Emmanuel Tumusiime-Mutebile: The global financial crisis and access to finance

Speech by Prof. Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at the AfDB Ministerial Round Table Discussions, Dakar, Senegal, 12 May 2009.

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I Introduction

The Ministerial Round Table discussion this morning has articulated the key issues faced by African economies in the context of the global financial crisis and global recession. These discussions have provided a springboard for further reflections on the effects of the global crisis onto our economies.

The global economic and financial crisis threatens to affect the key drivers (i.e. technology, capital and labor) of sustained economic growth via depressed prices of and demand for primary commodities and lower than anticipated foreign capital inflows and foreign direct investment (FDI). While the previous two decades witnessed sustained growth and macroeconomic stability in Africa on the backdrop of reduced fiscal deficits and current account deficits, the global recession risks compromising our macroeconomic gains via the triple deficit problem of high fiscal deficits, high current account deficits and high private sector savings-investment gap. The issue, therefore, is whether or not this triple-deficit problem is temporary (and therefore requiring short-term measures) or permanent (and therefore requiring major macroeconomic adjustment policies).

My discussion this afternoon will focus on the effects of the global financial crisis and access to financing in the African context. I will focus on three important issues:

- Is the international response well tailored to the different requirements of the African countries?
- Is the response commensurate to the challenges faced by the countries?
- What additional measures should be considered by the MDBs to increase access to finance?

The basic contours of the global financial crisis are by now well known. Mr. Alan Greenspan, the former Chairman of the Federal Reserve Board called it a “once in a century tsunami”, born of a collapse deep inside the US housing sector and cascaded outwards leading to instability in financial markets and near stagnation of the real economy, and more recently, a recession. The global financial crisis has affected the private-public sector divide alike with the hit being taken by private firms leading to heavy revenue shortfalls for governments the world over.

II Appropriateness of the international response to the different financing requirements of the African countries

Growth and sound macroeconomic policy considerations

The IMF projects the world economy to have experienced a severe recession caused by the financial crisis and loss of confidence. Consequently, global output is projected to decline sharply by -3.3% in 2009 in developed countries, and -2.0% each for emerging and developing countries, contrasting with previous growth rates of 3.2%, and 6.1% each in 2008 respectively.

By contrast, many African economies and indeed most emerging and developing countries have thrived in the two decades to 2007/08. This was largely on account of prudent macroeconomic management that resulted into lower inflation, sustainable fiscal and balance of payments and rapid economic growth that placed them in good stead to respond to exogenous shocks like the one we are discussing here today. The key issue is whether or not the new macroeconomic policy responses and investment decisions by the development partners are appropriate to safeguard the economic requirements of African economies.

For Africa as a whole, growth forecasts for 2009 have been drastically revised downwards, from 5.9% in November 2008 to 2.8% in February 2009. Likewise, export growth is projected to decline by 7% while import growth will decline by 4.7% largely on account of adverse terms of trade, as well as declining volumes. Although the effects of the global recession are not uniformly distributed, they are broadly resulting into a deterioration of current account balance for most countries.

Capital inflows

For over a decade, many African economies have been experiencing a super-cycle[1] in their terms-of-trade trends, robust private capital and remittance inflows, as well as FDI. This was largely on account of implementation of prudent macroeconomic policies, structural adjustment programs, the liberalisation of the current account and account as well as the boom in S.E. Asia and China. The strong balance of payments performance as a result of the above developments is under threat by the global economic crisis, as evidenced by falling export prices and volumes, and declining capital flows. If the global recession persists, then many African economies risk backsliding into a severe macroeconomic crisis regime caused by unsustainable triple-deficit problem of unsustainable balance of payments deficit, unsustainable fiscal deficit and unsustainable private sector savings-investment gap. This in turn risks high inflation and sustained decline in economic growth.

There are uncertainties about the magnitudes of the main risks arising from the global credit crunch, and a negative feed-back loop from the financial sector and the real economy in developed economies. There are also uncertainties about the magnitudes of the effects of the spillovers to African economies with respect to measured effects of the collapse of global demand, the effects of the collapse in commodity prices on African export volumes and values, and the effects of reduced balance of payments surplus.

In Uganda's case, the international economic slowdown and financial crisis is likely to impact adversely on Uganda's external accounts although the persistence of this remains uncertain. While there has been no indication of a decline in official aid, export receipts, private transfers and FDI have slowed in the last quarter of 2008 and are expected to remain depressed in the near future. Due to the high import component of public investment plans, it is expected that both the current and capital account balances of the balance of payments will decline, resulting in a small drawdown in official reserves in 2009/10. At the policy level, BOU remains committed to let the economy adjust, by allowing the level of the exchange rate to remain market determined, and intervening only to smoothen out excessive volatility. In the medium term the balance of payment is projected to remain weak but stable at the levels estimated in 2008/09.

[1] I.e. favorable terms of trade (tot) for many developing countries persisted for a longer than usual continuous periods of over five years compared to the past experiences when favorable tot tended to last less than two years.

To mitigate the effects of the global economic and financial crisis on African economies, the total value of the facilities at the IMF (Exogenous Financing Facility), the World Bank's Rapid Access Facility, the African Development Bank's US$2.5bn for both the emergency liquidity facility and the trade finance facility; and any new facilities from the bilateral donor community need to be increased (by the donors) adequately to offset the impact of both the current as well as future balance of payments deficits. In addition, while responding to the immediate challenge of revitalizing capital flows, the long-term challenge of economic diversification to reduce dependence on primary commodities remains key for improving Africa's resilience to external shocks. This is in addition to the need to provide fiscal space for countercyclical economic policies and investments to sustain economic growth in Africa.

Other current and capital inflows

The annual growth rate in exports of goods and services from developing countries was 12.3 percent for the five year period to 2007 compared to 4.2 percent registered in the 1980s and 4.8 percent in the 1990s. The search for higher returns in developing countries including African economies led to a record one trillion dollars worth of private capital flows in 2007. Also FDI and portfolio equity finances increased to about 4.5 percent of GDP in 2007 compared to 2-3 percent in early 2000s. All the above flows plus remittances provided financing to spur the continent into robust economic growth and poverty reduction.

III Commensurate responses to the challenges faced African economies

The global crisis-credit crunch, and the global recession are likely to impact financing and its access in varying ways. The dangers posed by the crisis to access to finances by the private sector can be summarized into refinancing risk, credit risk and regulatory risk.

Refinancing risk

The global liquidity contraction will likely affect the cost and availability of funding for African economies. Given the risk averseness of markets, both African domestic and international banks are likely to be tighter, slower and more conservative in lending. With the expected attendant hike in interest rates as observed in Eastern Europe and South Asia and recent depreciation of the local currencies witnessed across the continent, meeting of foreign currency loan obligations by the African private sector may be more difficult, especially for those companies that are net savers of foreign exchange.

Consolidating implementation of export-oriented, as well as capacity and productivity enhancing policies through reducing the costs of doing business in the African economies could assist entities to access domestic credit and reduce refinancing risks. This provides an opportunity for African economies to consolidate financial sector reforms policies aimed at avoiding financial repression, which remains a key factor in increasing efficiency in savings mobilization and investment allocation.

Credit risks

Although international commodity and oil prices have receded from the record levels reached in 2007/08, many economies are still reeling from the high food and fuel prices. Accordingly, given deep recession in many industrial countries, some businesses may have trouble with repayment of credit facilities. Also as investment financing drops off, business projects may be incomplete thereby saddling banks' balance sheets with non-performing assets. At a micro level, some exporters are reportedly already finding it hard to obtain trade credits from abroad which could cripple the export sector that has to contend already with falling foreign demand.

The above concerns provide an opportunity for central banks in Africa to strengthen their regulatory capacity by setting up financial stability units as well as the required capacity. This would enable Supervisory Authorities to undertake various sector stress tests with a view to undertaking appropriate policy responses to minimize the impact of the risks.

Regulatory risk and financial stability

One of the key roles of many central banks in Africa involves the task of maintaining a safe and sound banking system as well as ensuring an effective payments system. The task for continuous oversight of the financial system largely involves risk-based supervision and regulation. For Uganda's case, the Bank of Uganda has put in place a comprehensive and well-designed risk-based analytical apparatus for early detection of changes and vulnerabilities that could develop into a serious systemic crisis. The main purpose of this analytical apparatus is to ensure that there is timely detection of vulnerabilities in banks and all other depository institutions that are of central importance to depositors as well as for the payments system, which requires shareholders of these institutions to make prompt provisioning of capital. These measures are aimed at ensuring that the various institutions as well as the financial markets function properly. The process also involves continuous follow-up with financial market participants to ensure timely implementation. In view of the lessons from the global financial crisis and the global recession, the BOU is also setting up a Financial Stability Department whose role, among others, will be to provide basic analysis of financial stability. The emphasis will be to provide a comprehensive stability assessment, highlighting the various risks to macroeconomic stability.

The case for "light-touch" policy responses

The crisis also presents the danger of the policy makers and regulators panicking and overreacting in their response. In such circumstances, there is a high propensity to favor short-term "politically rewarding" policies like interest rate cuts, exchange rate policy reversals to the detriment of long run benefits of consolidation of macroeconomic stability and growth underpinned by fundamentals. Accordingly, there is need to consolidate macroeconomic stability and growth, and minimize policy reversals.

Dangers posed to public financing

As noted above, the global recession may impact negatively on the demand for exports leading to a higher trade deficits. This coupled with reduced current transfers poses concerns for the current account deficits and their attendant financing. In Uganda's case, export earnings have declined by an average of 20 percent for the period November 2008-February 2009 compared to their corresponding levels a year ago. Current transfer inflows have also reduced from US$ 844.6 million during the first half of 2007/08 to US$ 706.9 million received in the first half of 2008/09. Consequently, Uganda's current account position has worsened from a surplus of US$ 204.7 million in the first half of 2007/08 to a deficit of US$ 401.0 million registered in the first half of the current financial year.

With most African countries running current account deficits of 5 percent or more of GDP, vulnerability to swings in the various sources of external financing is unavoidable.

The likely slow down in global trade poses challenges for the Tax Revenue Authorities. A possible below-target performance is anticipated for FY 2008/09 leading to higher than anticipated fiscal deficits for Uganda and other African economies. Portfolio investment could also fall, as greater risk aversion may keep capital closer to "home". Exit of offshore investors in capital markets was observed in the latter part of 2008 leading to instability in the foreign exchange markets and decline in share values across Africa.

Although FDI is historically more resilient to shocks, some decline is anticipated. In addition, access to international capital by African governments and businesses may come at higher interest rates on account of risk-aversion of lenders.

Though budget priorities of donor countries are expected to shift with some impact on donor flows and aid to African economies, the recent G20 summit in London went a long way in reassuring the world and especially Africa on the key issues of financing by the advanced countries and multilateral institutions like the IMF and the World Bank. The rescue package put in place by the industrial countries, and the one trillion US dollar package may go a long way to reverse the global recession.

Possible policy responses include fast-tracking regional integration to increase exports within the regional, consolidation of export-oriented trade policy measures, as well as investing in infrastructure aimed at increasing domestic productivity and reducing domestic resource cost ratios.

IV Policy measures that could be considered by the MDBs to increase access to finance

The main challenges facing many African economies relate to addressing acute shortages of financing, especially for long-term public investment programs, private investment, and export trade financing. Addressing these challenges remains critical for both minimizing the impact of the global crisis and positioning the continent to take advantage of opportunities arising from the global economic recovery after the crisis.

Credit crunch

Although many African economies survived the initial impact of the financial crisis due to lack of direct exposure to the American sub-prime mortgage debts, their access to international capital has been severely curtailed. For example, in the case of Uganda, several entities are reported to have repositioned themselves from borrowing from abroad, to borrowing from the domestic banks. The limited capacity for domestic banks to meet the new domestic credit demands suggests a threat to maximum growth of Africa's trade. Accordingly, this suggests a need for MDBs to provide lines credits to domestic financial institutions, to increase their capacity to deal with this new development.

Capital inflows

The global crisis is reversing the recent upward trend in capital inflows to Africa. The stagnation and in some cases, decline in private foreign capital inflows a need for the MDBs and the G20 to increase development assistance to Africa in amounts that should be adequate to offset the projected shortfalls in the balance of payments in both the short-, medium- and long-run.

Shortage of infrastructure financing

The severe shortage of key infrastructure in Africa is a key constraint to supporting high productivity and economic growth in the continent, as well as increased access to markets. This suggests a critical need for MDBs and the G20 group of countries to increase access to investment finance for African economies by scaling up and targeting development assistance to bridge the infrastructure gap.

Access to finance for SMEs

Many SMEs in Africa lack access to long-term finance to support large-scale activities. MDBs could assist local domestic banks to build capacity by providing lines of credits aimed at addressing the financing needs of SMEs, especially during this time of tight access to international credit markets following the global crisis.

Measures to support domestic savings mobilization

MDBs need to support domestic efforts aimed at increasing and strengthening domestic resource mobilization to augment the aid and other development efforts. Accordingly, it is important that MDBs support the development of the domestic financial sector is to enhance domestic resource mobilization, with a focus on promoting its efficiency and deepening.

Stabilization funds

The persistent swings in commodity prices as well as terms of trade for many African economies, and the global recession, suggest a need for MDGs to put in place stabilization funds to finance countercyclical measures.

Additional policy measures need to be tailor-made to address the downward risks to growth as discussed above. Key among these include external sector policy measures aimed mitigating the decline in the demand for exports of Africa and other developing countries, especially from industrial countries. It also requires measures to address the adverse effects of the terms of trade. In the case of Uganda, the Government has decided to consolidate its public infrastructure investments in roads and energy to increase productivity by reducing the costs of doing business and to increase exports within the region.

Multilateral Institutions could assist African economies by providing appropriate instruments to enable appropriate adjustment to the global shocks. For example, balance of payments support as well as structural adjustment loans could be provided for those countries that are primary commodity dependent and have been severely affected by adverse terms of trade. For well diversified economies, emphasis could be consolidating measures aimed increasing productivity gains. In Uganda's case, as the global financial centers seemingly headed towards a meltdown in September/October 2008, the BOU allowed the economy to partly adjust to the global shocks through the flexible exchange rate policy already in place. Accordingly, in the face of uncertainty, policy measures aimed maintaining a flexible exchange rate regime might assist to absorb part of the balance of payments pressures, as well as partly to reduce the adverse impact of the terms of trade.

Most importantly, the issue of macroeconomic stability and the triple-deficit problem need to be appropriately calibrated and well coordinated to avoid a potential risk of a return to unsustainable macroeconomic imbalances. In the case of Uganda, a review of the fiscal program was made to accommodate lower than programmed domestic revenues.

Additional policies going forward

The global recession is a threat to Africa's strong economic growth performance of recent years as well as its plans to scale-up infrastructure spending. But reflecting the prudent policies of recent years, Africa must be in a good position to weather the storm including on account of the planned increase in public investment.

The scaling up of investment especially into infrastructure should prove a good enough stimuli if absorption issues as ell as efficiency and effectiveness in the implementation of public programs are well catered for.

With respect to monetary policy, the Central Banks across Africa should pursue the objective of preserving foreign reserves and maintaining sound macroeconomic stability. This is important because the outlook for capital inflows of all forms (FDI, portfolio, remittances) as outlined prior is declining.

The Balance of Payments (BOP) shocks should be partly allowed to be absorbed via flexible exchange rate adjustments.

I will also add my voice to the need to strengthen and broaden financial stability assessments beyond the traditional banking sector. This should include cross-border cooperation to ensure sound international financial rules and systems to minimize financial contagion.

V Concluding remarks

The impact so far on financing for development is not too big to warrant a major policy shift in a number of our economies, and certainly not in the case of Uganda. In other countries that are heavily dependent on few primary commodities, the appropriate policy would be to diversify exports and maintain a flexible exchange rate policy.

While the global financial and economic recession appears to be severe among industrial countries, the limited integration of Uganda's financial sector and the overall economy into the global economy provides some safety net. However, the second round effects associated with the global recession poses a major threat to Uganda's economy.

Maintaining sound economic fundamentals necessary to help economies adjust to the crisis will require prudent and flexible macroeconomic management policies together with smarter financial market regulation, including risk-based banking supervision.

Finally, there is need for an effective and focused public communication strategy of confidence building by our governments so as not to undermine the performance of our economies through mistakes that could be caused by unnecessary panic. The communication strategy needs to emphasize the need to exploit all the opportunities that could be availed by the global crisis. Government actions need to be well-coordinated to avoid "beggar-thy-neighbor" policies that could make the financial sector regulators' job harder in the future.