why Africa is now incurring trade deficits in agricultural products is that the growth of domestic food production has been weak, at about 2.7 percent per annum over the last three decades, and has failed to keep pace with the increase in demand for food on the continent.

Africa has the potential to expand agricultural production and close its trade deficit in agricultural products, but this will require substantial investments to raise productivity and to commercialise agriculture among the smallholder farmers. Smallholders both dominate food

[2] "Uganda Economic Update: A Renewed Growth Momentum, Harnessing the Potential of Regional Trade and Integration", World Bank, Kampala, 2012.

production on the continent and generate much higher yields per acre than larger farms, an advantage which will become increasingly important as land availability becomes a more binding constraint to output growth in Africa. As a result, it is not conceivable to envisage that African agriculture can be modernized and production increased by ignoring the continent's smallholder farmers and focusing instead on large farms. The priority of agricultural policy should be to support smallholder farmers to adopt good agricultural practices and to sell more of their output on the market, which then enable them to begin using more purchased farm inputs and improved farm technologies. Agricultural policy should focus on the provision of public goods and services to smallholders, in particular the provision of efficient agricultural extension services and improving the network of rural feeder roads to allow smallholders to access markets. Agricultural and rural development will also require public investment in rural infrastructure, especially rural electrification, schools and health centres.

Because of the natural barriers to international food trade (transport costs are high), many African food producers are potentially competitive on the regional market even if they cannot compete on international markets. Consequently, expanding opportunities for intra-regional trade cam make an important contribution to the commercialisation of food production in Africa. Although some individual African countries are likely to remain net food importers, some of the neighbours could supply their import needs competitively if domestic policies support agricultural modernisation and if the NTBs to intra-regional trade which I have already mentioned are removed.

4. Conclusions

The deleterious effects of the global economic and financial crisis are likely to remain a feature of the world economy for many years to come. Developing countries in Africa and other regions of the world will have to adjust to a much less benign global economic environment than was the case in the years leading up to the crisis. The weaknesses in the global economy will make it much harder to sustain strong export growth and to mobilise foreign savings to fund large trade deficits. To adjust to this more difficult external environment, African economies will have to live with smaller trade deficits, which implies constraining the growth of consumption and prioritising policies which can support sustainable export growth. Stable and undervalued real exchange rates, if sustained over the long term, can help to promote investment in export industries. Opportunities to expand intra-regional trade will only be realised if the ubiquitous non tariff barriers are removed. Finally, prioritising the modernisation of smallholder agriculture can support exports and reduce Africa's large trade deficit in agricultural products.