AFRICA'S GROWTH PROSPECTS FOR 2019

The broad-based and synchronized global expansion of early last year was not sufficiently robust to contain the powerful headwinds triggered by escalating trade wars, the contraction phase of financial cycles and global volatility associated with tightening global financial conditions. After the year-end rout in equity and credit markets, the Dow Jones Industrial Average fell by almost 6 percent, making 2018 the worst year for stock performance in the United States since the 2007-08 global financial crisis. The IMF revised its 2018 estimates of global economic growth downward to 3.7 percent, down 0.2 percentage points from an earlier forecast. It forecasts further growth deceleration in 2019, with aggregate output expanding by 3.5 percent, perhaps reflecting the materialization of downside risks associated with the rise of beggar-thy-neighbor policies in international trade.

Despite that challenging global economic environment of zero-sum game trade policies and decelerating global growth, African economies expanded by 3.4 percent in 2018. Though still below its potential, Africa emerged as the second fastest-growing region in the world, highlighting the continued resilience of its economies to negative shocks and global volatility. The region's economies are forecast to strengthen still further in 2019, to a projected combined growth rate of 3.9 percent. That forecast is based on broad economic expansion underpinned by strengthening recovery in larger economies and robust economic growth in non-resource-intensive economies, along with increasing infrastructure investment, including transnational infrastructure for cross-border trade.

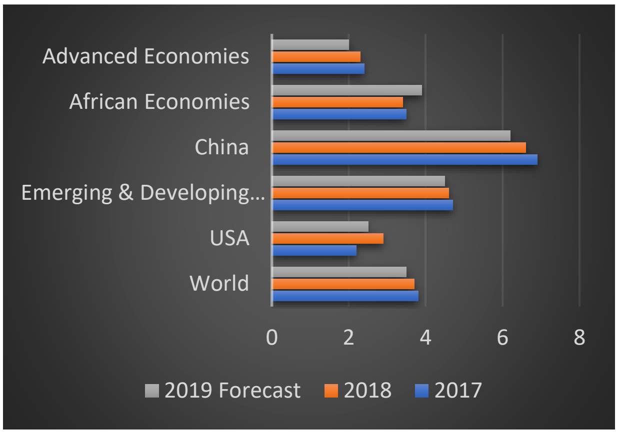
The increasing resilience of African economies on a strengthening growth trajectory is driven by both internal and external factors.

External Drivers of Africa's Growth Prospects

First, among the external factors, the variance of growth performances and macroeconomic outcomes in advanced economies, most of whom are at different stages of their business cycles, do not justify an across-the-board normalization of monetary policy that could further accelerate the pace of interest rate increases and raise the costs of tightening financial conditions for emerging developing market economies. Although increases in the US federal funds rate in the aftermath of the quantitative easing programme have exacerbated capital outflows from emerging developing market economies and somehow reduced the scale of monetary policy tailwinds, the divergence of monetary policy, most notably between the US and the Eurozone continues to play in a favor of a more gradual approach to tightening financing conditions.

Core inflation remains different across advanced economies. The level of inflation-adjusted interest rate is barely in the positive territory in the US. It remains deeply in the negative in Europe, where labor market slack continues to weigh on core inflation and will probably act against any hasty move toward monetary policy convergence. That process could set the global financial system on an accelerated path of tightening financing conditions, especially after the European Central Bank (ECB) decision last December to unwind the quantitative easing programme it adopted to lower longer-term interest rates and combat the threat of deflation across the Eurozone. In a move that is likely to sustain its balance sheets at current levels, the ECB is investing the proceeds of its maturing debt, perhaps to prevent further growth deceleration across its member countries. After a further downgrade of growth prospects in the Eurozone by an additional 0.2 percentage points to 1.8 percent in 2018 (down from 2.4 percent in 2017), the IMF also revised its 2019 growth forecast for the region downward. Eurozone growth is now forecast to expand by 1.6 percent in 2019.

Figure 1: Real GDP Growth by Region and Selected Countries



Sources: IMF, Afreximbank Research

Furthermore, recent developments on the US yield curve and credit spreads, which have widened considerably, equally weigh against any move to accelerate the pace of interest rate increases after four hikes in 2018. The flattening US yield curve has brought interest rates on longer-term debt instruments closer to rates on shorter-term debt instruments of the same credit quality. Further tightening by the US Federal Reserve could push short-term interest rates above long-term rates, and in the process invert the yield curve to precipitate a recession after the decade-long cycle of economic expansion. Historically, yield curve inversions have been a reliable and consistent predictor of economic recession.

Reflecting this risk to growth, especially very late in the business cycle and given the fading sugar-high from the 2018 tax cut and the recent rout in equity markets, investors have welcomed the commitment by the US Federal Reserve to a more patient approach to monetary policy tightening. That shift will allow the Federal Reserve to move away from the unilateral policy of interest rate hikes which has exacerbated global volatility and could further emboldened the divergence of monetary policy between the US and other major economies at different stages in their business cycles, not just in Europe but also in Africa and Asia.

In Asia, the Bank of Japan is not likely to move toward monetary policy tightening anytime soon, especially in the face of anemic growth and increasing price stickiness. Despite the very tight labor market and recent boost from higher energy prices, inflation remains significantly below the Bank of Japan's target of 2 percent. Similarly, China is still in an active stimulus mode, especially with growing concerns about the country's growth prospects following the first monthly contraction in manufacturing activity since 2016 and a sharp drop in exports. After lowering short-term interest rates and cutting bank reserve requirements four times last year, the People's Bank of China this month issued yet another, and this time its largest, cut to bank reserve requirements. Through open market operations it injected a record US$84 billion into the banking sector, perhaps to boost liquidity and drive investment in support of economic growth.

The extraordinary policy measures taken by China to remain on a strong growth trajectory in the face of strengthening trade headwinds may also favor continued easy financial conditions. The Chinese government is drawing on both monetary and fiscal policy tools to sustain economic expansion at rates commensurate with its overarching development goal of doubling the country GDP by 2020. Earlier this month, the government adopted a large fiscal stimulus to boost economic growth through increased infrastructure investment, drawing on a complementary expansionary fiscal policy to help cushion downward pressures on global demand from the trade war.

Unlike most other advanced economies and leading emerging developing market economies which have limited policy tools to manage the ongoing process of growth deceleration and softening global demand, China still has significant financial buffer and policy space to stimulate growth and drive global demand. In a changing global economic and trading environment where the geographical diversification of African trading partners has enabled the region to deepen its economic cooperation with China, these policy measures adopted to keep China on a robust economic growth path are also likely to enhance economic expansion in Africa and catalyze economic expansion.

Despite the decelerating global growth environment, trade between Africa and China increased by 14.5 percent in the first three quarters of 2018, faster than the growth rate of world trade (11.6 percent), reflecting the deepening economic dependency between the two major trading partners. Existing empirical evidence shows that China's domestic investment has become highly correlated with economic expansion in Africa. So much so that a 1 percentage point increase in China's domestic investment growth is associated with an average 0.6 percentage point increase in overall African countries' export growth. And, the expected economic development and trade impact of expanding Chinese investment on resource-rich African countries, especially oil-exporting countries, is even more important.

In addition to increasing prospects for easy financial conditions which in the short term will boost investment and growth while rebalancing the global distribution of risks and stemming the current wave of currency gyrations and capital outflows from emerging market economies toward less risky US assets, Eurozone countries with fiscal and financial buffers are also considering fiscal stimulus to sustain economic recovery in a global environment of slowing demand and growth. For instance, Germany, the largest European economy and one of the surplus nations, which is particularly exposed to global trade frictions by virtue of its export-oriented growth model, is considering a fiscal stimulus in the form of tax cuts to head off recession after its first economic contraction in almost a decade. More recently, softening private consumption and weak industrial production following the introduction of revised auto emission standards have further highlighted concerns about weakening growth momentum in the country.

In the short and medium term, a combination of continued easy global financial conditions in a context of price stickiness and decelerating growth, especially in advanced economies, and stimulating fiscal policies by Africa's main trading partners—mainly Europe and China— are expected to boost private consumption and domestic investment and drive African trade. Eventually, more than mitigating the risk of a hard landing, especially in China, Africa's single largest trading partner, where a trade war is taking a toll on growth and trade, these policies will support global demands and investment with positive spillover effects for African trade and economic growth.

Internal Drivers of Africa's Growth Resilience

On the internal front, the forecast growth acceleration and increasing resilience of African economies reflects more fixed investment, strengthening public and private consumption lifted by softening inflation and expanding urban populations, and increasingly favorable domestic environment of strengthening economic recovery, both in large and in hard-hit natural resource-dependent economies. Meanwhile, the commitment to macroeconomic stability, which has become the anchor of economic growth within the region, is increasingly mainstreamed in policymaking. A growing number of countries, both large and small, are undertaking difficult economic reforms to improve the business environment, raise fiscal buffers and boost private investment.

In Egypt, significant cuts to energy and food subsidies and liberalization of the exchange rate have set the country on a strong growth trajectory, where rising foreign direct investment is fueling growth acceleration. In oil-rich Central African countries, increases in policy rates and drastic cuts in capital expenditures have lowered fiscal deficits and raised the level of international reserves. In addition to improving macroeconomic management and external current accounts, the implementation of difficult economic reforms is reducing the risk of accumulation of domestic arrears, which in the past, have constrained private investment and more generally, the ability of the private sector to sustainably drive growth.

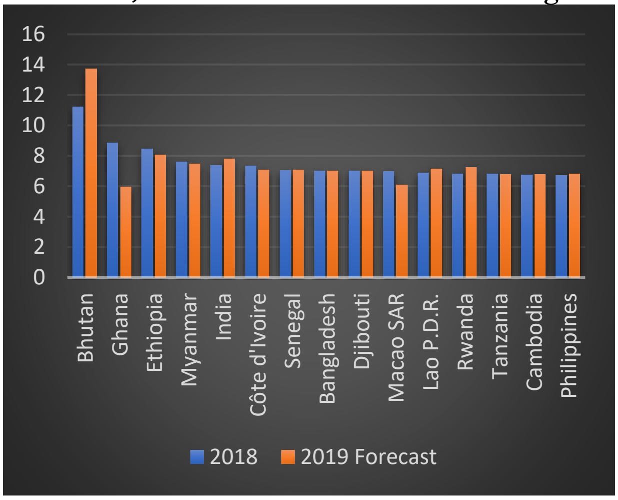
The implementation of difficult economic reforms is also an important driver of resilience in larger economies, where economic downturns have become shorter. The four largest African economies are forecast to go through a period of growth acceleration in 2019, with Egypt posting the most impressive rate of economic growth, expanding by 5.7 percent (up from 5.5 percent in 2018). Growth is also projected to strengthen in South Africa. After slipping into a recession in the second half of 2018, the South African economy is forecast to expand by 1.4 percent in 2019 (up from 0.8 percent), supported by the implementation of structural reforms to improve the business environment and infrastructure delivery and to rationalize public spending and raise returns on public investment.

Likewise, the resilience of African economies is supported by strengthening growth in Nigeria, where growth is projected to rebound to 2.2 percent (up 0.3 of a percentage point from 2018). The rebound is largely due to a continued recovery in the oil sector and infrastructure investment. Current forecasts also project that Angola will post the strongest recovery among the large economies in the region, expanding by 3 percent in 2019, after the lingering effects of the sharp contraction triggered by the end of the last commodity boom. The rebound and speed of economic recovery in both oil-rich and non-resource-intensive economies are dividends of difficult economic reforms to improve macroeconomic management and bolster the business environment. In the short term, the synchronized expansion across Africa's largest economies will further support the forecast growth acceleration.

Besides the strengthening growth performance in the larger economies, the robust and broad-based nature of economic expansion is another important driver of Africa's upbeat growth forecast. More than one-third of African economies are projected to grow more that 5 percent during the forecast period. Furthermore, more than 90 percent of African countries are projected to enjoy growth acceleration over the same period, up by 30 percentage points from last year. Even among countries not projected for ramped-up economic growth this year, some are among the fastest-growing economies in the world. This is the case for Côte d'Ivoire, whose economy is forecast to expand by 7.3 percent, down from 7.5 percent last year.

In addition to Côte d'Ivoire, consensus forecasts show that several other African countries are among the fastest-growing economies in the world (see Figure 2). These high-performing countries include Ethiopia, Ghana, Senegal, Djibouti, Rwanda, and Tanzania, which have been on a strong growth trajectory, with each set to achieve an annualized growth rate of more than 6 percent in 2019. With a forecast growth rate of 8.5 percent in 2019, Ethiopia is the fastest-growing economy in the continent and the second fastest in the world. The strong activity in these and other high-performing non-resource-intensive African economies is supported by strengthening agricultural output and services on the production side, as well as household consumption and infrastructure investment on the demand side.

Figure 2: Fastest Growing Economies in the World, Real GDP Annual Percent Change



Source: IMF (2019)

The increasing resilience of African economies can also be attributed to growing cross-border investment and infrastructure development. Together the two factors are accelerating the process of structural transformation in a continent where industrial output and services account for a growing share of GDP. In a changing development paradigm of deepening global economic integration and capital flows, emerging globally competitive African corporations and industrialists which are expanding their industrial footprint across Africa and globally are leading the diversification from agriculture into higher value goods in manufacturing and service sectors. These industrial champions are carrying out transcontinental operations, with investment holdings around the globe. They have a strong presence in Europe and Pacific Asia which together account for more than 75 percent of their combined activities outside Africa.

A survey of 30 leading emerging African corporations with global footprints and combined revenue of more than US$118 billion shows that, they are active in several industries, including manufacturing, basic materials, telecommunications, finance, and oil and gas. In addition to mitigating risks highly correlated with African economies—commodity cycles and currency volatility, for instance—these emerging African global corporations are accelerating the diversification of sources of growth and reducing the exposure of countries to adverse commodity terms of trade shocks. At the same time, cross-border investment by these corporations, especially in manufacturing sectors, are supporting the expansion of intra-African trade and further reducing the incidence of adverse global shocks and volatility on growth and economic development across the region.

But the resilience of African economies on a rather volatile global growth trajectory is also a reflection of increasing diversification of trading partners in a changing global economic and trade environment, where South-South trade has become a key driver of global trade and growth. The deepening trade ties between China and Africa enabled the latter to sustain robust economic growth rates in the aftermath of the global financial crisis, when numerous European countries which for decades had been Africa's main trading partners were going through a protracted cycle of deflation—the consequences of lingering fiscal and sovereign debt crises. The South is opening more opportunities for growth in Africa and mitigating its exposure to adverse external shocks associated with the business cycles of any its single individual trading partners.

Africa-South trade now accounts for 53 percent of total African trade, up from 37 percent a decade ago. In addition to China, Africa has other leading trading partners in the developing South, including India and the members of the Gulf Cooperation Council (GCC), which together with China, account for more than 25 percent of total African trade (up from 14.2 percent a decade ago). Still, intra-African trade, which increased by 57.9 percent to account for around 16 percent of total African trade in the same period is set to play an even more important role in the growth of South-South trade. Intra-African trade is projected to double a decade into the implementation of the African Continental Free Trade Area (AfCFTA) agreement. That agreement has the potential to accelerate the growth of African small and medium-sized enterprises and their transition to mature global corporations, as more investors take advantage of economies of scale associated with the continental free trade area to strengthen competitiveness and to build robust regional value chains.

Risks to Africa's Growth Outlook

The escalation of global trade tensions turned the synchronized global growth witnessed early in 2018 into a synchronized slowdown, perhaps pointing to the materialization of risks to Africa and global growth previously flagged in several assessments of the economic outlook. These risks are now heavily tilted to the downside, in a context of elevated policy uncertainty. In Africa, they are largely driven by external factors, most notably the spillover effects of trade wars which could affect African growth through investment and trade, slowing growth in China and tightening global financial conditions.

The synchronized slowdown largely attributed to escalating trade tensions has highlighted the extent to which trade wars are bad not only for the two belligerents on the front lines of the trade war theater, but also for the world economy. As a potential collateral victim of a trade war between the two leading global economies, Africa could indeed be affected through trade and investment channels, specifically through faltering global demand for primary commodities and natural resources linked to slowing growth in Europe and China—its two main trading partners.

The recent truce on tariff increases and the commitment to reduce Chinese tariffs on US car imports are positive developments. But if a long-term and more permanent solution to ongoing trade frictions is not secured, an escalation of the trade war could undermine African and global growth prospects beyond trade. The economic costs could take several other forms, including increased costs of imported intermediate and capital goods, disruption of global supply chains, and declining productivity growth in a region where the deficit of infrastructure is already a major constraint to productivity enhancement.

Highly correlated with the first risk is growth performance in China, where the trade war has taken a toll on growth and trade. Slower-than projected growth in China could also undermine growth prospects within the region. Although Chinese authorities have deployed a battery of fiscal and monetary policy tools to head off headwinds from trade war and remain on a sustainable and robust growth trajectory, the success of these policy responses is not necessarily guaranteed, especially if ongoing trade negotiations do not ease the tension. Under that daunting alternative, the costs to African growth, especially in natural resource-dependent economies, could be significant since China is a major actor in the global dynamics of commodity markets.

The third risk to African economies relates to the pace of tightening global financial conditions and their inherent implications for investor sentiment. While softening inflation and synchronized growth deceleration in advanced and leading emerging developing market economies have slowed the pace of normalization of monetary policy, global financial conditions have been on a tightening mode for some time, with the US Federal Reserve delivering seven interest rate increases over the last two years. The implications of ongoing process of normalization of monetary policy have already been significant. Capital outflows chasing less risky US assets have led to disorderly exchange rate movements in emerging developing market economies.

In South Africa, the most sophisticated African economy, the magnitude of capital flow reversals has led to sharp currency depreciation and declines in equity prices. But most other African countries are at risk as well. Further tightening of global financial conditions triggered either by sharper-than expected increases in US interest rates or accelerated pace of monetary policy convergence could exacerbate global volatility, raise the costs of debt service and refinancing risk. In the medium and long term, these risks could undermine the quest for debt sustainability and overall macroeconomic management and growth, especially in highly leveraged economies.

The speed at which the world has turned from synchronized global growth to synchronized slowdown has highlighted the risks associated with the rise of a beggar-thy-neighbor zero-sum-game global trade environment. It has also reasserted the need to foster greater multilateral cooperation and draw on rules-based frameworks to address trade disputes. Although Africa is projected to achieve broad-based growth acceleration in this challenging global trade and economic environment, the region remains vulnerable to global volatility and risks.

Sustaining and further raising the rates of economic expansion to make a dent on poverty alleviation will require accelerating the process of economic diversification to boost intra-African trade and to deepen economic integration during the implementation of the AfCFTA. At the same time, the rising costs of debt service associated with the sharp depreciation of local currencies has highlighted the risks of increased non-resident participation in domestic debt markets and of excessive reliance on foreign currency borrowings, especially on non-concessional terms, for economic management and debt sustainability. The priority for African governments in the medium and long term should also be to improve debt management and accelerate the development of domestic financial markets, to diversify financial products and increase the issuance of debt denominated in local currencies, which in turn should lower exposure and exchange risks.

This assessment of Africa’s growth prospects has been prepared by Dr. Hippolyte Fofack, Chief Economist at the African Export-Import Bank (Afreximbank). The document provides analyses of the Research Department and does not purport to reflect the views of Afreximbank.