REGIONAL ECONOMIC OUTLOOK (SUB-SAHARAN AFRICA): NAVIGATING HEADWINDS

INTRODUCTION

The economy of sub-Saharan Africa is projected to grow at 4.5 percent in 2015. This is solid by global standards though lower than in the recent past. The slowdown reflects the adverse shock of the sharp decline in oil prices and its impact on the region's largest economies.

The projected slowdown is consistent with the growth decelerations that have occurred in previous episodes of decline in global commodity prices in 1986, 1998, 2008. It needs to be emphasized that in all these instances, the impact of the shock is quite heterogeneous.

There are eight oil exporters in SSA and for them the shock will no doubt pose formidable challenges given the fact of their low buffers – limited fiscal policy space. This leaves them with no option but to undertake significant and painful fiscal adjustment – in short austerity. For the majority of the countries in the region – net oil importers – however, lower oil prices represent a positive commodity terms of trade shock – a favorable development.

Twenty two countries, including Ghana, are classified as resource intensive. While it is true that prices of some export commodities such as zinc have increased, many more key commodities exported by sub-Saharan Africa – some like natural gas, iron ore, coal, cotton, copper, and platinum – have also declined since mid-2014 by considerable margins. Of interest to Ghana, prices of cocoa and gold have also fallen somewhat over the period even if relatively only marginally. The favorable impact of oil price decline, therefore, would be partly off-set in some cases by the lower prices of other commodities.

The global environment has seen some major changes since mid-2014. Supply and demand factors have both contributed to the 50 percent decline in oil prices. World

Economic Outlook (WEO) projections show a rebound in oil prices although still below the levels in the recent past. The evolution of demand and supply factors remains quite uncertain.

Prospects for global growth have turned weaker in spite of oil price declines. Among the main trade partners of SSA, prospects in Europe are seen as "lackluster at best." And the ongoing transition away from the investment-led growth strategy in China is expected to lower growth prospects and consequentially lower demand for exports in SSA.

At the same time the outlook for the USA is strong and this has increased the probability of its exit from unconventional monetary policy (UMP) – popularly referred to as quantitative easing (QE). The US dollar has appreciated substantially against most currencies – equivalently several currencies including the euro, and for that matter the cedi, have recorded significant depreciation against the US dollar.

FALLING COMMODITY PRICES – A TALE OF TWO AFRICAS

The sharp decline in commodity prices is projected to impact SSA in a highly heterogeneous manner. In what follows, therefore, we examine the impact on two broad groupings – net oil exporters and net oil importers – separately.

Oil exporters

There are eight countries – together comprising over a quarter of the population and about half of the GDP of SSA – that produce the bulk of the region's oil. Of them, two – namely Angola and Nigeria, the largest and third largest economies in the region – supply nearly three quarters of the region's oil output. Leaving aside Cameroon which is a relatively minor oil producer, gross oil exports account for nearly one quarter of oil exporters' GDP, a large share of total exports; and oil-related activities account for more than half of their revenues.

For the oil exporters, it is evident that the initial impact of the shock will fall directly on the twin deficits – the fiscal and external current account. Under unchanged policies, fiscal deficits this year could worsen by at least 5 percentage points of GDP. Similarly, the external current account balance would deteriorate by an estimated 8 percentage points of GDP – turning to deficit in most countries under unchanged policies.

In recognition of the multi-year nature of the oil price shock and its adverse impact on the twin deficits in the current year, oil exporters have typically proceeded with unavoidable, though painful adjustments / reforms.

The WEO (April 2015) projects only a modest recovery in prices, making fiscal adjustments now the priority. This is important given:

- the very tight financing conditions they face;
- the bouts of market pressure experienced in some cases; and
- the substantial increase in public debt even under current policies in others.

Spending cuts are generally directed at recurrent spending — purchases of goods and services – as well as “the elimination of costly and inefficient fuel subsidies”. As the REO puts it:

> This is a unique opportunity for all countries in the region to introduce a politically difficult set of reforms by concomitantly reducing energy subsidies, improving the health of the public sector energy producers and passing through some of the price declines to consumers and companies. In this regard, countries that already have automatic price adjustment mechanisms — and that have therefore adjusted retail prices upward when global prices increased — should maintain them, allowing the lower global prices to be reflected fully in lower retail prices. Where retail prices are administratively set authorities should consider passing on at least some of the decline in global prices to consumers, while starting the process of establishing

> flexible fuel and energy pricing mechanisms. Only in cases of seriously over-stretched public finances should the lower prices be used only to improve the fiscal position [REO, page 5].

It may be noted that retail prices could in fact increase — as they have done in some countries — as countries seek to eliminate subsidies/under-recoveries especially in the context of depreciating local currencies.

Significant cuts in public investments are unavoidable in present circumstances. This also requires that efforts to improve efficiency of public spending—hard insistence on value-for-money to bring down incremental capital/output ratio (ICOR), emphasis on completion of projects and improved maintenance of existing infrastructure and a move away from commissioning new ones as uncompleted projects are abandoned — are essential.

Real GDP growth would decline substantially since the fiscal adjustment in response to the shock would dampen economic activity. The IMF's Flexible System of Global Models (FSGM) has produced results which illustrate the trade-offs between a gradualist adjustment (as in Ghana's home-grown plan) and a front-loaded approach (as in the program agreed under the ECF in April). In the present case under consideration, preliminary results indicate that a gradual adjustment spread over four years would reduce the adverse impact on growth cumulatively by 0.5 percentage points of GDP in 2015-16 relative to adjusting fully in one year. The point to note, however, is that slower adjustment would lead to <u>higher public debt and increase the vulnerability to financing risks</u>. "Should the required fiscal adjustment not be sustained, there would be significant risk of serious macroeconomic repercussions. Conversely, the required fiscal adjustment may itself have a larger-than-expected adverse impact on growth" (ibid, page 9).

One concern and a key consideration in the decision to front-load adjustment, is that the availability of fiscal buffers is generally limited. In this situation, real GDP growth is exposed to the risk of sharper adjustment, should suitable levels of financing to smooth the adjustment to the shock not be available or inflationary pressures disallow running down government deposits. On the external side, the concern is that, as countries smooth their adjustment in the face of depleted buffers, macroeconomic pressures could arise.

Public investment is therefore expected to bear the brunt of the adjustment in most oil-exporting countries which could hurt medium-term growth prospects. To the extent, however, that public investment has a large import content, the impact on near-term growth will be more muted. Lowered prospects for real GDP growth will also act as a disincentive for private investment and weaken the capacity for diversification away from aid-related sectors. This could reinforce the direct effect of lower investment in the sector stemming from the depressed oil prices over the medium-term, as well as the possible impact of exchange rate depreciation on private sector balance sheets, and hence on investment.`

Oil Importers

Ghana is one of 37 net oil importers in SSA – the projected flow of natural gas to replace oil (products) imports made Ghana to appear a net oil exporter in 2015. Other commodity exports – such as gold and cocoa in the case of Ghana are important in several of these countries. Countries with large non-oil commodity export sectors account for an estimated 40 percent of both sub-Sahara African population and its GDP.

SSA oil imports stand to benefit substantially from the decline in oil prices. CEPA estimates that in the case of Ghana, the price decline could result in an improvement of the balance of payments by almost US$ 500 million. At the same time a number of these oil importers face substantial non-oil commodity price declines. The relative importance of oil and commodities in the trade of SSA's oil imports is expected to result in a muted impact of the shocks of an oil-importers' terms of trade – remaining broadly unchanged in 2015 compared to 2014.

The direct impact of the oil price decline on fiscal balances would vary depending on each country's tax structure and the authorities' policy response.

In the case of Ghana, the price decline would reduce import duties and the newly-introduced special tax – 17.5 percent VAT – on petroleum products, and because the demand for petroleum products is typically inelastic, revenue will also decline – ad valorem taxes are set as a percentage of the price of the product while specific taxes are per quantitative unit of the product.

Where the decline in oil prices is passed on to consumers as in Ethiopia, Kenya, South Africa, Tanzania and Uganda – and in the case of Ghana by a cumulative 11.8 percent in two installments since October 2014 – aggregate domestic consumption spending could increase to the extent that households and firms spend part of the savings associated from the price pass-through in which case revenue from taxes on goods and services could increase.

The decline in non-oil export commodity prices would reduce revenue – from gold and cocoa in the case of Ghana. The impact from this however, will be much milder than that on oil exporters. Overall the share of revenue derived from natural resources (other than oil) in SSA is relatively small.

On the expenditure side, the lower oil prices imply a windfall gain on the oil import bill – in Ghana this is projected to accrue into a Mitigation Account set up in the 2015 Budget approved by Parliament in November 2014. Moreover, this windfall is financing the VAT on petroleum products as well as over-recoveries for the bulk distributing companies (BDCs) to help clear the backlog of under-recoveries – of the previously unfunded subsidies.

Reflecting the muted near-term impact on key macroeconomic aggregates, the growth of oil importers is expected to be only marginally impacted by the commodity price decline. In the case of Ghana a front-loaded fiscal consolidation program has been agreed with the IMF under its Extended Credit Facility (ECF) – a repeat of 2009 – which is expected to result in a growth slowdown in 2015.

In general oil importers are not expected to be affected by direct spill over from oil exporters on account of the latter's limited trade linkages with other countries in SSA. Lower oil prices, however, could adversely impact investments intended to develop otherwise good prospects in the energy sector in East Africa. The postponement of such investment could slow down near- and medium-term growth.

EXTERNAL FINANCING CONDITIONS

Spreads for countries in SSA remain elevated, but with 10-year US bond yields still low "SSA frontier market yields are not high by historical standards." (ibid page 12)

The REO reports the results of an empirical study "The Determinants of Sovereign Spreads" (see Box 1.3 page 22). Strong growth and good macroeconomic policy implementation had created the conditions that allowed SSA's sovereign international bond issuance to grow significantly in the last decade."

Moreover, ample global liquidity had drawn the attention of international investors in search of yield and portfolio diversification. An important question arising in this regard is whether or not SSA countries' international bonds have been priced favourably relative to emerging markets outside SSA.

An empirical investigation of the relevant macroeconomic fundamentals and global liquidity and risk factors that determine sovereign spreads was conducted by IMF over the period 2009–2014 based on a panel study of 57 frontier market and middle-income countries. The macroeconomic fundamental variables in the study included GDP per capita, international reserves, primary balance, public debt, the current account and inflation.

The regression results suggest that the set of global factors and macroeconomic fundamental variables in the study are all determinants of the levels of sovereign spreads.

Higher global risk aversion, higher funding costs that limit arbitrage opportunities of sovereign bonds trading market participants and the US term premium – approximated by the difference between ten-year and three months yields – are positively associated with spreads.

As expected, stronger country-specific macroeconomic fundamentals are associated with lower sovereign spreads. Among the macroeconomic fundamentals, beyond the level of development captured by the GDP per capita, country spreads are most sensitive to changes in international <u>reserves and public debt-to-GDP ratio</u>.

Fitted and actual spreads were compared for each SSA country in the study to "analyze if their market bond prices were in line with their fundamentals. Negative misalignments were observed (except for Ghana)" with spreads being slightly tighter than would be suggested by the empirical model" in 2014 – possibly on account of higher global liquidity and a stronger interest of individual investors, together with the fact that the economic outlook for more mature emerging markets has been deteriorating more quickly than for frontier market sovereigns.

The positive misalignment of Ghana "likely reflected the <u>concerns about the fiscal stance and low external reserves</u>, as well as renewed pressures on the currency" (emphasis added). Markets indeed can punish bad policies more hardly than the typical donor institution.

THE IMPACT OF THE EBOLA OUTBREAK

The Ebola outbreak brought considerable economic damage to the three ECOWAS member countries – Guinea, Liberia and Sierra Leone. Beyond the larger number of deaths and extensive human suffering, the epidemic disrupted labor markets and created substantial health and containment costs for both the public and private sectors.

Moreover, the epidemic led to enhanced risk-aversion behavior by domestic and international agents which had a large knock-on effect on activity. Commerce, travel and transportation have been severely impacted by the departure of expatriates, the suspension of flights, the closure of markets and regional borders, reduced capacity utilization – such as mine closures – and internal travel restrictions due to quarantine measures. Domestic food production suffered from the hard hit the agricultural sector took – creating food security issues in the face of food import constraints related to the border closures.

Future output losses are expected to be large with current growth projections marked down substantially in all three countries.

The epidemic has impacted seriously the public finances of the three affected countries. Government reserve is expected to decline by 4.5 percentage points of their combined GDP, compared with levels projected prior to the epidemic. In addition, lower iron ore prices have also impacted revenues in all three countries, especially Sierra Leone. Delayed pass-through of lower oil prices to consumers in Guinea is expected to offset in part the revenue shortfall.

Outlays have been raised to help contain the disease and implement social programs to support vulnerable groups. Thus, even allowing for some decline in investment spending due to labor market disruptions and import bottlenecks, total public expenditure for the three countries is projected to increase by 4 percent of the combined GDP over 2014-2015 (Non-Ebola public expenditure – a wage increase – is projected to lead to ¾ percentage point of GDP increase in the Guinea wage bill).

Overall fiscal balance for the three is projected to deteriorate by about 8 percent of the combined GDP in 2014-15. Because of some partial offset from under-execution of capital budgets, however the change in overall fiscal balance under-estimates the true fiscal impact of the epidemic.

A few countries outside the epicenter have experienced considerable economic spillovers, mainly in terms of lower inflows of tourists and business travel in some cases delaying investment. In the Gambia where tourism represents the largest source of foreign exchange earnings, the shock is estimated to have led to a decline of 60 percent in tourist arrivals in the 2014-15 seasons. Senegal and Burkina Faso have also seen decline in tourism activity.

Countries bordering the three Ebola epicenter countries such as Cote d'Ivoire and Mali, and regional travel or trade hubs (for example Nigeria) have experienced small declines in cross-border trade, as travel has been restricted and borders closed.

A key policy lesson is that for fragile states to hold suitably large buffers to combat Ebola-like shocks, however comforting a thought, would be prohibitively expensive in terms of the opportunity of foregone investment in social and physical infrastructure. Nonetheless, the presence of some buffers could have facilitated an early response while the support of the international community was being mobilized. The international community pledged significant funding support to the three to contain the epidemic quickly and effectively. "A large portion of this financial support remains to be delivered" Liberia had received only a quarter of the pledged amount as of January 2015" (REO April 2015, page 17).