Nordiska Afrikainstitutet
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IMPACT OF THE FINANCIAL CRISIS ON AFRICA

The unpredictable flows: remittances and aid

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The forecast of economic growth in Sub-Saharan Africa have repeatedly been revised downwards over the last 6 months. It has now reached 2% which is close to a third of what it was a year ago, implying negative growth in per capita terms. Considerable uncertainties remain in these forecasts. Oil- and mineral exporters are likely to take a severe first hit, as collapsing commodity prices translate to reduced export revenues and foreign direct investments are paralyzed. Two additional flows that connect Africa to the global economy, where impact is harder to predict, are aid and remittances. This note explores how these flows have reacted in OECD countries during previous episodes of severe financial crises. It is shown that if these past episodes serve as a guide to the present, then a considerable reduction is to be expected. Remittances would react immediately, while the impact on aid would be lagged but being more prolonged. Given that projection, the critical need for more of accountability in international aid commitments is discussed.

The immediate impact of the crisis: export revenues and FDI down

Predicting the impact of the financial crisis on Sub-Saharan Africa is still something of a guess work. The growth forecasts of IMF and the World Bank have repeatedly been revised downwards since October 2008. The April 2009 IMF/Global Economic Outlook predicts a Sub-Saharan growth rate of 2%, to be compared to the actual 5.2% growth rate of 2008. It implies negative growth in per capita terms for Africa, for the first time in over a decade. Previous speculations that Africa might be saved from the global recession, due to its limited connections to financial markets, sound increasingly as wishful thinking.

The main channels through which Africa is affected by this crisis are trade (volumes and terms of trade), foreign direct investments, remittances and aid. Some African countries are also affected by losing access (or by more expensive access) to international financial markets and by a decline in tourism. Table 1 gives an overview of the magnitudes of some of these flows to Africa. Table 2 presents a ten-top ranking of the African countries that are most exposed to each one of them.

Table 1, Exports and Financial flows to Sub-Saharan Africa 2006, billion USD

Exports, fob	250
AID (ODA net)	40
FDI (net inflow)	15
Remittances	15

Source: World Bank, World Development Indicators

Table 2: Dependency on aid, remittances and FDI as % of GDP, ten-top ranking of Sub-Saharan African countries

AID (%GDP)	Remittances (%GDP)	FDI (%GDP)
Mozambique (43)	Liberia (111)	Djibouti (31)
Lesotho (38)	Lesotho (24)	Liberia (24)
Liberia (27)	Gambia (12)	Congo/DRC (23)
Guinea Bissau (21)	Cape Verde (12)	Chad (14)
Rwanda (18)	Guinea-Bissau (9)	Cape Verde (10)
Burundi (18)	Togo (8)	Angola (9,5)
Malawi (12)	Uganda (7)	Gambia (9)
Tanzania (11)	Senegal (7)	Niger (8)
Uganda (5)	Kenya (5)	Madagascar (8)
Zambia (5)	Benin (4)	Uganda (7)

Source: Aid and FDI: IMF 2009b (IMF projected gross flows 2008). Remittances calculated from World Bank/WDI and refer to 2006.

The trade and foreign direct investment channels are relatively clear-cut, directly linked to the development on the global markets. Drastic worsening of terms of trade for oil and mineral exporters is already apparent, as is a sharp decline in foreign direct investments (also oil and mineral related to a large extent). There are already numerous reports from African countries of FDIs being delayed or suspended with short notice. The impact on African aggregate export revenues is also immediate and substantial. During the second half of 2008 oil prices declined by 69% and non-energy commodity prices by 38%. According to some estimates Sub-Saharan export revenues are expected to decline by approximately 40% in 2009 (Ali 2009). African oil and mineral exporters will hence receive the most immediate impact of the crisis in the form of reduced export revenues and foreign direct investments. The expected loss in growth rates

2009 as compared to 2008 are particularly severe in previously booming economies such as Angola (-18,5%), Equatorial Guinea (-16,7%), Botswana (-13,3%), and Niger (-6,5%). In South Africa, the most important economy on the continent, negative growth is now projected for 2009. (IMF 2009b)

Forecasting remittances and aid flows

When it comes to remittances and aid the basis for making forecasts is far more shaky; in the case of remittances partly because they are still poorly measured[1], in the case of aid because it is politically determined and in both cases because the global character of this recession is without precedence. A recent World Bank report forecast remittances to Sub-Saharan Africa to remain quite resilient, falling by just 4,4% in 2009 (compared to a growth rate of 6,3% in 2008), with the caveat that the basis for this forecast is shaky (World Bank 2009). When it comes to aid flows most analyses of the impact of the crisis raise the warning flag - “aid might be at risk” - but avoiding any projections. The undesirable characteristic of aid being pro-cyclical, rather than working as a cushion in difficult times, is often pointed out. Solid empirical evidence support that claim (Bulir and Hamann 2006).

There are obvious difficulties in making forecasts of the impact of an exceptional event like the present financial crisis. However, a number of developed countries have, one by one, experienced severe financial crises also over the past decades. Can these past experiences be a guide to what is expected to happen with aid and remittances? This is what this note pretends to explore, following the logic of comparing exceptional events to exceptional events.

The approach is simple. Use is made of a study by Reinhart and Rogoff (2008), which identified 18 bank-centred financial crises experienced in OECD-countries since the 1970s. A few of these episodes were identified by Reinhart/Rogoff as the “big five”: Spain77, Norway87, Finland91, Sweden91 and Japan92. From these 18 episodes countries with missing data on remittances and/or aid were excluded (see note below chart for further comments) which left us with 14 episodes in the case of remittances and 13 episodes in the case of aid. Among these are the “four big ones” (Spain77 dropped from “big five” as it had no registered flows at that time). The flows are indexed to 100 at the year of the identified financial crisis, labelled “year zero”. Averages are constructed of these indexes for the “big four” as well as for the entire group of episodes, forming synchronised time series from five years before the crises to ten years after they ended. The results are shown in Figure 1 and 2. As revealed by these curves both flows are highly sensitive to financial crises episodes, and particularly to the severe ones.

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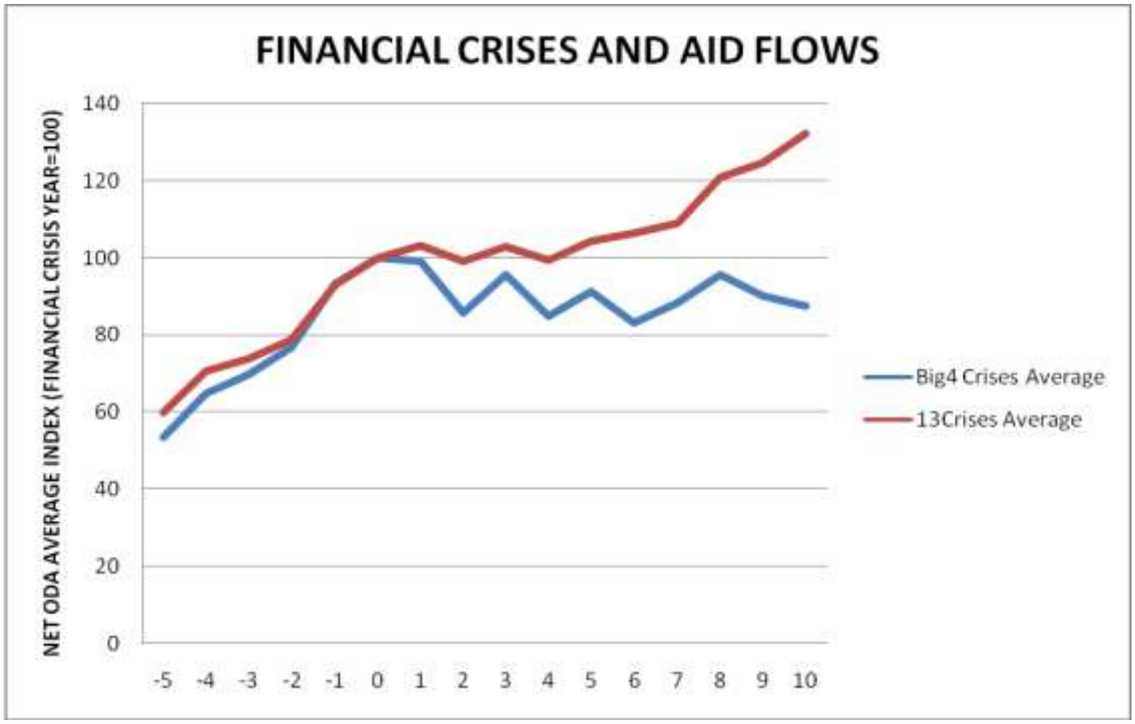
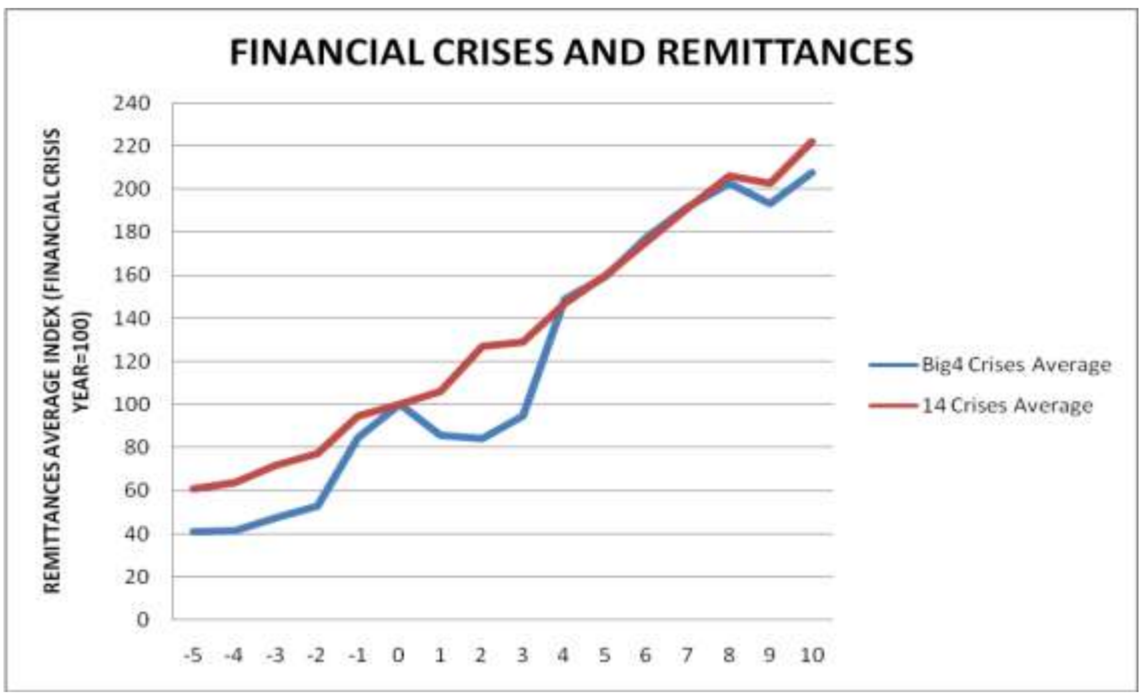
[1] According to some World Bank estimates there is an underreporting of remittances in official statistics that could come close to 50% (World Bank 2006). To the extent that measurement errors remain more or less constant this is less of a problem when time series are the object of study.



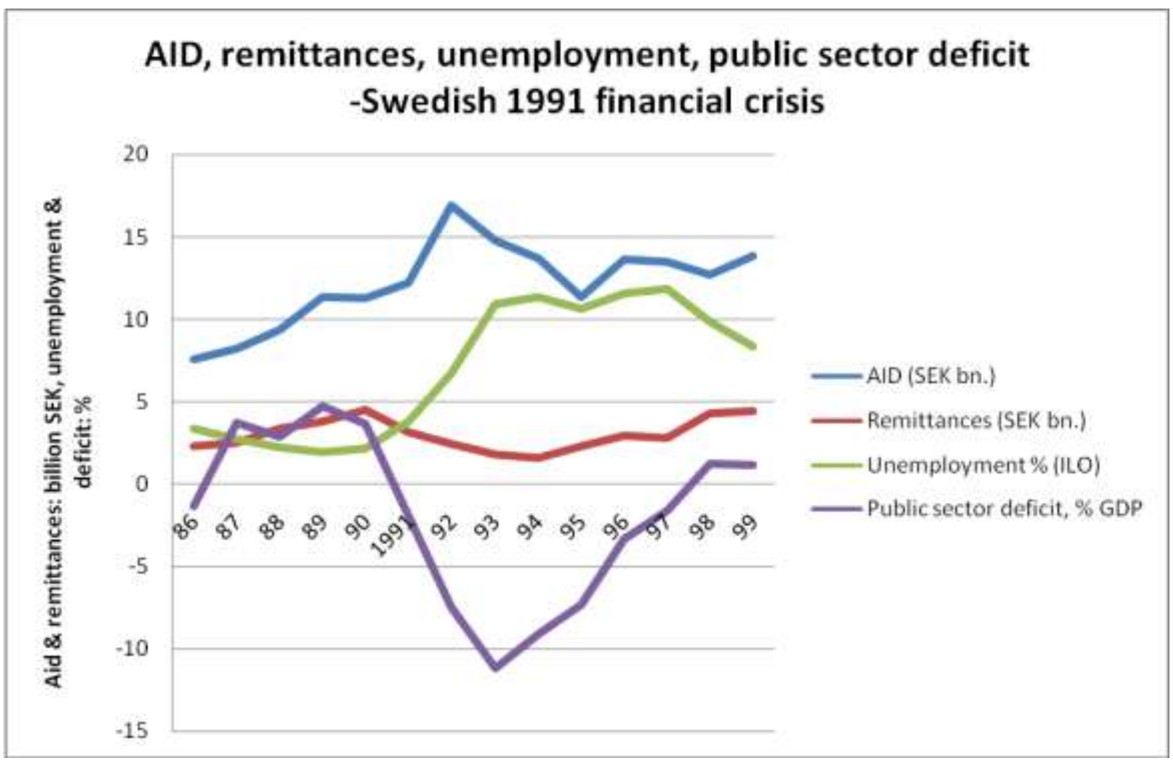


Comment: Year 0 is the year of financial crisis. 18 episodes of financial crises identified from Reinhart and Rogoff (2008). "The Big 4 Crises" are Norway87, Finland91, Sweden91 and Japan92. Other crises events are Australia89, Canada83, Denmark87, France94, Greece91, Iceland85, Italy90, New Zealand87, UK91, UK95, US84. Some countries excluded due to missing data on aid (Iceland, Greece) or remittances (Canada). Also Spain1977 had no registered aid or remittances flows. Only crises after 1980 included. Flows (in current USD) indexed to 100 at year 0, with averages based on these indexes.
Data sources: AID (ODA net in current mUSD) from OECD/DAC. Remittances from World Bank World Development Indicators

In the case of aid flows, which were rising steadily prior to “year 0”, both curves have a clear kink. It is of interest to note that in the case of the “big four” episodes (blue curve Figure 1), aid flows stagnated and did not return to the pre-crisis level even after ten years. So if past exceptional events are used as a guide, one would expect this financial crisis to have a substantial and prolonged negative impact on aid flows.

In the case of remittances it is only in the case of the “four big” episodes that we see a clear impact, with remittances down by some 20%. The curve returns to its pre-crisis path after 3-4 years. When all country episodes are included, no impact is noted (red curve).

A comparison of the countries of the “big four” episodes reveals heterogeneity in the time patterns of how the flow responded. In Finland it was immediate and substantial (aid down by 70% and remittances by 50%). Japanese remittances were largely unaffected, while the impact on aid came with a 4-5 year lag (then down by approximately 40%). The Swedish aid response came with a 1-2 year lag (down by 30%) while remittances reacted immediately and fell by some 50%. Norway 1987 is an exception, with only minor impact on aid and remittances flow (down by 5-10% and rapidly returning to pre-crisis levels).



Sources: Aid from OECD/DAC and Remittances from World Bank/Global Development Finance, both flows reconverted to Swedish kronor from current USD. Unemployment and Public Sector deficit from Konjunkturinstitutet/Nyckeltal.

Which are the drivers behind these responses? Exchange rate effects is one element, as flows are measured in current USD and some of these crises were combined with considerable exchange rate fluctuations. Furthermore, it seems reasonable to suspect that remittances are most likely reacting to labour market conditions while aid flows are linked to fiscal adjustment processes. Figure three show four curves for Sweden: aid, remittances, unemployment rate and public sector deficit/GDP. In this case flows are measured in Swedish kronor, so that any exchange rate effects are not taken into account (unemployment and deficit are measured as percentages). The hypotheses it lends itself to is that remittances react immediately as unemployment goes up, while aid reacts as rising budget deficits have to be dealt with in a fiscal adjustment process. Translated into the present financial crisis we should hence expect a rather immediate response in lower remittances as labour market conditions in remitting countries worsen, and a lagged but more prolonged response in lower aid flows.

Concluding remarks

If past episodes serve as a guide to the present we should expect a sharp decline of remittances and aid. However, there is obviously nothing deterministic about aid flows, as they are direct outcomes of conscious policy choices (which is not the case with largely politically uncontrolled remittances). It is still probably safe to predict that there will be strong forces operating against keeping up aid flows as donor countries go through their fiscal adjustment processes within the next few years. Ministers of development co-operation will have to face the challenge of defending a particular budget line while most other expenditures are subject to cuts. Other ministers (i.a. defence, environment, trade) are likely to propose more relaxing aid definitions as a way to compensate for budget cuts within their expenditure areas. The latter will be done despite OECD/DAC agreed definitions and commitments of “additional support on top of ODA” having been used playing cards at international conferences to gain concessions from developing countries. An already vocal anti-aid lobby will provide the messages many will be pleased to hear (even if difficult intellectually to defend cutting down aid pro-cyclically, reinforcing other external shocks). That is the political game we should expect in donor countries as they enter their fiscal adjustment processes just a few years from now.

Are there any countervailing forces? After all, the annual USD40 billion in ODA to Africa is nothing but a tiny fraction of the several thousands of billions in stimulus packages in the US, EU and Japan. The main countervailing force is the fact that rich countries have made public commitments. G8 promised to double aid to Africa at Gleneagles 2005 and at the conference on Financing for Development in Doha, December 2008, donors reconfirmed their aid commitments from Monterrey 2002. As late as April 2009 the G20 announced: “We reconfirm our historic commitment in meeting MDGs and to achieving our respective aid pledges, including commitments on aid for trade, debt relief, and the Gleneagles commitment, especially to Sub-Saharan Africa” (G20 London declaration). But aid commitments have been made over an over again, ever since the UN target of 0,7% of GNP was set way back in the sixties. It has been repeated at conference after conference over the following decades in a trail of broken promises. When it comes to aid commitments accountability mechanisms are apparently absent. “Breaking G8 aid pledges has inflicted no significant political damage on anyone” a Financial Times editorial recently complained, asking for more accountability from the London G20 meeting (FT 14 April 2009: “G20 aid pledges must be more than just hot air”).

But who will demand accountability from G20, G8 and others if all donors involved in these fora fail to comply themselves? Some role could be played in this respect by the select group of countries that actually have lived up to the 0,7% UN target, let us from now on label them the “G5”: Denmark, Norway, Netherlands, Sweden and Luxembourg. Maybe some parallel “G5”-meetings should be organized as side-events to the next round of G20’s and G8’s? Do theses G5- governments dare to take on the role as provokers?

In any case, for the Nordic countries as members of this select group, it is more crucial than ever to stay clear on their own commitments. It is also in their interest that transparent and internationally agreed aid definitions are upheld and respected. This obviously also imply that they themselves should refrain from any temptation to operate in the grey zone of aid definitions.

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