What Kind of Fiscal Stimulus for Africa?

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Before the global financial crisis of 2008, African economies were experiencing an unprecedented economic boom. While the unweighted GDP per capita growth was -0.2 percent in 1980-95, it jumped to 2.26 percent in 1996-05, and accelerated to 2.90 percent in 2006-07. Evidence suggests that the growth push observed after 1995 was driven by a combination of better policies[2] and the commodity boom.[3] Between early 2003 and mid-2008, oil prices climbed by 320 percent in dollar terms, and internationally traded food prices by 138 percent. But the boom is over (see table below). Prices across the board have fallen, giving up much of their earlier gains due to slower global GDP growth, increased supplies, and revised expectations. This sudden change marks the end of what has been the biggest commodity price boom of the past decades.

Commodity	2006-2008	YTD (February)	2009 (forecast)
Crude oil, spot, $/barrel	77.4	41.8	46.7
Copper $/MT	6,932	3,314	3,462
Aluminum $/MT	2,593	1,330	1,404
Cotton, index c/kg	141.2	121.8	124.5
Coffee Arabica, c/kg	277.6	285.4	259.3

Source: Global Economic Monitor – World Bank.

With the commodity boom, investors were attracted to the region to take advantage of Africa's huge commodity potential. Between 2000 and 2006 foreign direct investments to the region almost tripled, and the bulk of these investments went to resource-rich countries.[4] As a consequence commodity production reached record highs, notably in oil and mineral sectors. Investments in new oil fields, copper, nickel, coal, gas, cobalt, uranium and other minerals are underway, and production capacity is expected to increase significantly in the near future – at a time when prices are depressed. In short, Africa is experiencing a dual commodity shock – a supply and a demand shock. And the commodity exporting sector is the main channel through which the global financial and economic crisis is hitting the region.

This note contributes to the recent discussion on a fiscal stimulus to mitigate risks of the global recession on Africa.[5] If the commodity exporting sector is the main transmission

[1] Office of the Chief Economist, Africa Region, The World Bank, Washington, DC. March 31, 2009.
[2] Annual average CPI in 2000-2006 was 20.7 percent, down from 128.3 percent in 1990-1999.
[3] Arbache, J.S. and J. Page (2009), How Fragile Is Africa's Recent Growth? *Journal of African Economies* (forthcoming). Available at http://papers.ssrn.com/sol3/cf_dev/AbsByAuth.cfm?per_id=290246.
[4] Oil producers Angola, Equatorial Guinea, Nigeria and Sudan alone received 63 percent of all FDI that went to the region in 2006.
[5] See, for example: http://africacan.worldbank.org/a-fiscal-stimulus-for-africa ; http://www.changes-challenges.org/story/joint-declaration ; http://www.odi.org.uk/resources/odi-publications/opinions/125-fiscal-stimulus-global-recession-downturn.pdf ; http://www.imf.org/external/np/speeches/2009/020309.htm .

channel, and because African economies typically have small domestic markets, then the nature, content and design of any chosen fiscal stimulus plan should differ from those that have been deployed in other regions in the form of tax cuts, cheap credit, extended unemployment insurance, active labor market policies, cleaning balance sheets of banks, etc.[6] There is some consensus that fiscal space and debt sustainability should guide the size of any expansionary fiscal policy. What is unclear is what policies are likely to be effective, taking into account the transmission channels and the structure of African economies. This note briefly discusses these issues and highlights targets and instruments that policy makers may want to look at for designing fiscal stimulus plans.

Targets

Sectors with large multiplier effects. A fiscal stimulus should favor sectors that have large multiplier effects and that can provide responses in a timely fashion. The commodity exporting sectors in Africa do not always meet these criteria because they typically employ relatively few workers, have small or no linkages to the rest of the economy, usually enjoy subsidies and tax breaks -- which exacerbate fiscal deficits,[7] and are therefore somehow isolated. One example is an aluminum smelter firm in Mozambique, which is responsible for 66 percent of total exports, enjoys large subsidies and tax breaks, has very limited linkages with the rest of the economy, and barely employs 1,000 workers. At the other side of the multiplier effect spectrum is the cotton sector in West African countries, which is labor intensive and production is spread across thousands of farms countrywide.[8]

The case of Brazil during the Great Depression, at a time when it was basically a coffee-exporting economy, is illustrative of the importance of the multiplier effect. In order to counteract the sharp drop in coffee demand, which could have devastated the economy, the government implemented a policy to buy and destroy the coffee surplus, financed by monetary expansion. The coffee sector was not only the largest, but it was labor intensive and spread across thousands of farms. The outcome of this policy was that income dropped significantly less than in the US during the crisis and the economic recovery was much faster. By targeting an existing and well-established economic activity, the policy was effective and timely.[9]

Unemployment and capacity utilization. In Africa, excess capacity utilization of the exporting sector is more relevant than unemployment. Unlike Africa, unemployment is increasing in China, Brazil, India and other developing countries as a result of falling exports. But a marked difference between these countries and Africa is that they export a lot of labor intensive manufacturing goods and services that generally have substantial

[6] Needless to say that a fiscal stimulus should take into account the specific features of countries and the different transmission channels through which the crisis will hit them.

[7] Zambia, for example, has introduced a new mining tax regime, which came after years of criticism for having one of the lowest royalty tax rates in the world and awarding lengthy tax holidays to foreign investors. The new mining tax regime is still very generous and the royalty tax rate for copper and cobalt mining is 3 percent of gross value up from 0.6 percent been levied to September 2008.

[8] In Burkina, for example, cotton is the primary source of rural incomes. It encompasses more than 200,000 producers and 17 percent of the population depends on the sector.

[9] Critics contend that political capture and protection of the coffee sector, which was then the most influential political group, was actually the main driving force of the government's policy.

linkages with the domestic economy.[10] In Africa, exporting sectors -- especially mineral -- do not typically employ any significant share of the labor force.[11] As a consequence, rising unemployment is unlikely to be one of the major consequences of the crisis.[12] Therefore, differently from other regions, a fiscal stimulus in Africa should not primarily focus on unemployment in the first instance. It is capacity utilization of the commodity sector that will be more affected by the global crisis and the severity of the impact on the economy will be determined by the size of its multiplier effect.

Inflation. Inflation caused by exchange rate depreciation is a major threat for the poor. As long as African economies remain heavily dependent on exports of a few traditional commodities, exchange rate depreciation is likely to follow the fall in exports. But as these countries are usually highly dependent on imports of food, fuel, and other important items, governments will have to seriously consider policies to cushion the impacts of higher prices on the poor. In the short run, the net effect of falling food and oil prices due to the crisis as against exchange rate depreciation will vary from country to country, but if the recession persists, the net effect is likely to be harmful to the poor of most African countries.

Investment climate and infrastructure. The fiscal stimulus should ease the conditions to do business. If the drop of commodity prices reduces the marginal return of capital and the market value of mines, oil fields, land and alike, then it will affect the incentives firms have to invest, further impacting economic growth. As there is little that the government can do to improve foreign demand for commodities, the fiscal stimulus should focus on improving the conditions to do business and upgrade the precarious infrastructure, which will increase the marginal return of capital in the medium and long run, encourage diversification away from the commodity sector, and increase economic growth.

Instruments

Public finance, tax cuts and income transfers. Fiscal stimulus plans should be guided by fiscal space and debt sustainability. Government revenues of African countries usually depend on export earnings. In many, these proceeds can reach as much as 70 percent or more of the budget. Falling exports will slash revenues of government, increasing budget deficits across the board. To fund a fiscal stimulus, finance-constrained governments can resort to inflationary sources of finance or increase debt, both of which could compromise the economic rebound. External finance is therefore a key source of funding for a more sustainable fiscal stimulus.

[10] Another difference is that unlike most African countries, these countries have large domestic markets to rely on to cushion the effects of declining exports.
[11] Unlike the mineral sector, agricultural commodities are usually produced by several small farms and employ a large number of people.
[12] Although unemployment rates in Africa are already high, only a small number of people are actually unemployed because the large majority of the labor force is attached to some form of subsistence, micro/small scale businesses, and informal activities. Unemployment can however be an issue in the capital and other large cities.

The income tax base is usually small in poor countries and therefore an income tax cut is unlikely to have any significant demand impact. General VAT cuts are also unlikely to add to the economy, at least in the short run, because the propensity to import is very high, thus leaking demand into other countries. A VAT cut will be effective as long as it is applied only to goods that are locally produced, but this would be administratively difficult. Income transfers such as conditional cash transfers, for example, are unlikely to boost demand in the short run because of lack of capacity and systems in place to reach targeted groups and prevent leaks.[13]

Safety nets. Expansionary spending through safety nets is usually effective when channeled quickly through existing programs to target the neediest and those who have higher marginal propensities to consume. This, however, is not the case for most African countries, where unemployment insurance and similar programs are either unavailable or very limited. Instead, fiscal policies could scale up service delivery of health, education and other social programs that already reach the poor, but are in need of resources, which would improve welfare and mitigate the risks of the crisis on the poor.

Credit. Credit expansion depends on market conditions. Differently from other countries, credit markets in Africa were already very limited before the crisis – there are a few banks operating with few basic financial instruments only. Thus, it is unlikely that the financial market will be able to channel and pump more credit into the economy in the short run. Finance-constrained firms, notably SMEs, can eventually benefit from increase in credit if they are operating in markets where there is still untapped demand. However, this is unlikely to be the case of many sectors during this point in time.

Conclusions

- Although there are common issues that cut across Africa, the nature of the fiscal stimulus will be country-specific.

- High dependence on exports of few commodities, small domestic markets to rely on, large informal economy, high propensity to import, low tax base, lack of safety nets – all these African-specific characteristics suggest that expansionary fiscal plans similar to those being applied in other regions are unlikely to be effective in Africa.

- A fiscal stimulus can work more effectively and quickly through commodity exporting sectors that have large multiplier effects, whenever they exist.

- Investments in infrastructure and reforms that improve the investment climate will be effective in improving economic growth in the medium term and set the stage for a more rewarding and rapid recovery.

- If the global recession persists, governments will have to introduce policies to protect vulnerable groups from likely increases in prices of food and fuel due to exchange rate depreciation.

[13] The Latin American experience suggests that putting a CCT system in place and making it work properly requires several months.

- The issue of funding for fiscal stimulus is critical. Donors should step in to support countries, especially in cases where government revenues dropped substantially as a result of falling export earnings.