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Paper n. ° 1

Impact of the financial and economic crisis on the ACP states and internal responses

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## **Executive summary**

Like many other developing countries, the Global Finance and Economic Crisis (GFEC) posed serious challenges of economic development and stability for African, Caribbean and Pacific (ACP) countries, this paper reviews the ongoing discussions in this context.

One of the major findings is that effects and measures against the global crisis are not the same but vary from one ACP country to another. And, in all cases, the crisis has swept away firms, jobs, revenues, and livelihoods in varying degrees.

This paper highlights the need for coordinated and consistent efforts to assist individual countries in mitigating the risk over the longer term.

This paper also will help in understanding how the crisis arose, factors responsible for the crisis and consequences, opportunities and threats from the crisis for ACP countries and review policies to prevent the effects from further reduction in ACP countries economic growth and development.

This paper is organized as follows. Section 2 presents an overview of the main drivers of the financial and economic crisis on ACP states. Section 3 summarizes the impact quantification of the financial and economic crisis on ACP states. Section 4 review the present and future development plans of the ACP states and additional financing needs arising from the financial and economic crisis. Section 5 summarizes the internal responses and strategies implemented for the ACP states in response to the financial and economic crisis: (i) lessons learned; (ii) case studies of responses (including monetary and fiscal measures and results). Section 6 reviews the policy features to decrease the vulnerability to ACP states: (i) measures to be considered and developed on future similar financial and economic crisis. Section 7 concludes.

## **I. Introduction**

The GFEC, though have its origin in the developed world has greatly affected developing countries around the world, has exposed weaknesses in the functioning of the global economy and led to calls for the reform of the international financial planning.

The crisis has lead to falls in industrial production, a rapid decrease in international trade, a reduced speed in the economic growth and development and a fall in foreign direct investments and potentially in development assistance.

The number of people who work but are still very poor keeps on increasing. To support this fact, a recent WB research shows that the global crisis has trapped up to 53 million more people in poverty in developing countries. Businesses are winding-up with increase in unemployment rate. Countries with well-ordered and regulated economic and financial systems have also been thrown into turmoil as a result of the crisis.

The crisis, therefore, presents significant economic and social development challenges for ACP countries, governments, Central Banks and academic researchers worldwide. It is imperative therefore to understand the anatomy and impact of the crisis.

## **II. Overview of the main drivers of the financial and economic crisis on ACP States**

The current crisis spread from developed countries to developing and transition economies through reduction in global trade and a related collapse in primary commodity exports, on which many countries are dependent. It has also spread through a sharp adjustment of the commodity prices which resulted into lower demand for raw materials, lower capital inflows, declining migrants' remittances flows and worsening of external debt indicators.

Identifying the causes of the crisis is a necessary precondition to learning the appropriate lessons from the crisis and to avoid a reoccurrence.

The crisis was essentially caused by the failure of economic, financial, regulatory and supervisory policies in the United States of America (USA) and other countries. The crisis was characterized by lack of transparency and financial integrity which have resulted in:

- excessive risk-taking,
- unsustainably high asset prices,
- irresponsible leveraging and high levels of consumption fuelled by easy credit and inflated asset prices.

Added to these, in many ACP countries the cause of the crisis has been traced to structural problems (in the fields of environment, energy, food and water), systemic factors such as the concentration of income and resources, as well as excessive market cycle volatility.

But, while the severe global recession seems to be bottoming out and the global economic outlook is turning cautiously optimistic, the negative impact of the crisis on many ACP countries continues to deepen.

The crisis has hit ACP countries with a delay, interrupting at best and ending at worst, the impressive growth record of the last ten years. The crisis has also already started to erode the hard-won improvements in macroeconomic positions. Even though most ACP countries have managed to avoid recession in 2009, the speed of the continent's recovery and longer-term prospects remain uncertain. Moreover, the human and social cost of the crisis could be devastating: unemployment in ACP countries will increase and the number of the working poor and vulnerable workers could reach unprecedented levels.

## **III. Impact quantification of the financial and economic crisis on ACP States**

ACP's rapid growth during 2000-08 came to an abrupt halt in 2009, due to a severe external shock caused by the GFEC.

The GFEC had serious effects on the developing countries including ACP countries based on their levels of integration into the global economy and position in the international division of labour.

The GFEC crisis has befallen the region mostly through real channels, such as:

- deteriorated terms-of-trade,
- reduced demand for exports,

- decline in Foreign Direct Investment (FDI),
- decline in remittances,
- decline in tourism, and
- possibly decline in aid inflows.

The crisis also worked through the financial channel, namely the credit crunch on global financial markets, and especially the limited access to trade credit.

The growth impact of the crisis has varied across countries. While many countries have experienced a sharp deterioration of growth prospects, others have continued to record improvements.

Two groups have taken a particularly heavy hit:

- emerging and frontier markets, such as South Africa or the Seychelles; and
- resource-rich countries, such as sub-Saharan African countries.

In contrast, resource-poor and land-locked countries have weathered the global downturn relatively well, and records of highest rates of growth are expected.

Similarly, Gross Domestic Product (GDP) growth in emerging and frontier markets has slowed more rapidly than in the rest of the region. While low-income economies continue to grow at higher rates than middle-income ones, the slowdown is particularly harmful for them, given widespread poverty and the risk of policy reversals. In addition to these risks, in fragile countries, deteriorating growth prospects raise the possibility of return to higher fragility.

The crisis has led to a deterioration of key macroeconomic indicators. The trade balance has deteriorated and a number of countries have faced both deteriorating current account and fiscal balances. Most ACP countries have also experienced a depreciation of their currencies relative to the United States Dollar (USD). These outcomes put pressures on accumulated reserves. Hence, unless sufficient FDI and concessional financing is available to cover the deficit, ACP's foreign exchange reserves, which took years to accumulate, could be rapidly wiped out.

The crisis has affected the fiscal space through two channels:

- directly through revenue losses; and
- indirectly through automatic stabilizers associated with slower economic activity.

Summarizing the effects by the three main areas:

i. Effects on growth and inflation

Economic growth is necessary for development even if it is not a perfect indicator of progress.

In the early stage of the financial crisis, there was a widely held view that the impact on ACP countries would be minimal probably because of their low integration into the global economy.

But at present, there is enough evidence of the negative effects of the crisis. The crisis is posing a serious setback because it is taking place at a time when the region is making progress in economic performance and management. The impacts of the global financial crisis come on the heels of the food and fuel price shocks of 2007-08.

The sudden drop in ACP economic growth rate is threatening the prospect of the region to meet one of the Millennium Development Goal (MDG) - halving the number of people living on less than one dollar a day. ACP countries need economic growth around 7% per annum in order to meet this goal.

The fall in economic growth rate has been attributed to direct outcome of:

- falling export demand and tourism receipts,
- declining commodity prices,
- reductions in the availability of credit and trade finance,
- less inflows of remittances,
- private portfolio flows and foreign direct investment,
- higher unemployment and poverty,
- increases in infant mortality, and
- adverse coping with long-lasting impacts such as higher school drop-out rates, reductions in healthcare, environmental degradation, and political instability.

The global economic slowdown is reducing the flow of remittances to the ACP region as migrant workers in Europe, North America and the Gulf States are laid off and return home.

ii. Effects on financial sector

The direct effects of the crisis on ACP countries are felt mostly through the financial sector (for example: stock market volatility has increased since the beginning of the crisis and losses have been observed in the major stock exchanges). The turmoil in African stock markets is beginning to have significant negative effects on the financial sector and on aggregate demand.

There is also growing evidence that the crisis had a negative effect on Bank balance sheets and this is capable of causing financial instability in the region.

Another major finding is that, the rate of Bank failures so far have not been much reported in many ACP countries. This may largely be as a result of lack of significant contact of most ACP Banks to the sub-prime mortgage market and asset-backed securities. Foreign-owned Banks in some of these countries after the crisis reduced their support of local Banks and some have sold their assets (which had serious negative consequences for the financial sector in the region).

Exchange rate movements of ACP currencies during the GFEC were also found to be unusual. Several of these countries have high foreign debt, such that the expected depreciation of their currencies against the dollar is imposing serious debt-service burdens on the region.

The depreciation of currency as a result of the crisis has also been observed to have increased the cost of imported intermediate inputs.

In addition, since several countries in the region are net importers of food, which is a major component of the consumer price index, the expected depreciation of currencies in the region is now increasing the domestic prices of consumer goods and reducing access to food by vulnerable groups. The exchange-rate depreciation is also increasing exchange-rate risks faced by domestic firms and increasing the likelihood of default on loans owed to domestic Banks, thereby making most ACP Banks more vulnerable.

iii. Effects on commodity prices and trade

The financial crisis is also having a negative effect on trade for ACP countries.

In particular, there has been a significant decline in the prices of key commodities exported by ACP countries since the second half of 2008. Findings have shown a downward trend in prices of commodity groups (food, fuel, agricultural materials and metal) since the second half of 2008.

The declines in commodity prices and export volumes have led to a decrease in export revenues in ACP countries. The reduction in expected export earnings will constrain the ability of governments to finance imported inputs necessary for production. It would also limit the ability of governments to cushion the negative effects of the crisis on the economy.

The slowdown in economic growth in three key export markets (Europe, the United States and China) has affected the demand for exports from ACP countries.

**IV. Present and future development plans of the ACP States and additional financing needs arising from the financial and economic crisis**

The current macro-economic and social challenges posed by the global financial crisis require a much better understanding of appropriate policy responses.

The ACP governments have taken a number of initiatives to mitigate the impact of the crisis. **Although ACP limited resources compared to the developed countries are still very inadequate in relation to the scale of the impact.**

Comment [JS1]: ?????

In general, the scope for rule-based countercyclical fiscal policies in ACP countries is limited. Given limited social safety nets, automatic stabilizers can only play a role on the revenue side. And even there, the room is constrained by the generally low share of revenues in GDP, especially among low-income and resource-poor countries. As government increased expenditures and cut tax rates during booms, the policy space for the downturns was eroded. The volatile and pro-cyclical pattern of foreign aid has further amplified the fiscal cycle.

In the context of the crisis, even countries that have the space to adopt discretionary fiscal stimulus would need to do so cautiously. Past evidence from emerging countries indicates that while the effects of a fiscal stimulus tend to be positive, they remain modest, especially for small open (import dependent) economies. Moreover, a broad consensus has been reached among economists and International Finance Institutions (IFI) on the properties of an effective fiscal stimulus package. Specifically, discretionary measures should be timely, targeted, and temporary.

But in general, measures adopted in ACP countries seem timely, as they were introduced shortly after the first signs of the negative impact of the global crisis. The measures also seem well-targeted: while some measures stimulate domestic demand (thus aiming to offset declining exports), many strive to ease the supply bottlenecks and support businesses as well. As most of the measures are temporary, they are not expected to interfere with the medium term fiscal targets.

More generally, most measures discussed above also support longer-term growth:

1. they aimed primarily at the supply side and are accompanied by efforts to improve the business environment (infrastructure projects are at the core of the countries' response measures, for example). Such steps are likely to encourage longer term production and boost investor confidence;
2. while some of the packages contain demand measures (reduction of Value Add Tax (VAT) rates, for example), these are limited and populist measures seem minimal;
3. with a few exceptions, the absence of significant foreign debt (or debt denominated in foreign currencies) makes the devaluation of the currencies less of concern. In most countries, the risk of future inflation is of a secondary order at this point and can be addressed in due course as the need arises;
4. the governments have made debt sustainability one of the key priorities and are aware that while they undertake short-term stimulus measures, they need to stay the course with longer-term structural reforms.

Nevertheless, some ACP countries have set up special monitoring units to identify the level of the crisis and to formulate targeted responses.

i. Fiscal stimulus packages

In some ACP countries, the severity of the crisis has forced the governments to retrench and undertake a contractionary fiscal policy. In line with the steps that have been taken by the developed and emerging economies, some ACP governments have also implemented fiscal stimulus plans like increase in public investment expenditures as well as tax reductions.

ii. Targeted assistance to key sectors

Many ACP countries have implemented targeted sectoral assistance plans to support sectors that are considered as key growth drivers. These measures are intended to reduce job destruction and the loss of sector specific capital and know-how.

iii. Banking regulation and capital controls

Careful capital controls in most ACP banking systems have helped to minimize contagion effects on ACP Banks. These controls also reduced capital outflows during the crisis. Some ACP governments have introduced deposit insurance schemes to cushion the adverse effects of the crisis.

Furthermore, in order to respond to the large depreciation of the national currencies, some ACP governments have undertaken a variety of measures to defend their currency or to increase competitiveness. Some have attempted to defend a managed exchange rate. In some countries with fixed exchange rate regimes, governments have devaluated their currencies to increase competitiveness.

iv. Liquidity injections

Findings have shown that, some ACP countries have taken actions to increase liquidity in the banking system and to domestic firms to avert the effects of the crisis.

v. Expansionary monetary policy

Since the onset of the present crisis in 2008, some ACP countries have reduced their interest rate in response to the crisis.

vi. Bond financing of public expenditure

Some ACP countries have also been observed to finance counter-cycle expenditures via the emission of treasury bills and bonds. The specific policy goal is the restoration of the credit system in which Banks are the principal actors.

vii. Trade policy measures

Boosting economic growth through trade has been an important component of the response plans in several countries.

viii. Recapitalization of Banks and regulatory changes

Some countries have also taken specific measures to recapitalize domestic Banks.

A set of international financial intervention policies / programmes initiative aimed at reducing the scotch of the GFEC on ACP countries was also implemented, in particular:

i. International Monetary Fund (IMF) initiatives

Providing solution to the effects of the crisis had gone beyond the conduct of monetary policy and regulation of the financial sector. The IMF therefore had come up to assist the low-income countries during and after the crisis (p.e.: doubling the borrowing limits of the poorest countries under its concessional Poverty Reduction and Growth Facility and Exogenous Shocks Facility).

ii. African Development Bank (AfDB) initiatives

The AfDB has also devised a set of initiatives to mitigate the impact of the GFEC. These measures are contained in a policy document entitled "Bank Response to the Economic Impact of the Financial Crisis". The four new crisis-response initiatives announced in March 2009 by AfDB included:

- \$1.5 billion Emergency Liquidity Facility (ELF);
- \$1 billion Trade Finance Initiative (TFI);
- a framework for accelerated transfer of African Development Fund (ADF) resources to eligible countries; and
- enhanced policy advisory support.

The ELF aims to provide financing to eligible African beneficiaries to support a broad range of obligations, including underpinning a fiscal stimulus and supporting public-private partnerships at risk.

The TFI launched a new line of credit of USD 500 million designed to enable commercial Banks and development institutions in Africa to use Bank resources to support trade financing. Accelerated ADF transfers (concessional loans and grants) are expected to provide budget support and infrastructure financing, macroeconomic policy, skills development, humanitarian relief, and other areas.

The AfDB has also approved several loans in recent times primarily to offset the impact of the GFEC. AfDB has reportedly doubled its lending to nearly USD 11 billion between mid-2008 and mid-2009, with funds going largely to budgetary support, trade finance, and infrastructure projects (notably ports and airports in Tunisia, Senegal, and Djibouti).

But, even if the packages that African countries have designed are economically sound, many countries do not have adequate domestic resources to counter the crisis.

### iii. World Bank (WB) intervention policy

The WB has also initiated several policies aimed at mitigating the impacts of the crisis. Some of their intervention policies / programmes include scaling up its lending and policy advice with a focus on poverty reducing activities, safety nets, infrastructure support, and budget support to compensate for the loss in private capital flows.

About 15 African countries were found to have benefitted from front-loading of International Development Association (IDA) resources. The WB Infrastructure Facility Crisis (IFC) is also making USD 300 million available to provide top-up financing for viable, privately funded infrastructure projects that are experiencing financial distress, or are no longer able to reach financial closure. The WB is also stepping up knowledge assistance to help many countries to prepare contingency plans for responding to the crisis. This package of assistance supplements the Bank with about USD 1,2 billion.

### iv. Other international bodies' interventions

International bodies such as the Financial Stability Forum (FSF) and the Basel Committee on Banking Supervision (BCBS) have also worked hard in finding solutions towards reverting to a stable financial environment and for the credit markets to resume lending after the crisis. These bodies are focusing on the improvement of the existing regulatory and supervisory approaches.

Their main objective is to refine and strengthen further liquidity and capital adequacy regulations, thereby adjusting them to new products and developments in the financial system. It is however observed that the current regulation such as revisions in Basle II have not adequately addressed the relevance of the regulatory instruments of Banks in ACP countries. The focus should therefore be on the provision of risk management kits to ACP countries financial system that are tailored to the financial services provided by those Banks.

Regardless of the source of financing, the stimulus measures of ACP countries should be carefully selected in coordination with measures of the international community, whose economic recovery is a prerequisite for their success. Given ACP's strong dependence on exports, stimulating the aggregate demand from the domestic side is likely to have only a limited impact, as the required sectoral responses tend to take time to materialize. At the same time, much of the outcomes of the support to struggling export sectors will also depend on a healthy global recovery.

Furthermore, and as part of a desirable common response to the crisis, a set of future measures was identified to cushion GFEC impact in the region, among which stand out:

- That ACP countries need to undertake a comprehensive review of their regulatory and supervisory regimes with the view of identifying areas for further improvement. In particular, all sectors of the financial industry are expected to be subjected to proper regulation and oversight, to avoid excessive risk-taking by financial institutions;

- That macroeconomic policy and structural reforms implemented in ACP countries over the last two decades have served ACP countries well. But, there is a need to deepen economic reforms further. This would help minimize the effects of the crisis and lay the foundation for sustainable growth in the region;
- While measures aimed at restoring growth and financial stability are important, they must be accompanied by measures to minimize the potential negative social impact of the crisis in poor countries. Giving priority to social protection and pro-poor expenditure is important in this regard;
- Official development assistance can also play an important role in augmenting shrinking domestic resource bases arising from falling exports, remittances and tourist receipts. In this regard, donors are expected to increase aid to ACP countries in accordance with their Monterrey and G-8 Summit commitments;
- Strengthening developing countries voice and representation by reforming the governance of international financial institutions is also very important. This has become imperative especially in the light of the increasing globalization of financial markets.

#### **V. Internal responses and strategies implemented for the ACP States in response to the financial and economic crisis**

At the onset of the crisis in 2008, ACP countries had a markedly stronger macroeconomic position, especially in terms of fiscal balances, external debt, and stock of foreign exchange reserves than prior to the previous global recession. While the good growth performance in recent years was largely due to a favourable global environment, prudent macroeconomic policies have also played an important role. Policies of recent years have not only increased growth but also created cushions in a number of countries. The resulting stronger macroeconomic positions in a number of countries increased the capacity of governments to soften the crisis impact on their economies.

Several oil exporters' countries (such as Angola, Botswana and Nigeria) insulate their economies from the early impact of the crisis. In contrast, oil importers recorded current account deficits during that period. Some countries, especially the fragile and post-conflict states, still lack the policy space for counter-cyclical measures that could ease recovery, which makes them particularly vulnerable to any shortfalls in aid and remittance inflows.

The region has adopted a variety of measures to cushion the impact of the crisis, including setting up special monitoring units to identify causes and responses to the crisis, fiscal stimulus packages, targeted sectoral assistance, capital and exchange controls, and new regulations in the banking sector. Several middle-income countries have applied expansionary monetary policies such as lowering policy interest rates.

##### **1. Lessons learned**

The effects of the crisis are not yet over thereby making it difficult to develop a full list of the lessons from the crisis, either in general or for developing countries in particular.

It is important to learn from the past errors in order to correct the future with good economic and financial regulations. In every crisis there is bound to be opportunities and threats.

While the current crisis has undermined the progress most countries have made in raising the standards of living, it has also led to some fundamental changes both in

economic and financial regulations as well as in skills development in different ACP countries at national, local and individual levels.

One interesting thing to learn from the crisis is that:

- i. the crisis affected all categories of countries in the region including:
  - a. those considered to have good economic policies and governance;
  - b. those with poor macroeconomic records;
  - c. fragile states;
  - d. small and large economies; and
  - e. oil and non-oil exporting countries.

The decline in economic growth is not limited to the advanced economies where the crisis originated but to the developing countries as well. This implies that, the real causes of the crisis in the region are not simply due to the nature of macroeconomic policies and governance but other factors too;

- ii. as a result of globalization, any crisis that affects a major country or group of countries in the global economy or financial system will have some adverse effects on all other countries of the world.

So markets do not have self-correcting mechanisms. If the largest economy in the world, whose currency and institutions are at the core of the global financial system stops functioning, the resulting crisis is bound to become global. Again, it is not unusual for a crisis to begin in the financial sector, spread to the real economy, cycle back to further weaken the financial sector, and thereby further weaken the real economy.

What we have learned is that deleveraging is a process that does not discriminate even among economies and financial systems that are less leveraged than others. Similarly, at the start of the crisis, trade links were stronger than they had been for a century with USA economy driving much of the recent expansion in trade with its external deficits;

- iii. one attempt by the developed countries in their fight against the CFEC is the reversal of most of the policies developed countries had advocated for decades in ACP countries and in other "poor" countries under the now discredited Structural Adjustment Programme (SAP).

ACP governments are not to put their trust on the IMF and WB who are now supporting fiscal stimulus (expansionary fiscal policies) in the USA, Europe and Asia. They are supporting rescue plans, including nationalization of private Banks and other financial institutions. The priority of the day is no longer inflation but jobs and economic recovery;

- iv. no running after large holdings of foreign exchange reserves to provide an expensive buffer against GFEC.

This provides to government and economic agents into a false sense of security while potentially distorting the functioning of the global economy and financial system. Gross financial flows are more relevant than net financial flows;

- v. prudent government spending, social safety nets, the need by government to support Banks at all costs, and free trade.

The crisis provides us with an opportunity to reflect on the kind of nation we want to build. Recent technological advances and globalization implies that international economies are more interconnected than ever before. The international co-operation on macroeconomic policies, trade and financial regulations present at a period of crisis provide an opportunity for various countries to take the first step towards addressing the far deeper global problems.

The welfare of developed and developing countries is mutually interdependent in an increasingly integrated world economy.

There are dangers that some measures that have been taken against the crisis by developed countries may have adverse effects if ACP countries are to take the same measures. For example, developed countries' agriculture subsidies used to be the main distortion in world trade but developing countries lack funds to match these subsidies.

In situation like this the developing countries should be allowed to take measures to prevent subsidized service providers like Banks and subsidized goods from overwhelming their domestic markets. In the area of tariffs, developing countries should be allowed to exercise their right to use the policy space to raise their applied tariff if it is below the bound tariff. A moratorium against raising applied tariffs would be imbalanced because there is little difference between the applied and bound rates in developed countries, unlike the developing countries.

It is observed that many development agencies do not have developing countries best interests at heart, citing failures to cancel debt and to dedicate 0,7% of GDP to official development assistance budgets, along with restricting the access of ACP exports to Western markets.

ACP governments should therefore learn on restoring capital controls and reject unfavourable trade liberalization policies, as well as reversing the privatization of key sectors and natural resources. Lack of knowledge about the inter linkages between individual, regional and global financial system is observed as a problem leading to the widespread of the crisis.

There is the need for ACP governments to restore the role of the state in the development process, reclaim the debate on development while learning from the experiences of other countries in the global South. ACP countries should learn to build an alternative means for financing development including South–South co-operation and the integration of Diaspora remittances into a coherent strategy.

## **2. Case studies of responses**

### **2.1. Monetary and fiscal measures and results**

In this section are presented a set of cases studies of crisis mitigation strategies in selected countries:

- Angola

The government of Angola has been planning to raise additional revenues through its first international bond issue to offset the revenue loss from low oil prices.

- Botswana

The Central Bank reduced its policy rate several times (has cut its rate by 50 basis points to 15% in December 2008).

In the face of uncertainty, as to the duration of the global economic slowdown, the cushion provided by the foreign exchange reserves may not be sufficient. Some increase in borrowing is expected.

Reductions in spending targeting, not only the development budget, but also some recurrent expenditure items, such as personnel emoluments and the cost of travel.

On the fiscal side, the revenue loss due to collapsed exports prevented the government from considering a major stimulus package. But the government has sustained support of the private sector through infrastructure development. Currently, large investment projects are under way, including the coal-fired Morupule B Power Station.

- Cape Verde

Dialogue with the IMF for adjustment of the Policy Support Instrument (PSI) performance criteria.

Careful management of the interest rates and the budget.

Development of the Treasury bills to encourage the saving to remain in the national financial system.

- Egypt

The Ministry of Trade and Industry engaged Egyptian Pound (EGP) 7 billion to boost exports and local production.

Crisis package for tourism sector, including tax-exemption for charter flights, offering of free nights in hotels, etc. implemented.

Establishment of a deposit insurance fund (to boost confidence in banking sector).

Parliament approved legislation on integrated supervision of non-Bank financial sector (p.e.: capital market, insurance, mortgage finance, financial leasing, and factoring) in January 2009.

2nd phase of the Financial Sector Reform Program (FSRP) discussed, between the Prime Minister (PM), the Minister of Investment and the Governor of the Central Bank, in January 2009. Program for strengthening the role of the financial sector by expanding the volume of Bank lending and enhancing Small and Medium Enterprises (SME) access to credit.

The Central Bank has cut its benchmark interest rate for the first time since April 2006. The overnight deposit rate was lowered by 100 basis points to 10,5%, while the lending rate was cut by the same amount to 12,5%.

In February 2009, the government doubled its fiscal stimulus plan to USD 5,4 billion, to be spent on infrastructure projects. A further increase in the fiscal stimulus, USD 1,8 billion, is being considered.

Expansionary fiscal policy was supported by easing the monetary stance, as the Central Bank continued to lower its policy rate, down to its lowest level in three years in September 2009.

- Ghana

The government saw their reserves fall to precarious levels.

The limited reserves, together with an unsustainable fiscal position, have prevented the government from implementing a stimulus package.

The precarious macroeconomic situation in Ghana requires the country to focus on macroeconomic stability.

In 2009 Ghana had projected to post sizeable twin deficits (fiscal deficit of about 10% of GDP and a current account deficit of over 10% of GDP, both after grants), high inflation and low reserves.

To reach high and sustainable growth, Ghana's key policy challenges include consolidating its fiscal position so as to prevent the crowding-out of private sector credit due to domestic financing of large deficits and maintaining debt sustainability.

- Kenya

The Central Bank reduced the threshold for investments in Treasury bills in the primary market from the current Kenyan Shillings (KSHS) 1 million to KSHS 0,1 million from January 2009 to induce small investors.

The government issued infrastructure bond that amounted to KSHS 18,5 billion (USD 232,6 million) with 12-year maturity in February 2009.

Government expenditures in 2009-10 increased by about 25% relative to the previous year, while the fiscal deficit (after grants) is targeted to reach 6% of GDP, most of which will be financed by the proceeds from local infrastructure bonds, and the rest from foreign aid.

Measures to stimulate the economy included a reduction of VAT on electricity, the removal of duties on maize and related products, as well as a public works program. The objectives of the package are:

- to boost domestic demand to compensate for lower export earnings;
- to enhance competitiveness through increased investment, including in infrastructure;
- to create more employment opportunities;
- to expand the food subsidy scheme.

The Central Bank pursued more accommodative monetary policies, including through cutting the policy rate.

- Mauritius

To mitigate the impact of the crisis, Mauritius implemented a monetary and fiscal policy mix.

Government announced in January 2009 a stimulus package to bolster economic growth, increase jobs and boost purchasing power as a response to the global financial crisis. The package provide Mauritian Rupees 10,4 billion, equivalent to about 3 percent of GDP.

The stimulus package amounted to 3,4% of GDP. Most of the expenditures went to infrastructure and other growth-enhancing outlays (financing education; raising competitiveness of domestic-oriented industries and SME).

The fiscal stimulus package was well coordinated with monetary policy: the Bank of Mauritius reduced its policy rate by cumulative 400 basis points between January 2008 and March 2009.

In parallel, the regulation of domestic prices of gas and oil was changed, so that consumers and producers became able to benefit from the declining of international prices.

- Morocco

In a bid to stimulate trade, the Moroccan government has taken a series of measures to re-energize the markets (p.e.: allowing companies to buy back their own shares without a minimum set price in the event that their share prices drop below a certain level).

Government introduced an emergency plan in early 2009. Under the program, public investment is expected to increase from 3,4% to 3,6% of GDP in 2009, to sustain growth and support structural reforms. The financing component of the program focuses mainly on major export industries (textile, leather and manufacturing), and provides state guarantees for a substantial portion of Bank credit to these industries.

- Nigeria

The Central Bank of Nigeria injected funds into the banking system in August 2009, when the country's five leading Banks posted losses due to excessive lending to the energy sector and the burst of the stock market.

Management in the Banks was replaced due to weak governance.

- South Africa

The government adopted a countercyclical fiscal stimulus amounting to Rand (R) 787 billion (about USD 100 billion) for public investment during 2010-12. These measures aimed at promoting high growth with job creation.

The South African Reserve Bank eased monetary policy between December 2008 and October 2009, through cutting its policy rate by cumulative 500 basis points.

As the banking and financial system has remained sound, unconventional measures or focus on financial stability issues were not necessary.

- Tanzania

Tanzania's fiscal space (provided by low public debt and adequate reserves) also allowed accommodating policies.

Government expenditures on infrastructure (road and energy projects) increased in the 2009-10 budgets by about 30%.

The country adopted fiscal measures to raise tax revenues, including through widening the tax base and revoking various exemptions. The net effect is expansionary – over the two fiscal years (2008-09 and 2009-10), the total fiscal stimulus is projected to reach about 4% of GDP. The package will rely partly on domestic financing of the deficit, thus deviating from the pre-crisis pro-cyclical stance of zero net domestic financing.

Tanzania's Central Bank also increased the money supply growth by several percentage points, capitalizing on reduced inflationary expectations due to low food prices.

- Tunisia

Public investment increased by more than 20 percent in 2009 relative to the 2008 budget, to compensate for a 35 percent decrease in FDI.

- Uganda

Past prudent economic policies also provided scope to implement counter-cyclical fiscal policies, and in particular to raise expenditures in the 2009-10 budget by about 20 percent relative to the previous year;

The package aims at supporting infrastructure and agriculture. This stimulus is to be accompanied by an improved business environment to enhance competitiveness;

Monetary policy was gradually relaxed.

## **VI. Policy features to decrease the vulnerability to ACP States**

### **1. Measures to be considered and developed on future similar financial and economic crisis**

Well-targeted and globally coordinated policy interventions are needed to reinvigorate the ACP's growth, increase income and employment and avoid a development crisis.

On their part, a number of ACP countries have adopted stimulus packages to soften the damage from a crisis they did not create. At the same time, many, especially low-income and fragile countries with limited fiscal space and international reserves, have lacked resources to implement countercyclical measures. In some cases, capacity constraints have presented an additional challenge to effective policy responses.

Provision of timely and adequate financial assistance from advanced economies and international financial institutions to ACP countries thus remains crucial. Moreover, policies in ACP countries need to be coordinated with actions of advanced economies. Only a global partnership can bring ACP economies back on a high and sustainable growth path, which would lead to lasting improvements in living standards.

Future macroeconomic frameworks can be foreseen for:

#### 1. Fiscal policies

Going forward, ACP countries may want to phase out pro-cyclical fiscal policies that in many cases characterized their economies in the run up to the crisis, especially because of the negative implications of such policies for longer term growth. In doing so, the countries could aim for balanced budgets (after grants) over the medium term. However, this would require modifying past practices and accumulating sufficient reserves during the booms to cushion the downturns.

Some countries, especially commodity exporters, would also need to eliminate ad-hoc fiscal expenditure practiced during upturns, thus decoupling expenditure decisions from revenue booms.

On the donors' side, there is a need for timely and predictable aid delivery, without a pro-cyclical bias so that aid does not amplify the cycle.

The international practice also shows that to maintain fiscal credibility, it is helpful if the annual fiscal budgets are anchored in a medium-term expenditure framework, preferably with nominal ceilings.

Another key lesson from emerging market economies in other regions is that well functioning government bond markets are necessary for a smooth financing of deficits. Moreover, government bond markets would foster financial sector development through increasing competition, expanding savings instruments, and providing price benchmarks.

When considering modifications of their fiscal frameworks, all ACP countries can draw on good international practices from other countries. These suggest that fiscal policy frameworks need to strike a balance between credibility and flexibility, reflecting country-specific circumstances. For most ACP countries, allowing enough room for counter-cyclical measures, while adhering to the longer-term fiscal sustainability goals, would be important. The chosen framework to be successfully implemented needs to be:

- simple,
- transparent and
- easily monitored,.

Finally, like any substantial reform, the rules require strong political will and broad societal consensus to be implemented.

#### 2. Monetary policies and inflation targeting

In the years prior to the crisis, inflation targeting has gained popularity all over the world as a framework for conducting monetary policy. Given this trend, it is important to understand whether and how the inflation targeting regime can be effective in ACP countries where the majority is subject to frequent exogenous shocks.

In practice, all inflation-targeting Central Banks, including those of advanced economies where most of them operate, have conducted flexible inflation targeting, that is they have targeted the inflation rate while flexibly accommodating for shocks hitting the real economy.

The ongoing global financial and economic crisis has only heightened this requirement for flexibility in the implementation of the inflation targeting regime.

## Conclusions

The GFEC is currently having a significant impact on ACP countries, although studies have shown that ACP's growth outlook is still better compared to industrialized countries. The impacts of the crisis are extensive, and it presents significant challenges for policymakers due to its complexity, its interrelated effects as well as the uncertainty of its duration.

The rapid spread of financial crisis from a small number of developed countries to engulf the global economy is an outcome of the failures in macroeconomic policies, financial supervision and regulation. This implies that, the international trade and financial system needs to be profoundly reformed to meet the needs and changes of the 21<sup>st</sup> century.

It is possible to have a soft economic depression without an associated financial crisis. It is also possible to have a financial disruption without an associated economic downturn. What is rare, but not impossible, is a significant economic downturn without a severe financial crisis, affecting a broad set of asset prices and credit markets, or vice versa.

One major problem while the crisis persists is that, policymakers were slow to learn that they were dealing with dual severe crises on a global scale. The current crisis is having unequal adverse impact on the poor, who are least able to bear these costs and that can have consequences long after the crisis is over.

One of the fundamental lessons from the crisis for ACP countries is that markets alone must not be relied on to deliver systemic economic stability since ACP countries financial markets do not even have self-correcting mechanisms. A new balance between the economic and the political sphere must be established to provide ACP countries with financial stability.

In a globalized economy, the actions of any one country have effects on others. But too often, these externalities are not taken into account in national policy decisions. Developed countries in particular need to be aware of the adverse consequences of these externalities, and developing countries need frameworks to help protect themselves from regulatory and macro-economic failures.

One major surprise is that, despite the responses made so far by some ACP countries to mitigate the impact of the financial crisis on their economies, the effect still remains. This is however traced to financial constraints that limit the range of policy measures the region could adopt in response to the crisis.

The major challenge is to mobilize ACP rich resources to finance growth, development, investment in infrastructure and poverty reduction programs rather than misappropriation. There is the need for strong solidarity and cooperation by ACP countries to develop a comprehensive and effective global response.

The international community needs to provide appropriate assistance to the region to prevent the financial crisis from turning into a regional humanitarian crisis. This global response should emphasize the restoration of consumer and producer confidence by creating job opportunities and ensuring provision of financial resources for the businesses in trouble.

There is the need for up-to-date monitoring of the impact of the crisis, restoring confidence in Banks, and expanding trade and trade finance. In doing this, ACP countries need support now more than ever to build up their capacity to monitor the global economic situation.

Another major area which needs serious consideration is the suppression of the social and human costs of the crisis in AP countries. As most of the developing countries have serious fiscal and financial constraints to deal with increasing hunger, poverty and unemployment, more trade and investment opportunities should be created for these countries through the provision of social protection schemes such as conditional cash transfer programmes that are targeted to the poor for sustainable development.

Since collapse in confidence in the financial system is widely recognized as central in the economic crisis; restoration of confidence will be central in the recovery. But it will be hard to restore confidence without changing the incentives and constraints facing the financial sector. It is therefore imperative that the regulatory reforms be real and substantive, and goes beyond the financial sector to address underlying problems in corporate governance and competition policy, and in tax structures, giving preferential treatment to capital gains, that may provide incentives for excessive leverage.

Central Bank of each ACP country should aim to ensure price stability in the context of delivering long-term sustainable growth, while being sensitive to the risks to financial stability, capital flows and exchange rates. Central Banks also need to give consideration to financial market and asset price developments through the use of wider range of instruments, including prudential financial instruments.

Care should be taken to maintain and improve good governance, which is essential for ACP countries to avoid introducing various “anti-growth policy syndromes” into their economies through introduction of further boom-bust cycles; another debt crisis; re-introducing crippling government controls so as to attain political goals; and entrenchment of inequities and inefficiencies in the global financial and aid planning.

Finally, taking a longer-term perspective, ACP countries could turn the crisis into an opportunity to restore their economic potentials and bring their economies on high growth paths. In this context, policies should focus on key structural reforms such as enhancing competition in the financial sector, streamlining labour market regulations, developing financial markets and strengthening governance, in order to improve domestic fundamentals, promote private sector development and enhance economic diversification. These reforms need to be accompanied by measures to establish social safety nets for the most vulnerable segments of the population. Prudent responses to the current crisis and increased demand of ACP countries constituencies for transparency in public policies heighten the prospects for sustainability of these reforms.