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How effective are countercyclical policy tools in mitigating the impact of financial and economic crises in Africa?

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Abstract

Using panel vector auto regression (PVAR) and GMM estimates we provide evidence for the transmission of financial crises to African economies through foreign direct investments and exports. Although many countries resort to stimulus packages to mitigate the impacts of financial crises, we find no evidence for fiscal policy to be considered an effective countercyclical policy tool in the African context. Monetary policy could be an effective tool in mitigating the impact in non-resource rich SSA countries, but not in others. Limited policy space calls for African economies to reconsider their policies towards trade, investment, finance and macroeconomic management.

JEL classification: C23; E23; E53; E63

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1. Introduction

The global financial and economic crisis of 2008 had a significant impact on African countries, although brief (IMF, 2009a). Economic growth of Sub-Saharan Africa (SSA) dropped to 2.6 per cent in 2009 against an original estimate of 6.4 per cent in April 2008, a potential loss of almost

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4 percentage points of gross domestic product (GDP) (IMF, 2008, 2010). The scale of the impact differed widely depending on the level of financial and economic integration with the rest of the world. While countries such as Botswana, Chad, Gabon, Guinea, Madagascar, Namibia, Niger and South Africa experienced a contraction in real economic growth in 2009, there were others whose economies showed resilience in the face of the financial crisis. Republic of Congo, Ethiopia, Malawi, Mozambique, Nigeria, Uganda, Tanzania, and Zambia for example, registered a growth of over 6 per cent although they indicated a slowdown (IMF, 2010). Economies of SSA grew on average by 5 per cent in 2010 (IMF, 2011) but it was below the 7 per cent growth recorded in 2007, prior to the onset of the crisis. The recovery, however, remains fragile as the global economy has seen setbacks in financial stability and policies to foster internal and external rebalancing are not yet in place.

Several factors seem to have underscored the rather quick recovery. First, the weak integration of African financial markets with global financial markets and the limited exposure of African financial markets to toxic assets in the crisis hit countries could have shielded the region from the crisis. Secondly, strong macroeconomic fundamentals through much of the region left it well positioned to benefit from a global recovery. Thirdly, the recovery was also supported by the countercyclical measures adopted by governments enabled by a build-up of fiscal policy space prior to the downturn.

Does limited integration of African economies with global financial markets act as a beneficial ‘buffer’ in times of a crisis? Or does it simply delay the inevitable effects? How effective are countercyclical policy tools in the African context? What are the policy implications? And how best could African countries respond to financial crises. These are the questions that the current paper intends to address. A key challenge for Africa is how to manage a crisis to ensure that it does not reverse the progress made in socio-economic development. As such, understanding the key transmission channels of financial crises to African economies is vital in intervening in crisis mitigation, prevention and recovery. While the analysis of transmission channels and the impact of financial crises is nothing new, our contribution to the body of knowledge on the subject comes from two counts: (i) we make a systematic assessment of the effectiveness of countercyclical policy tools to mitigate the impact of the crisis on African economies and (ii) we investigate how useful are financial flows in economic growth in the African context. We make these assessments for three groups of countries, Africa, SSA and non-resource rich SSA countries to give a better understanding of the diversity in transmission, impact and effectiveness of policy tools.

The rest of the paper is structured as follows: Section 2 provides theory and evidence on the impact of the financial and economic crises with a focus on possible transmission channels. Section 3 describes the modelling framework used to assess the impact of the crisis on African countries. A brief discussion on estimation techniques and results are provided in Section 4. Section 5 briefly analyses policy implications. Section 6 concludes.

2. Transmission channels: theory and evidence

Markets around the globe have become increasingly inter-connected with one another, particularly with respect to cross border trade and financial flows. These cross-border linkages have increased the likelihood of transmitting shocks in one country or region to another, and perhaps globally; the transmission becoming quicker and stronger as the integration intensifies. Several theories explain the transmission of a financial crisis from one country or region to another. Most of these fall into two broader groups: those explaining fundamental causes and those linked to investor behaviour. Common shocks such as a major shift in economic policy