The Impact of the Global Financial Crisis on Financial Markets in Sub-Saharan Africa

Executive Summary

The purpose of this note is to provide an overview of transmission channels of the global financial crisis to African countries, discuss key policy challenges and recommendations and provide more in-depth analysis of recent events in selected countries. As African countries increasingly feel the impact of the global economic slowdown, financial systems in these countries have so far been resilient to the credit crisis. Countries are facing increasing difficulties in financing their growing current account deficits as foreign sources of capital – portfolio flows, remittances and external borrowings by banks – have either reversed or slowed down. Hitherto the shock to external financing has been accommodated largely by a mix of foreign exchange reserve depletion, exchange rate depreciation, bank intermediated inflows (where available) and in some cases imposition of foreign exchange restrictions.

While the impact of the crisis has varied across banks, overall African banking systems have so far been fairly resilient to the crisis. However, there are several emerging sources of risk: (i) increases in non-performing loans resulting from the slow-down in economic activity, declining commodity prices, currency depreciation and the sharp drop in equity prices, (ii) tightening of liquidity due to reduced trade credit flows and withdrawal of liquidity from local subsidiaries of foreign banks reflecting the fall-out of distress in the banks’ home countries, and (iii) possible contagion risks from less well-supervised regional banks.

In addition, the initial indications are that remittance flows – a significant source of foreign exchange inflows for Sub-Saharan African countries – are weakening depending on the destination of migrant workers and thereby on where these flows originate.

The danger is that the gains made in reforming and deepening of financial sectors in Africa over the recent decade or so, especially with regard to defining and containing the role of government and harnessing the benefits of globalization through financial integration, could stall or be reversed. As banks de-leverage and as their liquidity declines, access to credit of small and medium enterprises...
and term financing in particular will be even more constrained. Moreover, as governments look at domestic markets to finance their deficits, private sector credit can be crowded out. Key financial sector policy issues that need attention are strengthening of crisis contingency planning and preparedness, maintenance of prudential regulations as well as more communication among regulatory authorities across borders, instituting market-conform mechanisms to preserve access to finance, especially for SMEs, and intensification of efforts to deepen domestic capital markets.

**Highlights of selected countries cases**

**South Africa** is facing mounting challenges in financing its deteriorating current account deficit as portfolio inflows – a major source of funding in the past – show a sharp reversal in fourth quarter of 2008. At the same time GDP growth is expected to slow to 1 to 2 percent or less in 2009.

**Nigeria** is seriously impacted by the decline in oil prices both as regards exports receipts and government revenues. The reversal of portfolio flows and the sharp downturn in equity prices have significantly affected the banking system due to its heavy reliance on equity market for raising capital and practice of lending against share purchases. The central bank has recently resorted to restricting banks’ access to foreign currency and imposed foreign exchange restrictions to curb the pressure on exchange rate. The drop in commodity prices is also the dominant impact on other countries, such as **Zambia** and **DRC**.

**Kenya** is witnessing a significant slow down in part due the residual effect of post-election conflict early in 2008 and the impact of the food crisis. The current account has deteriorated sharply due the drop in tourism receipts and horticulture exports. While having to postpone plans to make a eurobond issue, the Government has resorted to substantial domestic borrowing so as to sustain spending on infrastructure investments.

**Ghana** is experiencing the twin problem of high fiscal and current account deficits. Despite falling global demand the authorities have been obliged to tighten monetary policy. The rising cost of borrowing may prove to be especially problematic, if remittance flows that have been a major source of financing for the current account begin to slow down as a result of crisis.

Already prior to the crisis the financial systems of **WAEMU countries** were rather weak, being dominated by banking sectors with low capital adequacy ratios, high risk concentration and large shares of NPLs (especially in Benin, Mali and Togo). Over the past year, there has been further deterioration. Throughout 2008 the BCEAO has had to inject liquidity in the system. The crisis is exacerbating the funding problems already faced by agricultural producers reliant on pre-financing of their output.
Section I. Introduction

Even as some relatively more developed financial markets in Africa are dealing with the contagion effects from the current crisis in global finance, the broader risk to the region — the “real” consequences of a global recession — is also beginning to manifest itself. The recession in developed countries, the significant deceleration in large emerging markets, such as China and India, the consequent reversal of the world trade boom and falling commodity prices, the anticipated deceleration in remittances and aid disbursements; and other domestic macroeconomic and financial sector fragilities all make it very challenging for African countries to sustain the growth momentum of recent years.

This note monitors the impact of the on-going turbulence in global financial markets on African countries. It updates and expands on previous versions of the report. Section II discusses the transmission channels whereby the global financial crisis is affecting Africa, notably stock and foreign exchange markets, capital flows, banking systems, trade finance and remittances. Section III highlights key policy challenges and recommendations; and Section IV takes a more detailed look at selected countries that have already experienced significant disruptions.

Section II. Transmission Channels

II.A. Impact on Stock and Foreign Exchange Markets in Sub Saharan Africa

The most immediate effect of the crisis has been felt on stock markets and foreign exchange markets. Prominent stock markets in sub-Saharan have all fallen substantially since the onset of the global financial crisis, mirroring trends in developed country markets and reflecting the outlook towards slower growth. Similarly, dollar exchange rates have softened, reflecting worldwide trends towards increased investor appetite for dollars as a ‘safe-haven’ currency and the weakened current account prospects due both to the fall in commodity prices and falling export receipts.

Being more integrated with the international financial system South Africa remains exposed. The JSE All-Share Index has lost 31 percent since July 2008. The South African Rand (ZAR) experienced a sharp depreciation of 23 percent against major currencies in September/October, 2008. Following 4 years of expansion at 5% p.a., South African GDP had already begun to slow prior to the crisis and the latest 2009 GDP growth consensus estimate is for 1 percent to 2 percent. Hitherto South Africa has been reliant on foreign portfolio inflows to fund a sizeable current account deficit (projected to be close to 8.1 percent of GDP for 2009). As these flows show a sharp reversal in fourth quarter of 2008, the current account deficit is now being financed through bank-intermediated inflows and a mix of running down external deposits, accumulating non-resident deposits and external (short term) bank borrowing.

2 IMF, World Economic Database, Update January 2009
In Nigeria, the stock market has witnessed sharp decline since March 2008, with Nigeria All Share Index loosing more than 60 percent of its value. The correction (from very high price/earnings ratios) was triggered inter alia by foreign investor withdrawal, and led to margin calls and increases in required collateral, precipitating further declines. The decline in the Nigerian stock market is of particular concern to banks in Nigeria, as it will lead to increases in non-performing loans, as banks have undertaken lending for stock purchases and raises the cost of issuing new capital. At the same time the Naira exchange rate has depreciated by 20 percent from its level in July 2008 reflecting the drop in oil revenues. Owing to renewed pressure on the exchange rate in February 2009 the CBN replaced the existing wholesale Dutch auction system in foreign exchange markets by a retail Dutch auction system, which significantly limits the role of banks in setting rates and imposed restrictions on banks’ FX trading as a result of which banks cannot quote buying and selling rates in FX market at more than 1 percent outside the CBN published rate. In addition banks FX open positions have been further reduced from 5 to 1 percent of shareholders capital. As a consequence of these measures a parallel exchange market has re-emerged and as per news reports the rate in this market has widened 29 percent above the official exchange rate.

In Kenya since the beginning of July 2008 the Nairobi Stock Exchange 20 Share Index has fallen 48 percent. To some extent this reflects domestic factors, such as increased domestic political uncertainty following the post-election political turbulence in early 2008 and the third in a series of broker fraud scandals reflecting underlying weaknesses in governance of the Kenyan capital market. Kenya’s macroeconomic prospects have also been heavily impacted by food and fuel price inflation of early 2008 that resulted in increased pressures on consumer prices. Some part of the fall in the NSE index can also be ascribed to the Safaricom IPO in June 2008, which although heavily oversubscribed at the time, ‘drowned the market’ with a massive increase in equity supply just as sentiment was turning. As a result the many small investors who had been attracted by this issue suffered sizeable losses. Subsequently, the IPO by Co-operative Bank in November 2008 was 30 percent undersubscribed against a target of Ksh 6.7 billion. Since the beginning of July 2008 the Kenyan shilling has depreciated by 19 percent against the US dollar. The adjustment reflects high domestic inflation, a sharp increase of 92 percent in the current account deficit, in part due to the sharp downturn in tourism and horticulture receipts and increase in import bill particularly oil (due to higher prices in early part of 2008).

Ghana has recently received downgrade warnings regarding its B+ grade rating from the Standard and Poor’s and Fitch rating agencies. Ghana has a large budget deficit (that widened to 14.9 percent of GDP in 2008), a current account deficit (22.3 percent of GDP in December, 2008) and low reserve cover (1.8 months of imports at end December, 2008), and already has suffered an exchange rate depreciation of 22 percent since July 2008. Altogether the current market deterioration limits room for maneuver in deferring fiscal policy

3 Banking shares account for over 60 percent of total market capitalization in Nigeria.
tightening at a time when the economy is slowing down largely on account of domestic factors exacerbated by the global crisis. The rising cost of borrowing may prove to be especially problematic for Ghana if in addition remittances flows, that have in the past financed a large portion of its widening trade deficit, also begin to slow. The crisis has resulted in drying up of liquidity on Ghana’s relatively small domestic capital market. The long end of the bond market (beyond 2 years) was largely held by foreigners and has basically evaporated. Yields at the shorter end of the Treasury market are now about 23% versus an increase in annual inflation rate to 20.3 percent in February, 2009. The stock market that remained stable until end of 2008 (reflecting the absence of liquidity and few recorded trades), is now witnessing some downward pressure with Ghana all share index declining by 11 percent since January, 2009 (Figure 1). There are still quite a few foreign holders of Ghanaian stocks and so if they were to be able to find domestic purchasers for their shares, this would be another source of selling pressure on the cedi. Domestic mutual funds are under pressure as investor redemptions cannot be offset with sales in the illiquid equity markets (with at least one fund having to borrow for redemptions).

The SEMDEX index in Mauritius has declined by 44 percent since July, 2008, and the Mauritian rupee fell approximately 19 percent over the same period against the dollar. Foreign investment on the SEM represents roughly 20 percent of total market capitalization
In West Africa since November 2008 the Bourse Regionale des Valeurs Mobilieres (the regional stock exchange BRVM) 10 Share Index has fallen by 20%. To some extent this could reflect domestic factors, such as political uncertainty in Core d'Ivoire, the host country of the BRVM. Most of the decline can, however, be explained by the fall in oil company shares (Shell’s has fallen by 38.4%, Total by 18%). ECOBANK has not been able to fulfill it's objective of raising US$2.5 billion on the 3 regional stocks markets (Ghana, Nigeria and
WAEMU) -- raising only US$500 million in an operation that had to be extended from October 2008 to end December 2008.

II.B. Impact on Capital Flows to Sub-Saharan Africa

Prior to the crisis increased investor interest in African markets had resulted in rising portfolio inflows and foreign lending as well as an upward trend in FDI inflows, reaching an all-time high of $53 billion in 2007\(^4\). This trend reflected booming commodity markets, rising profitability of investments in the region and improved local business environments. In 2007, most FDI inflows went into Nigeria (US$ 12.5 billion) and South Africa (US$5.7 billion), but other sizable recipients were Sudan, Equatorial Guinea, Madagascar, and Zambia. FDI inflows were concentrated on natural resource extraction activities (mainly oil and gas), but telecommunications, banking services and other infrastructure also got a large share of the pie. At the same time, there was also growing appetite for foreign participation in local securities markets. Countries such as Nigeria, Kenya, Zambia and Uganda experienced increased foreign investor demand for sovereign issues, often sizable in relation to small size of the domestic securities markets.

As a result of crisis the most significant changes in financial flows have occurred in portfolio flows and external borrowing by banks. Sizeable inflows to equity and (in some cases) bond markets in recent years have stalled or have been substantially reversed (Ghana, Kenya, Nigeria, South Africa). In Nigeria net equity outflows are estimated to amount to over US$3.4 billion in 2008. In South Africa portfolio outflows in the final quarter of 2008 amounted to US$5.9 billion. External credit lines to domestic banks have come under significant pressure (reduced limits, higher spreads, cancellations), and the aggregate reduction in credit has been substantial in some cases, with credit lines to Nigerian banks reportedly down by one-half. Overall, however, with little direct financing by African corporates in international markets, apart from the major South African multinationals, tighter external credit availability has had only modest direct effects on African corporates, although some large projects have been halted and any shifting of funding onshore will likely crowd out lower-quality borrowers.

FDI flows are unlikely to reverse due to concentration of such flows in natural resource extraction that requires sizable up-front capital investment. However, a number of new projects are being cancelled, delayed or are at risk of being delayed on account of significantly lower commodity prices.

The shocks to external financing have been accommodated by a mix of foreign exchange reserve sales and exchange rate depreciation. Central banks in Ghana, Kenya, and Nigeria have accommodated the departure of foreign investors and the run-off of credit

\(^4\) World Investment Report, 2008. However, Africa’s share in global FDI remains at about 3 percent.
lines through reserve depletion – 15.4 percent in case of Kenya and 15 percent in case of Nigeria – and exchange rates have also been allowed to depreciate to varying degree. To a large extent the reversal of previous inflows appears to have run its course, with only South Africa, Mauritius and perhaps Kenya retaining a sizeable stock of inward foreign portfolio investment; but lack of inflows in the period ahead, coupled with falling export receipts and remittances may cause further pressure on the external account (see further discussion below).

II.C. Impact of the Financial Crisis on Africa’s Banking Systems

Banking systems in Africa have so far proven to be fairly resilient to the impact of the financial crisis. No major insolvencies or recapitalization exercises directly linked to the current global financial turmoil have been reported yet. Given that banking systems account for the bulk of African financial sectors, this has allowed the maintenance of overall financial stability, despite the recent performance of several African stock exchanges.

The relative resilience of African banking systems can be explained by a number of factors, including:

- their limited integration with global financial markets;
- the low level of product sophistication – banks were not exposed to sub-prime mortgage and derivative products;
- the reliance on low cost retail deposits, rather than on international borrowing or funding from parent institutions abroad; and
- generally low leverage ratios.

However, significant variations in impact can be seen from country to country, given the wide differences among African banking systems.

The crisis has impacted the ability of African banks to borrow externally to some extent. External credit lines to banks have seen a reduction in limits, an increase in spreads and some cancellations, while access to syndicated loans has dried up. This is reportedly the case in Nigeria, where credit lines have halved (IMF, 2009) and the central bank has had to inject liquidity in the banking system. It is also so in South Africa where access to external funding has tightened.

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5 According to Central Bank of Kenya Weekly bulletin, March 20, 2009, usable foreign exchange reserves as on March 19, 2009 stood at US$ 2,610 million (equivalent to 3.11 month of import cover) against the level of US$ 3,086 million as on September 30, 2008 (equivalent to 4.06 month of import cover).


7 The BIS reports that syndicated lending to emerging regions has more than halved between the end of 2007 and end-2008 (BIS Quarterly Review, March 2009).
However, the impact of these tightening market conditions has been limited, given that before the crisis only large South African and Nigerian banks had accessed syndicated loans abroad and that these were for modest amounts. Most of African banks’ funding has generally come from their own deposit base, rather than from international sources.

Few African countries have high levels of liabilities with foreign banks, but some of these are of a very short-term nature. South Africa has the highest amount of foreign liabilities, because of its ability to borrow internationally (Figure 2). However, its liabilities are mostly of a medium-term nature. This is not the case of countries like Liberia, Nigeria, Mauritius, Angola, Uganda and Cape Verde, which could find it hard to refinance obligations. In Nigeria, in particular, BIS reporting banks’ claims on the country are sizeable and 69 percent of them were at the time of reporting of a very short-term nature.

Interestingly, a significant share of foreign liabilities is on African countries’ banking systems. Figure 2 shows how nearly half of Nigerian and Cape Verdean foreign liabilities are on their banks. Given that these tend to be short-term liabilities, they may put considerable pressure on these countries banking systems. For most other countries, percentages are much lower. In South Africa, recent reports suggest that less than 5 percent of bank liabilities are non-rand denominated - a fall from the September 2008 BIS records shown in figure 2.

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8 Also, in the case of South Africa, these loans are mostly due in 2011-12, but less than 5 percent of bank liabilities are non-rand denominated.

9 Figure 2 uses the latest BIS data, which refers to end September 2008. Given that almost 6 months have passed, bleak predictions could be softened for those countries that have the highest shares of liabilities with a maturity of less than one year. Nonetheless, some also have a sizeable portion of liabilities with maturities between one and two years, making the separate reporting of liabilities with lower than 2 years and lower than 1 year maturities of interest.
While foreign ownership of banks in many African countries seems to have had a modest impact so far, foreign banks, with parent companies that have been hit hard, have and will continue to react faster than the local banks in increasing their collateral/deposit requirements, widening their spreads, and re-focusing their portfolios on blue-chip companies and high net worth clients, making access to credit even more difficult for SMEs. While, the African subsidiaries may not rely heavily on parent institutions for their funding, the concern in that in the current environment parent companies are withdrawing local liquidity just when it is needed most in the African countries. Thus, while the registered impact of contagion from troubled parent banks to domestic subsidiaries appears as yet to be modest, the situation bears close monitoring. In southern Africa (with the exception of South Africa and Mauritius) and Francophone Africa, banking systems tend to be largely foreign owned (Table 1). Reports from different countries indicate that some local subsidiaries of foreign banks have had to provide some – albeit limited – support to their parent institutions. For example, Nedbank (South Africa) has had to contribute to its UK parent, Old Mutual, and Barclays Bank is squeezing its local operation in Kenya to provide capital to its main operation in the UK. Moreover, some African banks have reportedly reduced their exposure to Citi subsidiaries in the region, given the troubles the American parent bank is going through.

Regional banks represent a new potential channel for contagion. Ownership by regional banking groups has increased significantly in recent times. South African banks own 24

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The expansion of regional banking groups has been accompanied in some countries with the withdrawal of some European banks, which used to dominate the financial landscape, particularly in Francophone Africa. For example, Credit Agricole sold its stakes in DRC, Cote D’Ivoire, Gabon, Cameroon and Senegal to Atijari Wafa (Morocco); Belgolaise withdrew from Togo, Mali, Burundi, Rwanda, DRC. This progressive withdrawal has been occurring over the past five years and is not linked to the current financial crisis.
percent of Africa’s banking assets (World Bank, Bankscope) and Nigerian banks have recently been expanding aggressively. Although this represents an increase in regional financial integration, it may cause heightened contagion risks, especially in case these institutions are not properly supervised. A recent World Bank (2008) assessment of the Nigerian banking system has pointed to the need to strengthen supervisory capacity and enhance monitoring of banking risks, particularly relating to the fast growth in private credit and bank lending for share purchases. If serious liquidity and solvency problems were to arise among Nigerian banks, they could have significant effects on their subsidiaries elsewhere in the region.

Table 1: Sub-Saharan African countries with highly concentrated foreign banking assets, 2005–06

<table>
<thead>
<tr>
<th>Host Country</th>
<th>Share of banking assets held by foreign banks (%)</th>
<th>Largest Foreign Banks</th>
<th>Home Country</th>
<th>Host Country Banking Sector Assets Held by the Foreign Bank (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angola</td>
<td>53</td>
<td>Banco BPI</td>
<td>Portugal</td>
<td>29</td>
</tr>
<tr>
<td>Botswana</td>
<td>77</td>
<td>Barclays Bank</td>
<td>UK</td>
<td>26</td>
</tr>
<tr>
<td>Mozambique</td>
<td>100</td>
<td>Banco Comercial Portugues</td>
<td>Portugal</td>
<td>25.9</td>
</tr>
<tr>
<td>Swaziland</td>
<td>100</td>
<td>Standard Bank</td>
<td>South Africa</td>
<td>24.6</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Nedbank</td>
<td>South Africa</td>
<td>17.8</td>
</tr>
<tr>
<td>Uganda</td>
<td>80</td>
<td>Standard Bank</td>
<td>South Africa</td>
<td>24.6</td>
</tr>
<tr>
<td>Zambia</td>
<td>77</td>
<td>Barclays Bank</td>
<td>UK</td>
<td>21.3</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Standard Chartered Bank</td>
<td>UK</td>
<td>14.9</td>
</tr>
<tr>
<td>Ghana</td>
<td>65</td>
<td>Standard Chartered Bank</td>
<td>UK</td>
<td>21.2</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Barclays Bank</td>
<td>UK</td>
<td>20.4</td>
</tr>
<tr>
<td>Côte d’Ivoire</td>
<td>66</td>
<td>Societe Generale</td>
<td>France</td>
<td>19.2</td>
</tr>
<tr>
<td>Madagascar</td>
<td>100</td>
<td>Calyon Bank of Africa</td>
<td>France</td>
<td>17.7</td>
</tr>
<tr>
<td>Cameroon</td>
<td>63</td>
<td>BFBP</td>
<td>France</td>
<td>11.9</td>
</tr>
</tbody>
</table>

Source: Global Development Finance, 2008. A bank is defined as foreign owned only if 50 percent or more of its shares in a given year are held directly by foreign nationals.

As a consequence of generally tighter credit conditions, many African banks report adopting stricter lending criteria. Banks have increased their collateral/deposit requirements, widened their spreads, and re-focused their portfolios on blue-chip companies.
and higher net-worth clients, making access to credit even more difficult for SMEs. This is both a problem of quantity of credit available for this type of clients as well as price with interest rates on bank loans reportedly rising. No hard data is available but anecdotal evidence points at spread increases of around 200bps in Nigerian and Kenya. With Governments turning to domestic markets to fund increased fiscal deficits (due to sharp downturn in tax receipts being experienced by many African countries), multinational firms in Africa shifting towards domestic funding on African markets, and available external funding being curbed, marginal client groups, such as SMEs, are being squeezed even more out of the credit market. This could represent a serious step back, after the rapid credit growth and African banks’ increased willingness to lend to this market segment in recent years.

**Thin domestic credit markets in Africa raises concerns about government borrowing crowding out the private sector.** The general slowdown in economic activity and the fall in commodity prices have created significant fiscal shortfalls in African countries (e.g. Nigeria, Zambia). Government paper often represents a viable investment opportunity for African banks, especially in turbulent periods with rising risk-aversion on the part of banks. However, due to the factors outlined above – all of which are increasing banks’ reluctance to lend – the room for governments to borrow, if they are to avoid crowding out the private sector and cause a further economic contraction, has already been significantly reduced.

**The global crisis could also swell the number of non-performing loans (NPLs).** Many African economies have experienced rapid credit growth in recent years (Nigeria, Zambia, DRC, Liberia, Ghana, etc.). Such credit booms are usually accompanied by a reduction in asset quality. Given the current slowdown, serious NPL problems in bank portfolios may arise, with businesses and households finding it harder to repay loans they had taken out at a time of higher risk-taking. This fear is rising in a number of countries and industries – the auto and construction industries and some Black Empowerment Deals in South Africa, possible risks from the household, tourism and horticulture sectors in Kenya, etc. Another risk faced, particularly by smaller banks, is their recent involvement in the SME market, generally shunned by larger/foreign banks, particularly in this period of crisis. As economies slow down, this could constitute a serious risk to the health of their portfolios.

**More specifically, NPLs could become a significant problem for commodity exporting countries.** With the large drop in commodity prices (e.g. oil, copper, cotton, etc.), credit risk has increased dramatically in highly concentrated banking sectors. Although commodity extractive industries are largely financed offshore, thereby to some extent protecting local financial systems in this period of falling commodity prices, commodity producers do rely on

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11 The IMF Regional Economic Outlook (2009) reports a 20 percent average annual growth of real credit to the private sector for the 2003-07 period.

12 NPLs in South Africa rose from 2 percent to 3.7 percent during 2008 (IMF, 2009).
domestic financing of local suppliers and franchises. Nigerian banks’ portfolios are heavily concentrated in the oil & gas sector (over 26 percent, according to JP Morgan, 2007) and with the dive oil prices have taken from the heights of July 2008, the number of NPLs could increase significantly. In Zambia, several mines have closed and laid off workers. In the WAEMU area, single exposure limits (already at 75 percent) are regularly breached, giving rise to high risk concentration in the cotton sector (IMF, 2009). In DRC, the sharp drop in mining output and exports is putting liquidity pressures on the banking system, which is overwhelmingly dollarized.

Credit risk for banks may also arise from the fall in equity prices. The significant reduction in foreign inflows triggered large falls in equity prices, which has in particular exposed those who had borrowed for share purchases. In Nigeria, where growth in the equity market has been predominantly related to expansion of banks’ share capital, bank lending for shares purchases has been widespread practice. To a lesser extent, problems of this kind have been experienced in Uganda and Kenya, with the large interest generated by recent IPOs.

Finally, credit risk for banks may increase due to the recent depreciation of many currencies, thereby reducing the ability to repay of those bank borrowers reliant on export revenues. Several countries have tried to counteract depreciation trends by using up their foreign reserves (e.g. Zambia) or imposing restrictions (e.g. Nigeria and Zambia). Despite these measures, currencies have depreciated in many countries (Zambia, South Africa, Nigeria, Kenya, Mauritius, Ghana, DRC13 etc.) where banks now require higher spreads, particularly on US-dollar denominated loans. However, banks’ exposure to foreign-currency denominated liabilities is not substantial. Although data is scarce, in Kenya for example forex liabilities account for a relatively small 20 percent of banks’ total liabilities.

II. D. Trade and Trade Finance

The impact from global growth deceleration and falling trade volumes is already beginning to be felt by some African economies. Most African exporters are already seeing earnings shrink as falling oil and metal prices have reversed the windfall revenues from the earlier boom in commodity markets (Fig. 3)14. The Democratic Republic of Congo has witnessed its recent economic gains substantially reversed in a few months as export earnings have dived. These prices are likely to remain low in the medium term as global demand remains significantly depressed. World trade is expected to contract for the first time since 1982 this year before recovering slowly in 2010.15 In addition, FDI and portfolio flows that have been drawn to commodity export markets in the boom years are unlikely to be sustained.

13 In the case of DRC, the sharp fall in the CDF has also eroded the local currency capital of the banking system, whose assets and liabilities are in USD.
15 IMF, World Economic Outlook, January 2009.
The dislocation of trade financing is a more immediate challenge to commodity exporters in Africa. In addition to the implied threat to the quality banks’ lending portfolios by weakening commodity prices, the dislocation of trade financing is a threat to commodity exporters, even in those sectors less impacted by the recent reversal of commodity prices (e.g. cotton and cocoa exporters in West Africa). Signs of the falling availability and rising costs of trade finance were already visible towards the end of 2008 (Figure 4).

At this time, it is difficult to separate the impact of tighter credit conditions on the one hand and that of falling commodity prices and shrinking demand for trade on the other hand. A recent IMF survey of banks indicates that the contraction in trade credit can to a

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16 Chart from “Access to Trade Finance by Emerging Market Countries”, International Trade Department, World Bank, February 20, 2009, prepared by Ismail Dalla under the guidance of Mona Haddad.
larger extent be attributed to the credit squeeze (higher costs and collateral requirements) than to changing market and sovereign risk perceptions. There are also reports that, as trade finance is drying up globally, larger domestic enterprises and multinationals are turning to African banks (whether foreign subsidiaries or domestic ones) to fill the gap. This risk is evident where trade credit is extended in the form of syndicated loans via a consortium of international and local banks, as is typical for the cash-crop/cotton sector in West Africa. Were the international banks in the consortium re-price risk or their own balance sheets to come under pressure, this could impact the cost and availability of trade credit. Current market conditions are also impacting the market in more sophisticated trade financing products. To the extent that volatile commodity prices and tighter credit make it harder to sell exports forward, this impacts the ability of exporters to enter pre-purchase agreements further down their supply chain and ultimately reduces access to credit for farmers and other suppliers in the rural economy. All told these factors will provide both the pretext and opportunity for banks to move from lending to riskier segments, such as SMEs, to their traditionally favored clients, the larger corporations. However, in evaluating these developments in trade financing, one caveat is that the recent cost increases could be a reflection of more realistic risk premia. During the credit boom period risk was likely under-priced.

II. E. Remittances

Policy makers have expressed concern over the possibility that migrant remittances may be adversely affected by the recent financial crisis and consequent economic downturn in OECD economies. Remittances are a significant source of foreign exchange inflows for sub-Saharan African countries — even more so than indicated by recorded data which severely underestimates money transferred via informal channels to Africa. The economic slow-down in migrant-receiving countries (in particular the US, UK and other European economies) may negatively affect the capacity of migrants to send money home. However, given that remittance flows tend to be compensatory\textsuperscript{17}, a deterioration in the “home” country economic situation could to some extent be compensated the efforts of migrants to maintain the amounts being sent despite adverse conditions in the originating economy. Depending on the significance of the latter effect, remittance flows to Africa may fall less than equivalent to the drop in incomes experienced by workers in the West where the immediate impact of the crisis has been most severe.

At this time, the available high-frequency (monthly) data show a mixed picture for SSA countries (Figure 5). While Kenya and Uganda have experienced year-on-year declines in migrant remittances since mid-2008\textsuperscript{18}, Ethiopia and Nigeria have seen increases in their

\textsuperscript{17} Chami, Ralph et al. (2008) “Macroeconomic Consequences of Remittances” IMF Occasional Paper 259, IMF, Washington, DC.

\textsuperscript{18} Ugandan data for December shows a decline of over 30 percent year-on-year.
inflows. Quarterly data for Mauritius and Lesotho also show a decline in the last quarter of 2008 (compared to the last quarter of 2007), whereas Swaziland and Guinea-Bissau experienced increases in recorded remittances in the period. In Kenya, remittances in January 2009 declined by over 26 percent year-on-year. Nigeria, which receives by far the largest amount of remittance inflows in Africa absolute terms, has actually recorded an increase in remittances year-on-year of over 60 percent in December 2008. However, this may be due to revisions in the way that the central bank compiles remittance data. Overall, with the exception of Nigeria, the rate of growth in remittance inflows (rather than levels of inflows) seems to be decelerating for the African countries for which data is available.

The impact of the financial crisis on remittances inflows to African countries so far seems to depend critically on which countries serve as the main destination for migrants. Kenya’s remittances from the US and Europe have declined sharply when comparing January 2009 to January 2008 (by 27 and 42 percent respectively), but remittances from other parts of the world have actually increased by 15 percent. Within Africa, South Africa is the most important remittance sending country and the mining sector is one of the main employers of migrant workers. This sector has been strongly affected by slower global demand for commodities, but remittances sent by foreign mine workers in South Africa (measured in Rand) have continued to increase when comparing the fourth quarter of 2008 to the corresponding period in 2007, albeit at a significantly slower rate.

19 The CBN reports over $3 billion in remittance inflows in December 2008 alone.

20 Source: Author’s calculations based on data collected from respective Central Banks for a brief prepared by AFTFP and DEC-PG on “Early effects of the global financial crisis on remittance flows to African countries” by Jacqueline Irving.
Section III. Key Policy Challenges and Recommendations

The on-going financial crisis has raised concerns as to whether progress achieved in recent years in implementing financial sector reforms in Sub-Saharan Africa will be sustained. There is the possibility that the gains made in reforming and deepening of financial sectors in Africa over the recent decade or so, especially with regard to defining and containing the role of government and harnessing the benefits of globalization, might be stalled or perhaps even reversed.

Certainly lessons learnt as regards limiting the role of government have been called into question – as regards (a) supporting development of market-enabling policies and (b) supporting the raising of the access possibilities frontier through market-developing policies, if only by the example set by many western governments by fairly widespread bail out of financial institutions. Fortunately there has been little evidence of back-tracking on progress made in divestiture of state’s direct involvement in the financial sector. There are several reasons for this, not least that the first-round impacts of the crisis on the financial systems in Africa has been limited, but also broad recognition that the consequences of the governance failures of former decades were severe, not least in the form of resource misappropriation and misallocation.

The impact of financial retrenchment on financial integration in Africa has as yet been similarly limited, partly because African banks have low loan/deposit ratios and were not exposed as, for example, banks in Eastern Europe to foreign borrowing and resulting currency mismatches and liquidity pressures (when foreign banks are unwilling or unable to roll-over their lending), partly due to the relatively small exposure of foreign banks reflecting the small size of African financial systems and relatively positive risk/reward perceptions associated with investment in African banking.

However, this does not imply that African financial systems will be immune to the second-round impacts of the crisis and that increased government intervention will be avoidable across the continent. On the contrary commodity exporters are already suffering from the extreme price volatility of the past year. Similarly the impact of foreign portfolio outflows, discontinuation of foreign direct investment, the drop in remittance inflows, tightening of the market for trade credit and the collapse in equity prices (weakening the financial sector particularly in Nigeria where banks have lent to clients to purchase shares) are impacting many African countries at the same time as weaker demand for African export products and weakening domestic demand are resulting in deteriorating current account and fiscal balances. While the jury remains out as to how African governments will respond to the stresses arising from these pressures, several policy responses seem appropriate and desirable:

- There is a need to strengthen crisis-preparedness involving strengthened cooperation between authorities – be they central banks, ministries of finance, deposit insurers, court judges, tax authorities etc. – in designing and implementing financial
institutions resolution practices. African countries are generally weakly prepared for handling problem banks expeditiously and effectively. Their lender of last resort liquidity management and payment systems routines and infrastructure are often ill-prepared, cumbersome in operation and highly discretionary. Bank resolution practices are often open to endless, arbitrary court challenges and deposit insurance schemes are slow to pay out depositors and unable to effect liquidations efficiently, if at all. Thus, by improving their crisis-preparedness African countries can not only improve their ability to respond to possible immediate difficulties, but also address long-standing development needs supporting the preservation of asset values in situations where financial institutions need to undergo restructuring or be resolved.

- Another factor which the crisis has brought to the fore are the challenges posed by increasing financial integration among financial markets in the form of south-south investment stemming from such countries as South Africa and Nigeria. There is an increasingly pressing need to improve the reporting, accounting and disclosure practices, but also to develop and respect memoranda of understanding among supervisory bodies regarding exchange of information on the soundness of financial institutions. While there are no signs of withdrawal of foreign banks – whose influence has as noted below been largely beneficial – the risk remains and supervisory authorities in Africa need to be aware of any such risks to be able to hopefully prevent or, if not, prepare for orderly exits, should they occur.

There will also be more lasting and perhaps serious impacts of the financial crisis on medium-term prospects for financial deepening. These relate to how to deal with mounting pressures to lessen the impact of the crisis through fiscal stimulus, when the shallow depth of local sovereign and corporate debt markets result in rapid crowding out of private sector lending by the banks, thus undoing recent years’ deepening of private access to credit. Pressures may also arise – particularly in those countries exposed to the commodity price collapse – to bail out problem institutions suffering from rapid growth in non-performing loans. And finally pressure will surely mount to intervene directly to support particularly vulnerable sectors through subsidized or directed credit. Hopefully policymakers will seize on the crisis more as an opportunity than as a threat to financial deepening in Africa:

- Efforts to deepen financial sovereign and corporate bond markets need to be intensified both to improve the capacity for local debt financing, to provide instruments of suitable maturity and security for longer-term saving and to facilitate the financing of African infrastructure. While constraints to infrastructure investment are many – not least the capacity to originate projects, the strength of

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21 The crisis has also brought to the fore the need for closer cooperation by OECD country regulators, who may regard the African operations of the banks for which they supervise as insignificant, while they may be systemic seen from the perspective of the African host.
regulatory/tariff-setting authorities, the governance arrangements relating to private-public partnerships etc. – the withdrawal of foreign direct investors poses a severe challenge to African countries, as these investors are also likely to be much more discerning once they re-engage. They will increasingly be looking to local investors to endorse and take the lead in investing in local infrastructure projects.

- **Those countries prepared to engage in strengthening of governance and improved transparency and accountability of their financial systems along with prudent fiscal and macroeconomic management stand to maintain recent years’ growth momentum.** This will be most transparent in those countries where there is a need for government to resolve financial institutions weakened by the crisis. Where this is necessary governments should seize the opportunity to demand much strengthened transparency and disclosure, upgrading the financial landscape particularly as regards governance and accountability. In those situations where governments are called upon to intervene in financial markets, they have the opportunity to provide market-conforming interventions, such as partially guaranteeing credit to groups of borrowers such as SMEs which are vulnerable to crowding out, while encouraging private banks to develop capacity and expertise in SME credit risk assessment.

- **Governments would be well-advised to intensify efforts to improve the efficiency of financial intermediation by strengthening the financial infrastructure for access.** Governments can contribute to this by harnessing remittances and reaping the benefits of mobile banking and introducing best practice credit registries. The fall-off in remittance flows intensifies pressure on governments to facilitate reduction in the pricing of remittance transfers by opening competition among money transfer operators, lessening the costs of the domestic leg of transfers through interoperability between payments service providers, and leveling of the playing field between providers of mobile-banking services and similar services provided by banks. Similarly intensified efforts at credit information sharing will broaden access to credit, especially for smaller enterprises. The need to increase financial literacy efforts is also evident. In the absence of such efforts households will be left confused about the safety/risks associated with deposits and investments (banks, stock markets) and lose confidence in the financial system - potentially rolling back the hard-earned gains (albeit still modest) in financial inclusion in the region.

- **The focus of financial sector policies will inevitably shift towards assisting SMEs in accessing finance.** Banks are becoming increasingly risk-averse and SMEs are being squeezed in their access to credit. This is likely to be exacerbated by governments resorting to increased borrowing to fund fiscal outlays, thereby crowding out private sector credit. There is already evidence that the SME sub-sector is being hit by adjustment in the composition and geographical redistribution of demand, e.g. in areas previously reliant on raw material extractive industries. This dislocation and tighter economic circumstances will inevitably be accompanied by
increased rent-seeking and corruption. In choosing between various means of providing support to the SME sector – whether through partial credit guarantees or, perhaps more appropriately with tightening liquidity, through credit lines targeted at the SME sector – African policy-makers are well-advised to design such support so that it is as strictly as possible market-conform. Adherence to the principle of market-conformity will preserve the financial sector reforms undertaken during the past decade to support financial deepening while also not providing new opportunities for rent-seeking.

Section IV. Selected Country Cases

South Africa

While the immediate fall-out of the global financial crisis has been manageable for South Africa, the crisis has resulted in considerable challenges regarding financing of a severe deterioration in the country’s current account.

Measures had been taken by the South African authorities already prior to the crisis to dampen rapid growth. This had given rise to rapid growth in private debt to disposable income, overheating in the housing market accompanied by high levels fixed investment both by the public and private sectors. As a result of considerable monetary tightening (5% rise in policy rates between June 2006 and June 2008) South African GDP growth was declining already prior to the crisis. Despite some recent easing the outlook is for anemic economic growth in 2009 of 1 – 2 percent or less. Consumer demand is slowing under the impact of relatively policy high interest rates and exports are much lower in some sectors (e.g. for iron & steel, coal, chemical products and motor vehicles) resulting in a fall (year-on-year) in industrial production of 11 percent in January 2009. As a result the crisis is expected to impact employment levels in the coming months.

On the one hand, the South African financial system was shielded from the excesses of many other developed financial systems. Banks financed themselves mainly on-shore rather than externally, they engaged in traditional lending activities with little reliance on securitization and derivative-type instruments and could rely on domestic corporations for ‘captive’ wholesale funding due to exchange controls. On the other hand the South African market is highly exposed to the crisis due to the need to finance a large current account deficit (estimated at 8 percent of GDP). While banks have contributed in the short-term to funding the current account deficit by repatriating foreign assets, their access to foreign funding is subject to severe tightening – both in the form of reduced availability of foreign syndicated borrowing, rising borrowing costs and shorter maturities of foreign funds. The dilemma going forward will be to maintain the easing of monetary policy and high levels of public investments, regarded as appropriate as countercyclical policy, while sustaining finance of the implied current account deficit.
Nigeria

Nigeria’s economy is being affected by the global crisis, mostly through the decline in the price of oil which accounts for the bulk of exports and three-quarters of government revenues. The reversal of portfolio flows as a consequence of the global financial turmoil (net equity outflows are estimated to amount to over $3.4 billion in 2008) and the decline in the Nigerian stock market have significantly affected Nigerian banks. These institutions have increasingly relied on equity markets to raise capital and have engaged in lending for share purchase (margin loans). Many analysts consider that Nigeria was experiencing a stock market bubble until the second quarter of 2008, partially fuelled by bank credit.22

There is considerable uncertainty about the magnitude of the exposure of banks to share lending given the weaknesses in the accounting and financial reporting framework in the country, but official reports suggest that it could amount to less than 10 percent of total bank loans. In any case, losses linked to share lending are likely to appear in balance sheets with some delay partly because the CBN in 2008 allowed banks to reschedule debt repayments on margin loans for a year. Most Nigerian banks were heavily capitalized following the 2005 consolidation exercise and this might provide a buffer against shocks. Nevertheless, the banking system is highly segmented and the recent increase in spreads between interbank rates and T-bill rates reflects concerns about counterparty risk in the interbank market. Banks prefer to invest in T-bills yielding as little as 5-7 percent instead of lending on the interbank market at around 16 percent.

Nigerian banks are experiencing tightening of external credit lines with limits being reduced, spreads increasing and some withdrawals. In some cases there has been a reversal to cash-collateralized letters of credit. In the context of tightening domestic liquidity conditions the Nigerian Central Bank (CBN) adopted various measures to inject liquidity in the banking system, including a lowering of reserve requirements and the provision of liquidity to troubled banks via an expansion of the discount window. Current global conditions also led the authorities to draw on the accumulated foreign exchange reserves and postpone a $500 million naira-denominated sovereign bond issue.

The global turmoil has also accentuated pressures on the exchange rate led to some depreciation of the Naira (27 percent in the period November 2008 to January 2009). As a response, in February 2009 the CBN replaced the existing wholesale Dutch auction system in foreign exchange markets by a retail Dutch auction system, which significantly limits the role of banks in setting rates, and limits on banks’ net open positions were also reduced from 5 percent to 1 percent of equity.23 The authorities claimed that these measures were introduced

22 The magnitude of the fall in the Nigeria stock exchange is illustrated by the fact that market capitalization in early 2008 was around $110 billion (N13 trillion) and by mid-February 2009 it had fallen to $32.5 billion.

23 Net open positions had been previously reduced from 20 percent to 5 percent in mid-December 2008.
to curb speculation, but analysts are concerned about the risks of a parallel foreign exchange emerging. Press reports suggest that in the week of March 12, parallel rates were already 29 percent above the official exchange rate.

Tighter monetary conditions have resulted in less access to credit, especially for SMEs, and initial signs of deterioration of bank lending portfolio quality. In this situation banks prefer to reduce their risks by focusing on lending to domestic top-tier corporations. They have increasingly also been able to engage in lending to multi-nationals whose access to foreign markets is impacted by the tightening of credit conditions abroad.

**Ghana**

Ghana’s GDP has been growing at around 6 percent since 2006 and a series of reforms have allowed the country to start a process of economic diversification that is slowly bearing fruit. However, the Ghanaian economy remains heavily skewed towards agriculture and commodity exports, which constitute around 25 percent of GDP. The country’s macroeconomic framework has been deteriorating, giving rise to large current account and fiscal deficits, with reserves falling below the 3 months of imports benchmark. Moreover, remittances inflows have been slowing down modestly.

The government has in recent years promoted a number of banking reforms, which were supported by considerable foreign investor interest and culminated in Ghana’s first Eurobond issue in October 2007. However, foreign inflows into equity and bond markets were reversed in the second half of 2008 and were accompanied by falling bond prices, reserve depletion and currency depreciation. Moreover, the stock market has been experiencing some downward pressure since January 2009.

Although Ghana’s banking system is owned for 65 percent by foreign banking groups, there has been no contagion from troubled parent institutions overseas. This is because Ghanaian banks mainly rely on their deposit base for funding and have little exposure to international markets. As in other countries in Sub-Saharan Africa, the terms on trade financing have tightened both in terms of cost and reduced maturity and with greater emphasis on cash-collateralized letters of credit. Although not heavily reliant on foreign financing, banks are experiencing that external lines of credit are less available. Interest rates on T-bills which banks use as their benchmark in setting lending rates have risen sharply recently – from 11 percent to 25 percent over the past year. This has put considerable pressure on banks’ loan portfolios, which have experienced very rapid growth in recent years (e.g. in year to May 2008, Loans grew 58.5%) particularly in the SME and household market segments (e.g. the share of household loans rose to 18.5 % as of May 2008 from 16.2 % in 2007). During 2008

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24 Both Fitch and S&P have warned this month that Ghana could be downgraded from its current B+, if current account and fiscal deficits keep widening.
banks registered an increase in Non Performing Loans (NPLs) from 6.8 percent to 7.8 percent, with the most exposed sectors being, in order, agriculture, mining and construction.

Cape Verde

Cape Verde is one of the few banking sectors in Africa to experience a significant direct contagion from the global financial turmoil. On February 13th, the government of Cape Verde announced its decision to revoke the license of Banco Insular de Cabo Verde, an offshore subsidiary of the Portuguese Bank of Business (BPN). BPN was nationalized by the Portuguese government in late 2008, owing to large losses on off-balance sheet loans worth Euro700million. BPN apparently used Banco Insular as a virtual branch for its riskiest credit operations and between 2004 and 2007 siphoned off over €300m through the bank to Brazilian accounts, mainly for insider lending (EIU, 2009).

It is as yet unclear the extent of the repercussions of this bank closure on the Cape Verdean economy, which last year grew at around 6 percent and saw an increase in foreign reserves and a fall in public debt. However, these are expected to be significant given:

- the unusually high level of financial intermediation in the African country (banking sector assets are over 250% of GDP, of which onshore banking assets represent around 90% of GDP);
- the rapid expansion of banks balance sheets (both onshore and offshore banks);
- the high risk concentration of bank portfolios in tourism and real estate that are badly affected by the global economic downturn and may struggle to keep up with debt repayments\footnote{The government has declared its intention to help real estate developers by renegotiating their increasing debt burden.};
- the slower growth of banks’ deposit base, due to the reduction in remittances from the Cape Verdean Diaspora\footnote{In 2008 these amounted to 10 percent of Cape Verde’s GDP (World Bank). Onshore banks report that over 60 percent of their deposits are from the Diaspora, whereas foreign deposits are 100 percent of offshore banks’ deposit base.}.

Kenya

Kenya’s economy is witnessing a significant slowdown as the fall out from domestic developments – residual effect of Kenya’s post-election conflict early in 2008 and ongoing food crisis – has been exacerbated by the direct and indirect impacts of global financial crisis. As a consequence, GDP growth in 2009 is now projected at 3.6 percent, much lower than an earlier estimate of 5.8 percent. The deterioration in external account is quite significant as the country recorded a BOP deficit of US$ 448 million in 2008 against a surplus of US$ 854 million in 2007 while current account deficit has almost doubled to US$ 2.1 billion. The capital account has suffered as private capital inflows have slowed from US$ 740 million to
US$ 86 million in 2008 coupled with a decline in remittances.\textsuperscript{27} These factors combined with a slowdown in tourism earnings – tourist arrivals have dropped by 30.5 percent in 2008 – and heightened risk aversion due to global crisis caused significant depreciation of the Kenyan shilling against USD during the third and fourth quarter of 2008, accompanied with a decline in official reserves that are currently marginally above the 3 month import cover.\textsuperscript{28} As a result, Kenya has requested up to US$ 100 million from the IMF to finance food imports and to rebuild its foreign exchange reserves.

In addition, the crisis has also constrained government access to international markets as plans to issue US$ 500 million Eurobond have been postponed indefinitely. As this issue was part of the current financing plan, the Government moved ahead in February 2009 with the issue of a sovereign bond for 22 billion shillings specifically ear-marked to finance investment in infrastructure. In addition, plans to float infrastructure bonds by state corporations – based on their own financial position – are underway. However, given uncertainties regarding future cash flows, these plans may face more difficulty in attracting investors, and the government may face difficulties in scaling back its role, either in providing guarantees or actual fiscal support.

The Kenyan financial system was able to withstand the immediate significant deterioration in exchange rate (13 percent depreciation) and stock market (31 percent loss in value) during September/November 2008 which occurred as the crisis unfolded. The continuing decline in equity prices reflects concerns about the governance of the market, and the failure hitherto of the authorities to address these. However the second round effects are proving to be more pronounced. The banking system appears to be well capitalized based on reported soundness indicators. Increases in the level of NPLs are likely on account of further slow down in economic activity, with particular concerns for tourism and construction coupled with the impact of formal sector lay-offs on household debt servicing capacity.

While the net foreign exposure of the banking system is low, as in other countries banks are increasingly facing difficulty and higher costs in funding themselves abroad, particularly with longer maturities. Conditions for corporate funding in the local market have also tightened. The banking system does face some contagion from foreign banks that have been impacted by the crisis, particularly Barclays bank which is squeezing its local operation to provide capital to its main operation in the UK. However, the central bank has step up its monitoring of banking sector soundness indicators including flow of funds between foreign parents and local subsidiaries on an ex-post basis. In addition to ensure adequate amount of liquidity in the system, cash reserve requirements were reduced in December 2008 from 6 percent to 5 percent and the benchmark rate was cut by 50bps to 8.5 percent in December, 2008 and further by 25bps in March, 2009.

\textsuperscript{27} Source: Central Bank of Kenya, Month Economic Review January 2009

\textsuperscript{28} See footnote 6.
Zambia

The drop in economic activity is affecting Zambia via a sharp decline in copper prices. Copper prices have fallen by more than 60 percent from their peak in mid-2008. This coupled with uncertainties leading up to the recent election and withdrawal of foreign portfolio investment has led to a steep depreciation in the kwacha against the dollar and drop in international reserves. The current account deficit has widened to US$ 910.7 million at end December 2008 from US$ 652.1 million in previous quarter. In addition foreign direct investment inflows declined to US$938.6 million in 2008 from US$ 1,323.9 million in 2007. These factors are beginning to dampen the GDP growth rate that is as yet projected at 5.0 percent in 2009 compared with the growth of 5.8 percent in 2008. The country has requested US$ 200 million from the IMF to provide a cushion for foreign exchange reserves. A planned Eurobond issue has been postponed.

While the Zambian banking system is currently stable and well-capitalized, it faces significant risk in the context of global slowdown. The steep decline in copper prices is likely to affect all sectors given the Zambian economy’s high dependence on the copper sector. Although the economy has been gradually diversifying away from copper production, it continues to be heavily reliant on activities related to the mining sector. The mines, which largely fund themselves abroad, outsource the bulk of their ancillary activities domestically e.g. transportation, construction, maintenance, etc. Therefore the banks’ direct exposure to the mining and quarrying sector – which accounted for only 5-7 percent of total corporate lending in 2005-2008 – vastly underestimates the banking sector’s vulnerability to a sustained decline in copper prices.

The Zambian banking sector may also be affected through financial channels. Given the high share of subsidiaries of international banks in the Zambian banking system, the global financial turmoil affects banks through parent-subsidiary relationships. As access to offshore funds through parent banks dries, the declining availability of foreign financing is likely to restrict some banks’ credit expansion plans.

The sharp decline in copper prices also results in reduced earnings from copper exports by mining companies and subsequently sharply reduced tax revenues in the form of mineral royalties and corporate taxes. As a result this downturn may reduce Government capacity to invest in much-needed infrastructure.

Democratic Republic of Congo

The Democratic Republic of Congo (DRC) has been severely and swiftly impacted by the “real” slowdown in the global economy. The downturn in global trade and falling commodity prices have significantly undermined the recent economic and political gains made by DRC. A steep fall from the revenues of mining exports and rapidly depleting international reserves
created a foreign currency financing gap that hurt imports of food, petroleum products, and construction materials and depressed growth prospects.\textsuperscript{29} Falling tax revenues, surging security spending due to the conflict in the eastern provinces, stalled FDI in the mining sector, have all pushed the DRC to the point of serious macroeconomic fragility and social unrest.

In the predominantly dollarized economy falling export revenues also constitute a risk for the financial system. Almost 85 percent of deposits and 90 percent of the loans of the banking sector, which dominates the financial sector, are denominated in US dollars. As export earnings have fallen and dollars have become increasingly unavailable this has created serious liquidity problems for banks. At the same, banks may also face significant solvency issues depending on their exposure to export businesses. Thus, the situation belies expectations that its underdevelopment will insulate DRC’s financial system from the ongoing turmoil in the global economy.

Motivated by a desire to keep dollar deposits abroad Congolese banks typically keep a large share of their assets in deposit correspondent banks. This is most direct exposure that financial institutions in the DRC have to the at-risk banks in developed markets. How significant a risk this is for Congolese banks depends on several factors including the bank rescue plans of OECD governments.

**WAEMU**

The West African Economic and Monetary Union (WAEMU) grew at around 4 percent in 2008, despite the fall in key commodity exports prices in the second half of the year. The area seemed to survive the global financial turmoil relatively unscathed last year, due to its relatively limited exposure to international markets and its insulation from exposure to complex financial instruments, such as mortgage-backed securities. The presence of European and US banks in the area had already been shrinking over the last few years, limiting the potential for contagion effects from troubled parent institutions overseas. Nevertheless, the changing financial landscape in the region as well as the impact of the global economic slowdown does expose these economies to potential fallout from the crisis.

Firstly, regional banking groups have been expanding aggressively in the region, e.g. Ecobank (Togo), Bank of Africa (Mali), UBA (Nigeria), Access (Nigeria), Attijari (Morocco) and BMCE (Morocco). Problems at parent institutions could lead to contagion effects on their subsidiaries in the region. Since the authorities of some of these countries (both those responsible for supervision of the parent and subsidiary institutions) have weak capacity and feeble communication links among them, this gives rise to concern. Secondly,

\textsuperscript{29} By the end of 2008 official reserves had fallen to a five-year low of just USD 75 million, providing less than one week of import cover (“IMF Executive Board Approves US$195.5 Million Disbursement to the Democratic Republic of the Congo Under the Exogenous Shocks Facility”, IMF Press Release No. 09/74 March 12, 2009).
already prior to the crisis the financial systems of WAEMU countries’ were rather weak, being dominated by banking sectors with low capital adequacy ratios, high risk concentration and large shares of NPLs (especially in Benin, Mali, and Togo). Over the past year, there has been further deterioration. Throughout 2008 the BCEAO has had to inject liquidity in the system. Moreover, the high and routinely breached single limit exposure (75 percent of regulatory capital\(^30\)) has caused excessive risk concentration in the agricultural sector and to large State Owned Enterprises. Thirdly, the regional WAEMU stock market index has dropped by 25 percent, mainly due to the performance of the Senegalese telecom company, Sonabel—a key driver of the market together with Ecobank.

The crisis of the cotton sector in Western Africa had already started before the current crisis, due to a drop in the international price of cotton, the sharp decline in the dollar, and subsidies to American and European cotton producers. Nonetheless, the global financial turmoil could further exacerbate the problems that the sector faces in the WAEMU area, where most agricultural production and trade (e.g. cocoa, cotton, etc.) are pre-financed by foreign/domestic banking consortia. With investors’ worldwide reducing risk appetite and deleveraging, country risk will play a greater role in credit assessment; the issuance of credits to below-investment-grade client-countries will see a significant drop and premiums will rise, curtailing the amount of affordable borrowing from international banks. In Burkina Faso, for example, spreads from the international banking pool for cotton\(^31\), led by HSBC, have reportedly increased by 200bps.

Moreover, a local subsidiary of a foreign-owned bank has reportedly withdrawn from the local pool for cotton financing for this year. This was apparently not precipitated by the advent of the crisis but was part of the bank’s strategic plans of operation in Burkina Faso. Nevertheless, it exerts further pressure on the cotton sector in the country. This liquidity squeeze, partly mitigated by the new regional banking groups that are stepping into the sector as international banks leave it, could have serious repercussions on production and exports and in turn cause an increase in the number of defaults on outstanding commitments.

Due to the high risk concentration in the banking sector, this may have even systemic consequences, particularly given the low amount of capital in the system. The same problem could be triggered by falling commodity prices and the CFA peg to the appreciating Euro, which again would increase the number of NPLs in the agricultural sector.

\(^30\) The largest individual exposures often amount to several times a bank’s capital in many countries and the level of compliance with this regulation varied between 18 percent in Burkina Faso to 69 percent in Senegal (IMF, 2009).

\(^31\) Finance for cotton production from international banks amounted to Euro60 ml last year.