African Department

09/2

Spillover Effects and the East African Community: Explaining the Slowdown and Recovery

Paulo Drummond and Gustavo Ramirez

INTERNATIONAL MONETARY FUND

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CHAPTER

1 Overview

The East African Community (EAC) countries—Kenya, Tanzania, Uganda, and Rwanda—have been affected by the global financial crisis and global recession.[1] The fall in global demand and inflows and tighter liquidity conditions abroad affected the countries in this region as elsewhere in sub-Saharan Africa. But how hard have countries in the EAC been hit? Have the spillovers from the global crisis affected countries in the region as much as other countries in the sub-Saharan region? Have the transmission channels or magnitudes of the spillovers been different across EAC countries? How can these countries return quickly to a path of sustained high growth? What is the role for policy? Would acceleration of regional integration and policy coordination help achieve this goal? Would it make the region less susceptible to shocks? This paper focus on the EAC countries and attempts to address these questions. The key messages are these:

- Spillover effects of the global crisis are driving the economic slowdown in the region. The downturn is most pronounced in Kenya, which has suffered from external shocks amplified by adverse domestic developments.
- Growth in the region is expected to rebound in the coming years, helped by a more favorable external environment as well as domestic stimulus. While the precise pace of the projected recovery remains highly uncertain, it seems that it might take some time, at least a few years, for growth to catch up to precrisis levels.
- Countries in the EAC generally responded to the slowdown with monetary and fiscal policy easing. In the coming years, adjustments to macroeconomic policy stances will be needed to sustain a strong recovery.

[1]Except where noted, this note excludes Burundi, focusing on the four EAC countries with the highest GDP.

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CHAPTER

2 The Current Slowdown and the Role of Spillover Effects

Explaining the Current Slowdown: Shocks and Channels

Historically, EAC growth has closely tracked global real GDP growth (Figure 1 and Appendix Figures 1a and 1b). Even though growth in the EAC countries seems to have trended upward since the early 1990s—to higher levels than that experienced by the world economy—real GDP growth in the region has generally been susceptible to fluctuations in world output growth. During global slowdowns, the EAC has generally been affected by reduced external demand for its exports and deteriorating the terms of trade prompted by declines in global commodity prices. At times, the region has also been affected by tighter financial conditions abroad, particularly during episodes of financial crisis. However, the magnitude of the impact of past slowdowns has varied greatly, depending on the causes of the decline in world growth and idiosyncratic domestic developments in EAC economies, including economic policy responses. Throughout the 1980s and 1990s, recessions in industrial countries led to more-than-proportional recessions in EAC economies, but this link seem to have been broken in the 2000s (Box 2.1).

The current global financial crisis is affecting EAC countries through three primary channels. First, as growth in trading partners slows, EAC economies suffer from a decline in external demand for their goods and services. Second, by reducing income, the sharp fall in commodity prices and terms of trade (Figure 2), and the decline in workers' remittances induced by the crisis are dampening domestic demand growth. Finally, global financial conditions have recently deteriorated to levels not seen in more than two decades. As a result, a reduction or reversal in capital flows to the region, including foreign direct investment (FDI), is constraining investment and dampening growth prospects.

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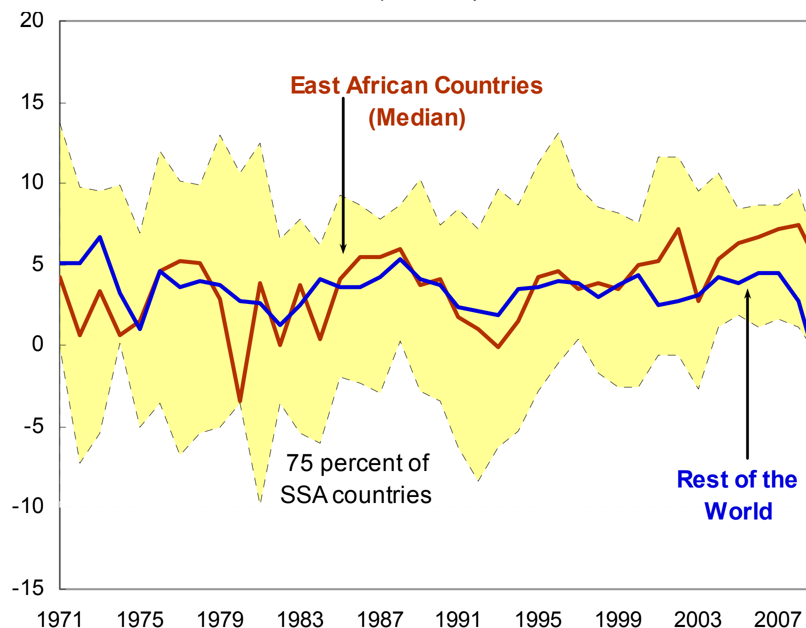
Figure 1. Sub-Saharan Africa and the Rest of the World: Real GDP Growth
(Percent)



Source: IMF, *World Economic Outlook*; and authors' calculations.

Trade Channel

- Exports are an increasing greater share of the EAC economies—about 20–25 percent of GDP, on average, compared to 10–15 percent in the 1980s and 15–20 percent in the 1990s. This has made the economy more exposed to declines in external demand. Kenya in particular is much more open than Rwanda, with Tanzania and Uganda right in between.

- Export destinations have become more diversified in recent years, with more exports now going to other emerging and developing economies (Figure 3). This suggests that trade spillovers are likely to manifest themselves indirectly, to the extent that the relevant trading partners are affected. Exports from the EAC to developing Asia and the rest of Africa (as a percent of GDP) have tripled from 1 percent of GDP in the mid-1980s to 3 percent of GDP in the 2000s, while exports to the United States and the euro area have been stable at close to 1 and 3 percent, respectively, in the same period.

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Box 2.1. Past Declines in World Growth and the EAC

While past declines in world growth have affected EAC countries, the magnitude of the impact varied greatly, partly due to the underlying cause of the decline in world growth, idiosyncratic domestic developments in EAC (e.g., droughts), and economic policy responses (Table 1). Through the 1980s and 90s, recessions in industrial countries led to more-than-proportional recessions in EAC economies, but this link seem to have been broken in the 2000s.

- The declines in world growth in 1980, 1982, and 1991 were accompanied by growth declines in SSA. In 1980-82, world growth suffered from a large U.S. recession and growth declines in other industrial countries. Due to the global nature of the crisis, and the associated large oil price shock, growth in EAC countries also suffered. And the decline in the EAC growth rates was stronger than experienced elsewhere. In 1991 the decline in world growth was driven by the U.S. recession. The associated Savings and Loan crisis in the U.S. and the resulting credit crunch affected growth in other industrial countries. And the EAC region also suffered.

- By contrast, the 2001 decline in world growth was not associated with a decline in EAC growth. Indeed, growth in the EAC actually increased. The global slowdown was driven by a U.S. recession associated with the burst of the IT bubble, including the sharp declines in most major stock market indices and drops in business investment around the world. The US recession was accompanied by growth declines in most industrial economies, and non-fuel commodity prices declined, but EAC growth was resilient.

Global slowdowns and EAC Growth

	Recessions[1]					Slowdowns [2]	
	1974-75	1980	1982	1991	2001	1986	19954
	Change in GDP growth (median for region; unless otherwise indicated)						
World [3]	-4.5	-1.6	-1.1	-1.3	-2.3	-0.1	-0.1
United States	-6.1	-3.4	-4.5	-2.1	-2.9	-0.7	-1.5
Other Industrial countri	-5.4	-1.5	0.4	-1.3	-2	-0.1	-0.3
Emerging Asia	-3.5	-0.3	-1.5	-0.1	-1.1	0.9	0.3
SSA	-0.5	?	1	?	0.6	-0.6	1.9
SSA	-1.6	-0.7	0.2	-1.1	0.9	-1.1	0.6
SSA [3]	-1.0	1.5	-2.3	-2.5	1.0	0.5	1.5
EAC	-2.9	-2.9	5.8	2.2	-0.9	1.8	-0.7
EAC [3]	0.0	-3.8	3.3	1.2	-1.3	0.0	1.4
Burundi	-8.0	0.1	19.0	2.1	0.2	11.6	2.4
Kenya	-3.8	-2.5	-1.5	-0.4	-1.8	2.5	2.6
Rwanda	-2.7	-0.4	6.0	6.1	-1.6	-8.6	-14.7
Tanzania	-0.6	0.8	-2.1	3.3	1.6	3.5	0.6
Uganda	0.8	-12.7	7.3	0.1	-3.0	0.0	5.5
	Change in percent						
Non-fuel commodity pı	47.8	7.1	-13.8	-9.1	-8.5	6.3	11.5
Oil prices	250.8	133.0	-7.3	-15.7	-13.8	-48.2	7.9

Source: *World Economic Outlook, April 2007*; and IMF staff calculations.

[1]Year during which most of the impact on U.S. growth was recorded.

[2]Periods in which U.S. output was below potential and not considered recessions by the NBER.

[3]Weighted average.

[4]1994 Figures for Rwanda, Tanzania, and Uganda.

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Figure 2. Foreign Demand and Export Prices in the EAC

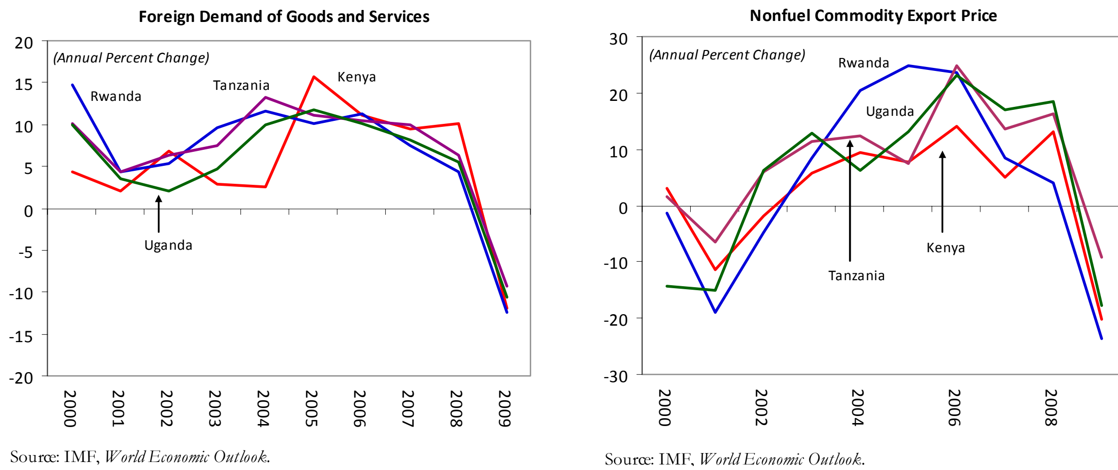
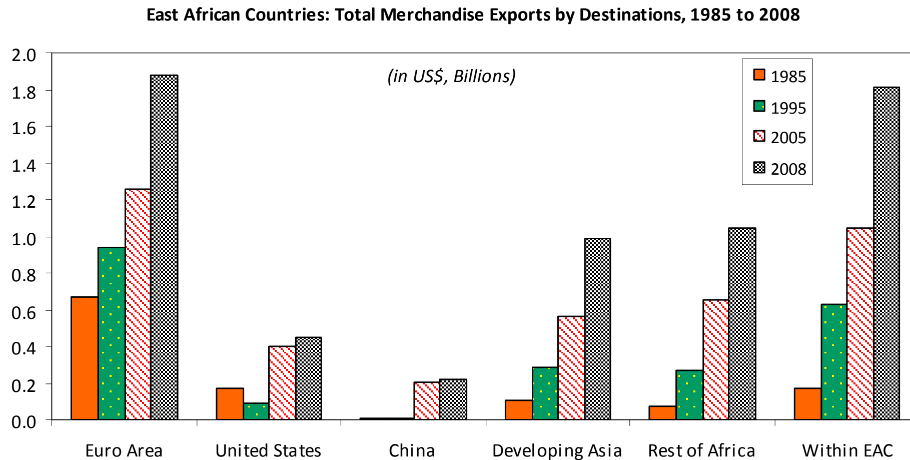


Figure 3. EAC Exports by Destination



Source: IMF, Direction of Trade Statistics.

- Exports to other EAC countries are now as large as exports to the euro area, suggesting that trade spillovers are likely to manifest themselves through intraregional trade.
- Deteriorating terms of trade have also put downward pressures on national income and thus domestic demand.

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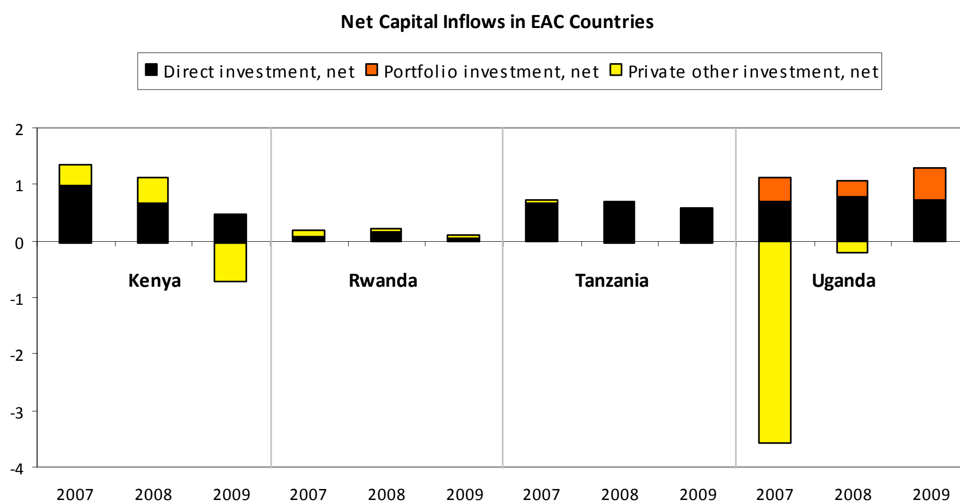
Figure 4. Net Capital Flows to the EAC



Source: IMF, *World Economic Outlook*.

Financial Links

- Flows of private capital have clearly diminished in Kenya, led by weaker FDI and other private flows, and portfolio flows turned negative at the beginning of the crisis is some countries (e.g., Uganda), although most flows to the other countries have been broadly spared (Figure 4). In some countries, however, including Kenya, having a clear picture of private capital flows is made difficult by the bunching of short-term flows with errors and omissions.

- Remittances declined in some countries (Uganda, Kenya) but by less than expected at the beginning of the crisis.

- Aid flows are less significant in Kenya than in the other EAC countries but seem to have held up relatively well.

As a result of the crisis, the contributions of both external and domestic demand to GDP growth have declined (Figure 5 and Appendix Figure 2). Both consumption and investment lost steam, partly due to tighter financing conditions as well. Government consumption, which had been slightly expansionary in 2006 and 2007, slipped to neutral for the region as a whole. The contribution of net exports to growth remained negative across all countries. The exact channel of transmission varies across countries

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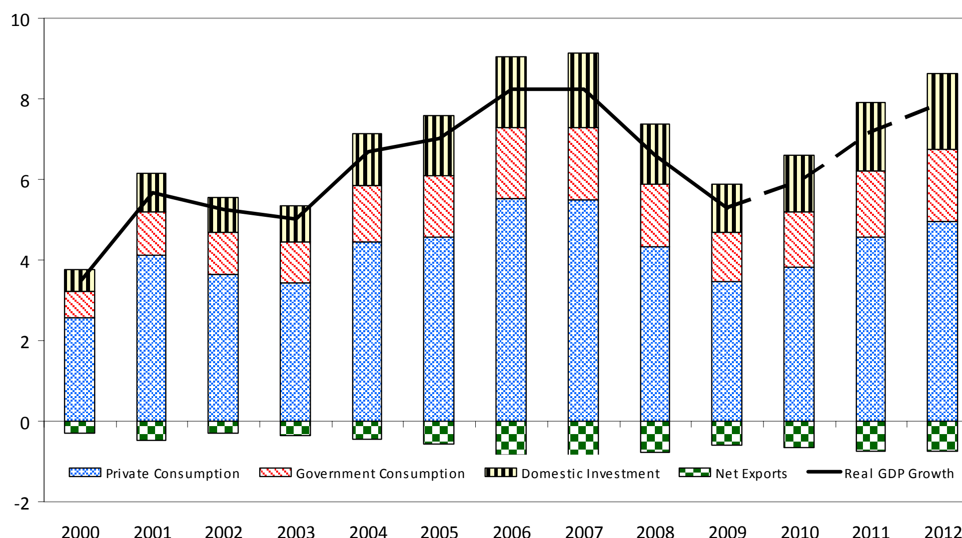
Figure 5. Contribution to GDP Growth



Source: IMF, World Economic Outlook and Staff Calculations.

depending on each country exposure to financial links abroad, the decline in external demand, and economic policy responses.

In 2009, growth remained subdued for all the EAC on account of the global economic crisis (Figure 6). Growth in Kenya dropped to below 2 percent in 2008—with the slowdown partly on account of a drought and domestic political crisis—and it is projected to remain below 3 percent in 2009, its lowest rates in the last five years. In the other countries (Rwanda, Tanzania, and Uganda), while growth improved in 2008 in comparison to 2007, it is expected to decline in 2009 with the impact of global spillovers partly moderated by the weight of agriculture and public investment spending in some countries (e.g., Uganda) and by the lower dependence of Tanzania and Uganda on external demand. Policy responses—fiscal stimulus and monetary easing—also helped boost consumption and investment.

How Does the Current Cycle Compare with Previous Cycles?

A comparison of the current economic cycle in the EAC with previous cycles in the region and cycles elsewhere in the sub-Saharan African (SSA) region provides the following insights (Figure 7 and Appendix Figure 3):

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Figure 6. Real GDP Growth, by Country

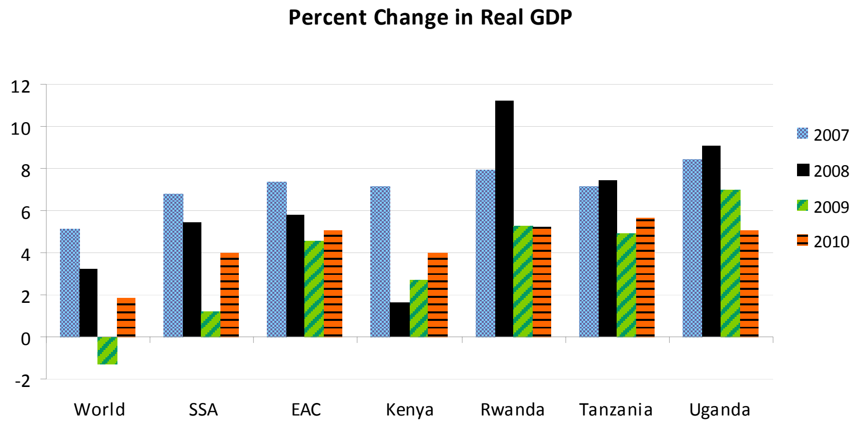
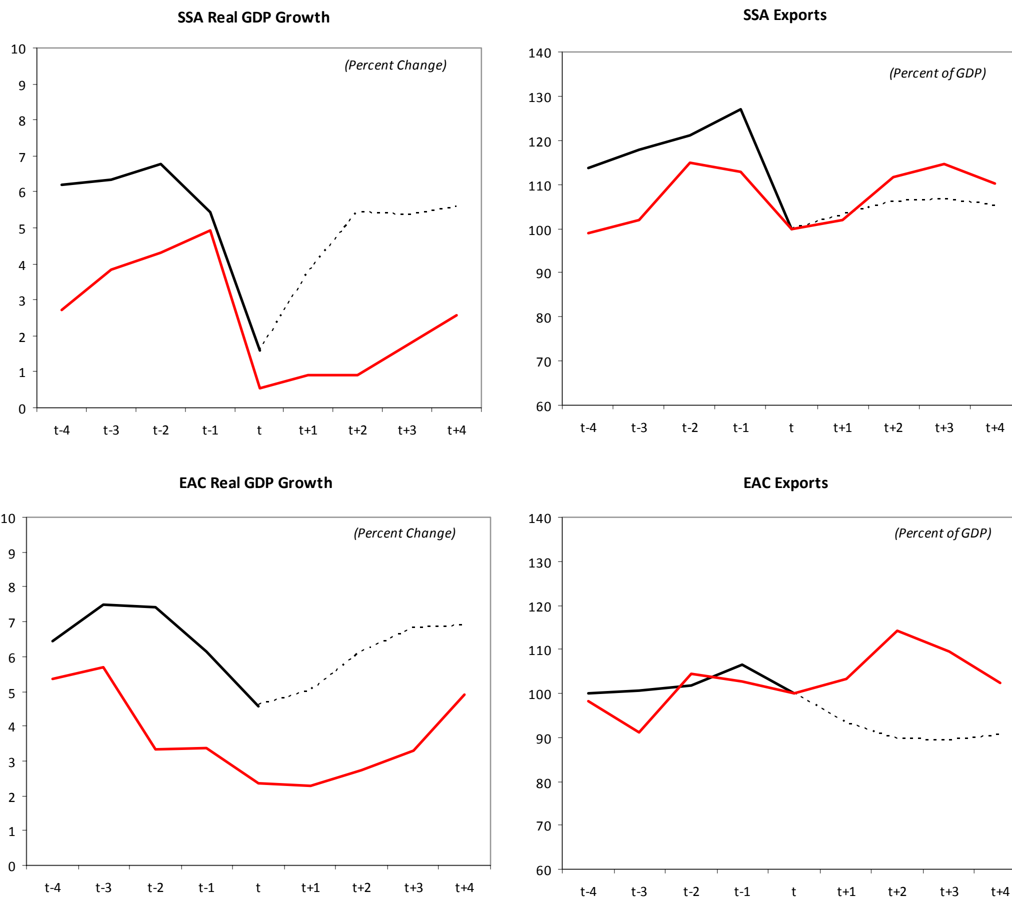


Figure 7. The Current Economic Cycle and Historical Cycles: The EAC and the SSA

(Red is historical pattern, black is current pattern)



Source: IMF, *World Economic Outlook*.

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- The current downturn starts from a more favorable position: precrisis growth was higher than that at comparable times in previous cycles, and fiscal positions and reserve levels were generally stronger. This has not only made the economies structurally less vulnerable to external spillovers but also enabled the authorities to consider countercyclical policies.

- The growth decline in the EAC has been, on average, less pronounced than that for other SSA countries. However, performance varies significantly across countries, with Kenya suffering a more pronounced downturn than other countries in the EAC region.

- The pace of the expected recovery suggests it will take about 3-4 years for growth to recover, on average, to precrisis levels. This pace would seem to be broadly similar to that observed in previous EAC cycles.

- The drop in EAC growth has been partly driven by a fall in exports, in some cases even as a share of GDP. But while the recovery for SSA countries is expected to be clearly export-led, growth in Kenya and the EAC is expected to reflect a combination of positive spillover effects and strong domestic demand in the initial years. Aid is also expected to sustain demand.

The Role of Spillover Effects

Much of the recent downturn in the EAC can be explained by spillovers. To measure the size of spillovers on individual African countries, we apply estimates from a dynamic panel model for countries in the region (Figure 8). The model relates real growth in domestic output to world growth weighted by trading partner countries and to several control variables: oil prices, non-oil prices, a measure of global financial stress, and country fixed effects (Box 2.2). The median estimates for the region as a whole suggest that the slowdown can be generally explained by spillover effects. The exception is Kenya, where a major slowdown took place in 2008 amid political disturbances, and the current year is set to record a mild recovery. Some offsetting factors seem to be at play, reflecting domestic developments, including strong agricultural growth, and perhaps, policy responses, an issue we turn to next.

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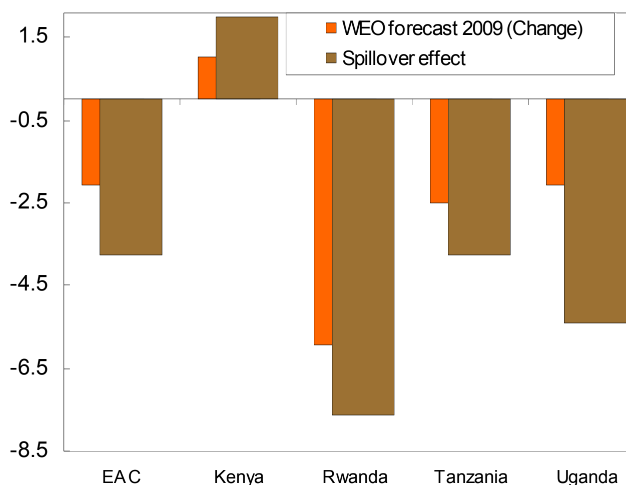
Figure 8. Spillover Effects and the EAC; Explaining the Slowdown for 2009 GDP
(Percentage point decline from 2008)



Box 2.2. Quantifying the Impact of a Global Slowdown on Individual African Countries

The following are the key estimates of the impact of a global slowdown on individual African countries, using a series of dynamic panel regressions for countries in the region:

- A 1 percentage point slowdown in the rest of the world has been found to lead to an estimated 0.4–0.5 percentage point slowdown in sub-Saharan African countries. The effect is partly felt contemporaneously (0.2 percentage points) and partly in the following year (0.2 percentage points).
- A nonfuel-commodity-prices-induced income reduction by 10 percent tends to reduce growth in sub-Saharan Africa by about 1.9 percentage points after two years.
- An oil price shock tends to be significant only above a certain threshold (5 percent increase in prices). The impact is calculated as the oil price change (above the threshold) times the share of net oil exports. An SSA country with oil imports of some 20 percent of GDP facing a decline in oil prices on the order of 50 percent, could expect a growth rate some 0.5 percentage points higher than otherwise. The impact is linear on price changes above the threshold and on the oil intensiveness of the economy. It appears symmetric for price increases and decreases in prices.
- A financial channel is significant when proxied by the spread of 3-month LIBOR vs. US Treasury bills: a 100 basis point increase in the spread reduces growth in SSA countries by an estimated 0.5 percentage points. To our knowledge, this is one of the first applications of such a measure of financial conditions for countries in the region.

Source: Drummond and Ramirez, 2009.

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CHAPTER

3 How Have Countries Responded to the Shocks?

Monetary and Exchange Rate Policy

Monetary and exchange rate developments have generally reflected the shocks in trade and capital flows in the region. While policy responses differed across countries, some broad movements seem to be have been common:

- Slow foreign asset growth has affected growth in money stocks (relative to income) in all countries (Figure 9).

- Lower liquidity coupled with more cautious lending by banks has reduced credit growth in all countries (Figure 10).

- While the intensity of exchange rate movements differed across countries, they tended to initially depreciate in nominal terms, with adjustments partly reflecting the countries' current account positions (Figure 11). Except Uganda, the real effective exchange rate, however, has appreciated.

- Real interest rates have dropped and became negative in all countries (Figure 12 shows treasury bill rates as an illustration).

Fiscal Policy

Most countries in the EAC responded to the shock with some fiscal stimulus. The overall fiscal balance for the region (including grants) deteriorated by about 1½ percentage points, to a deficit of close to 3 percent of GDP in 2008 (Figure 13). As expenditure growth outpaced both revenue and GDP growth in these countries, fiscal deficits widened, both actual and structural. Fiscal policy was expansionary in Kenya, Tanzania, and Uganda in

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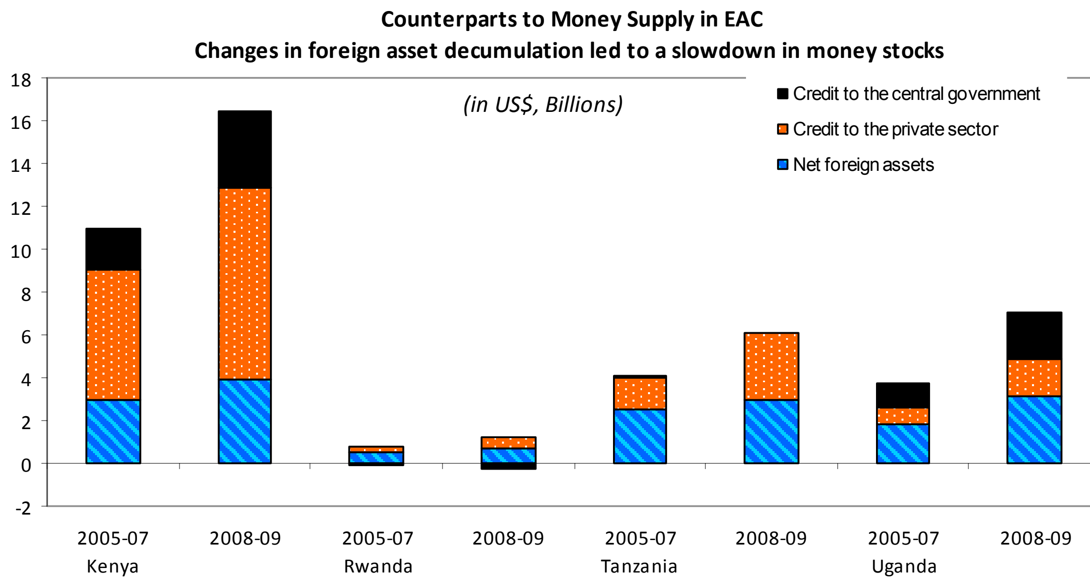
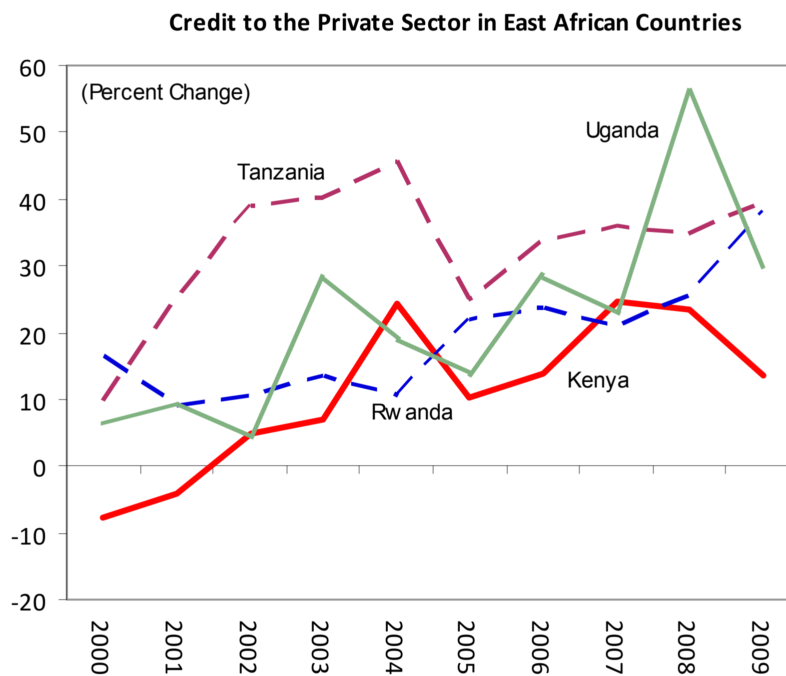
Figure 9. Foreign Assets and Growth in Money Stocks



Source: IMF, *International Financial Statistics.*

Figure 10. Slowdown in Credit Growth in the EAC



Source: IMF, *International Financial Statistics.*

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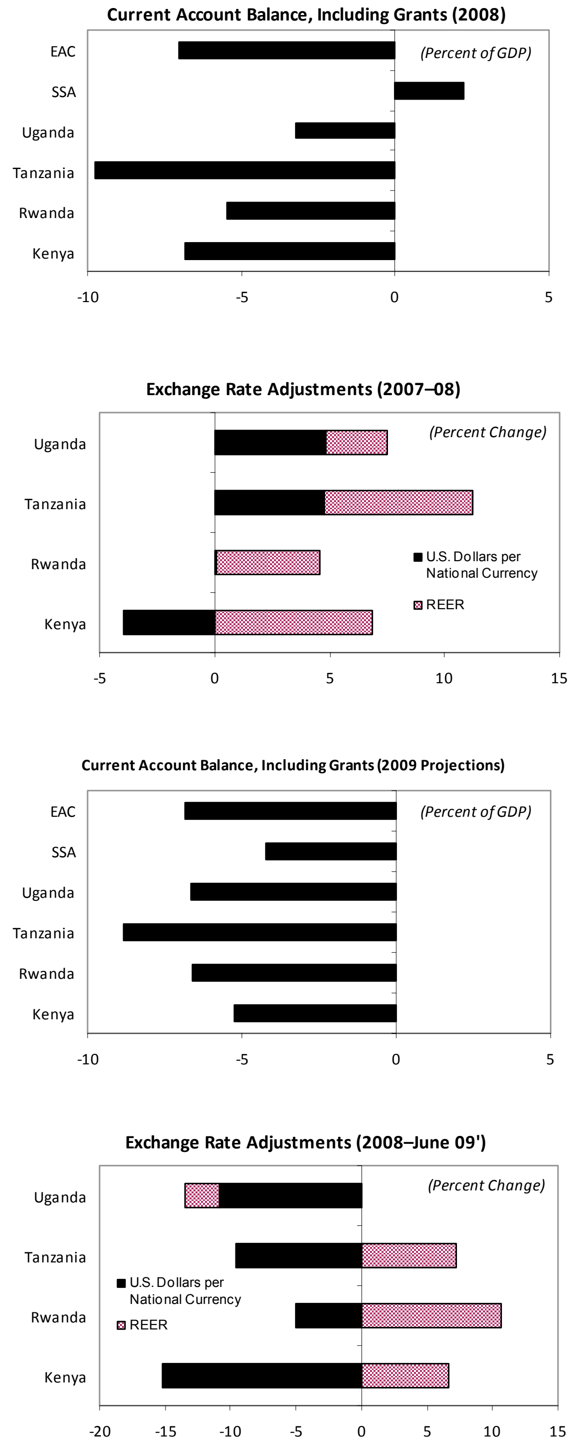
Figure 11. Exchange Rate Adjustments and Current Account Balances



Source: IMF, International Financial Statistics.

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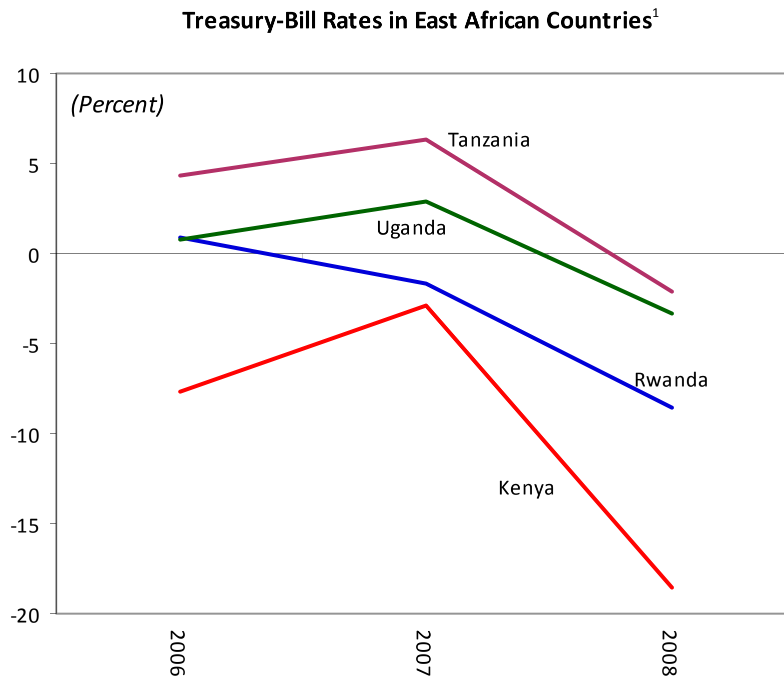
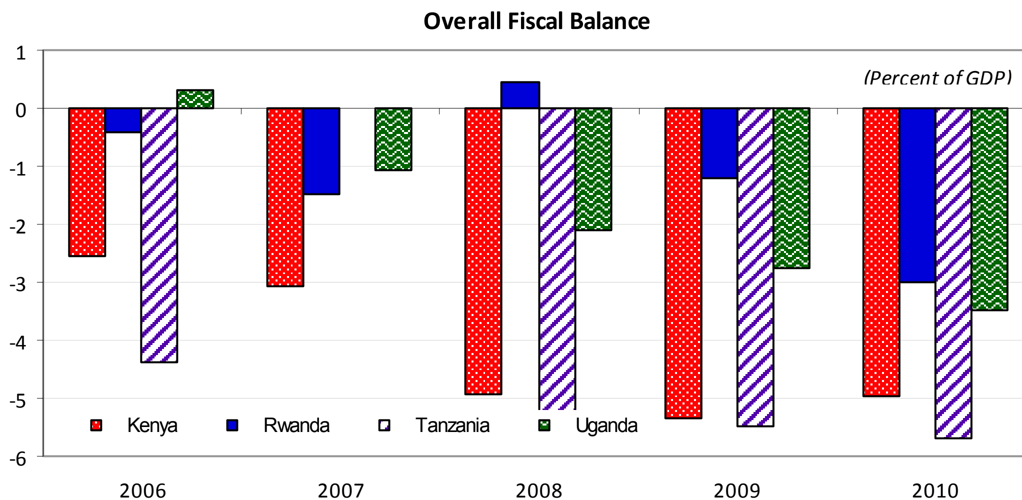
Figure 12. Real Interest Rates in the EAC



Source: IMF, *International Financial Statistics*.

[1]Interest rates are real and backward looking.

Figure 13. Fiscal Deficits in the EAC



Source: IMF, *Regional Economic Outlook*.

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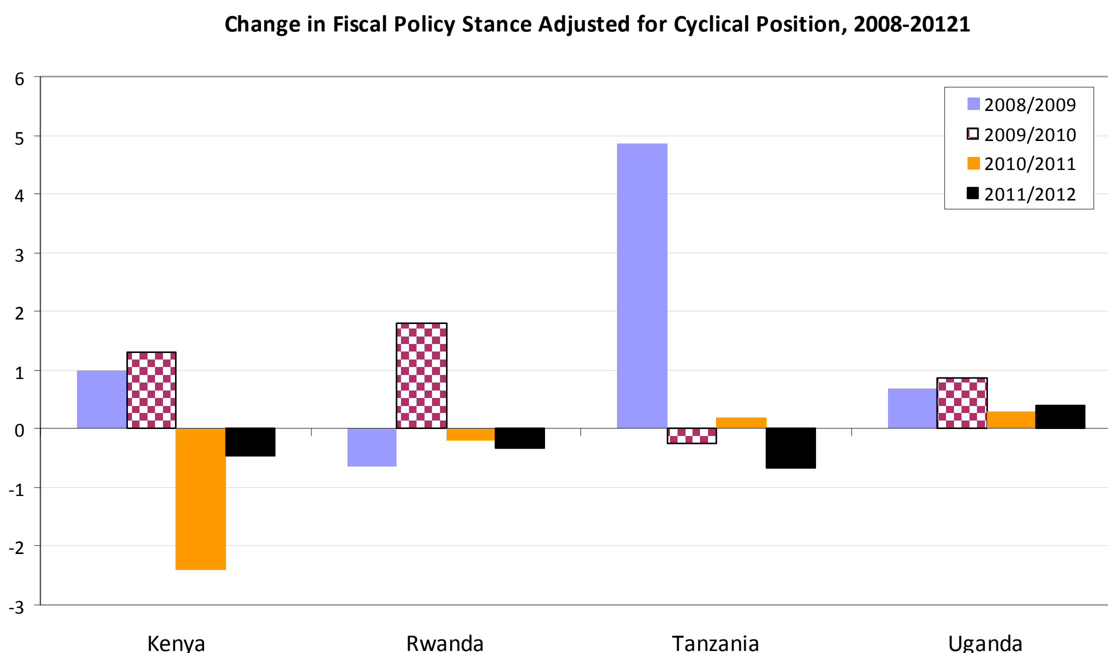
Figure 14. Cyclically Adjusted Fiscal Deficits in the EAC



[1]Change in primary balance adjusted for cyclical position, in percent of GDP relative to previous year. A positive number indicates a more expansionary fiscal impulse.
Assumes an income elasticity of tax revenues equal to 1, and that all expenditure is structural. Applies a simple cyclical correction to actual revenue calculated based on estimates of potential GDP (as calculated by desks).

2008/09. But the magnitude of the stimulus has varied across countries: in Tanzania, the budgeted stimulus was unparalleled in the region, while in Rwanda, the change in policy stance lagged one year. In most countries, due to capacity constraints in the execution of fiscal spending projects, the actual stimulus may turn out to be less than planned.

Adjusting for the cycle, two broad patterns can be distinguished in terms of how fiscal stimulus was provided in response to the global crisis (Figure 14):

- Initial stimulus, followed by broadly neutral stances and some fiscal withdrawal later in the cycle: Tanzania (exceptionally large initial stimulus, and moderate withdrawal late in the cycle); Kenya (large initial stimulus with substantive withdrawal early in the cycle); and, Rwanda (large but lagged initial stimulus with moderate withdrawal late in the cycle).
- Moderate and gradual stimulus from the time of the shock extending into the medium-term: Uganda.

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CHAPTER

4 How Fast Can Countries Return to a Path of Sustained Growth?

Spillover Effects in the Recovery

To what extent will a change in the global environment lead to a recovery, and how quickly? The global economy would seem to be on its way to provide a more supportive environment for countries in the region in coming years:

- Global output is projected to recover by about 2.5 percent in 2010 and 2011, helped by fiscal stimulus, monetary easing, and financial sector measures in major economies. Foreign demand for goods and services in the region is expected to follow suit (Figure 15).

- Capital flows to emerging and developing economies are projected to regain momentum over the next few years, after a sharp drop in 2009. Net flows to the region will continue to depend heavily on foreign direct investment. Countries are expected to regain access to market financing.

- Non-fuel commodity prices are expected to rise modestly in 2010 as the global recovery gets underway, consistent with pricing in forward markets.

Estimates of moderate, positive spillover effects seem to justify expectations that the recovery will be mild for countries in the region (Figure 16). The expected spillovers account for part of the projected growth in the coming years, partly because the region will still be feeling the lagged effects of the global downturn. Thus, the projected recovery assumes that at least in the first few years, domestic demand will be a key driver of growth. In any case, an eventual return to the growth path observed in the years before the global financial crisis will require a continued effort to pursue good and sound economic policies that fashion an environment conducive to sustained growth.

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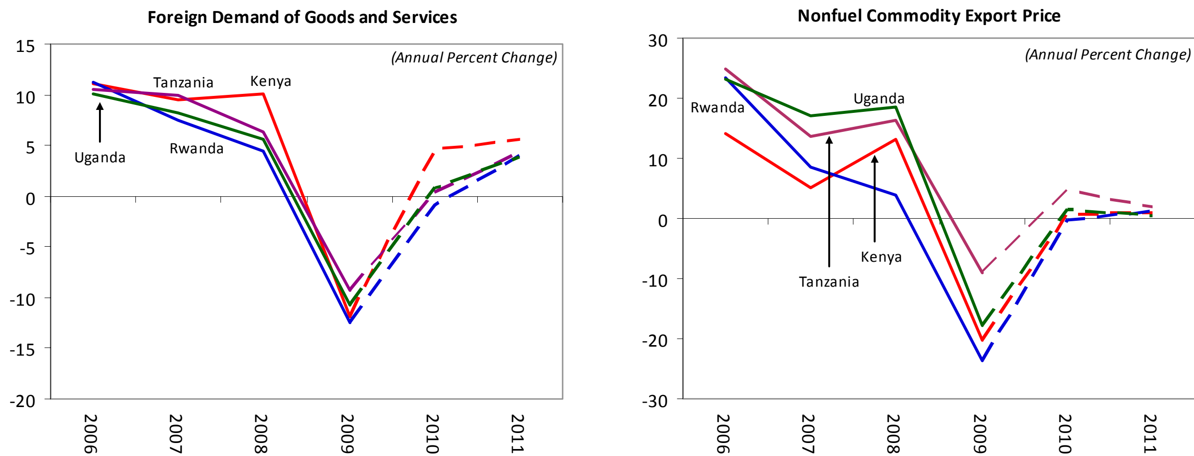
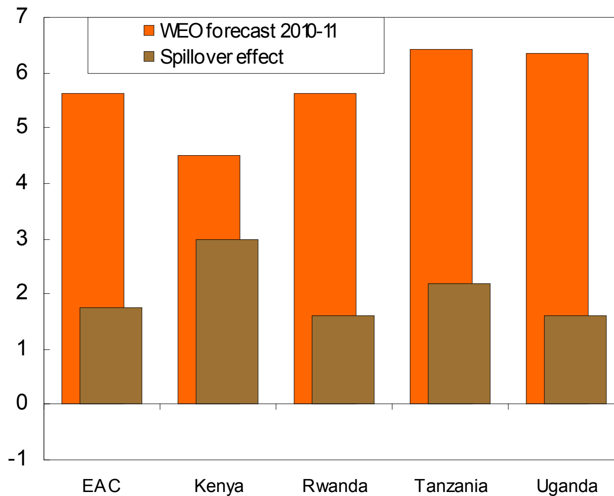
Figure 15. Driving the Recovery: Foreign Demand and Commodity Export Prices



Source: IMF, *World Economic Outlook*.

Source: IMF, *World Economic Outlook*.

Figure 16. Spillover Effect on the Expected Recovery, 2010–11 GDP Growth
(Percentage points)



Catching Up to Precrisis Growth: How Fast?

Growth in the region is expected to rebound, helped by a turnaround in trade as well as domestic stimulus (Figure 17). The recovery for the region as a whole, however, masks a very diverse set of country circumstances:

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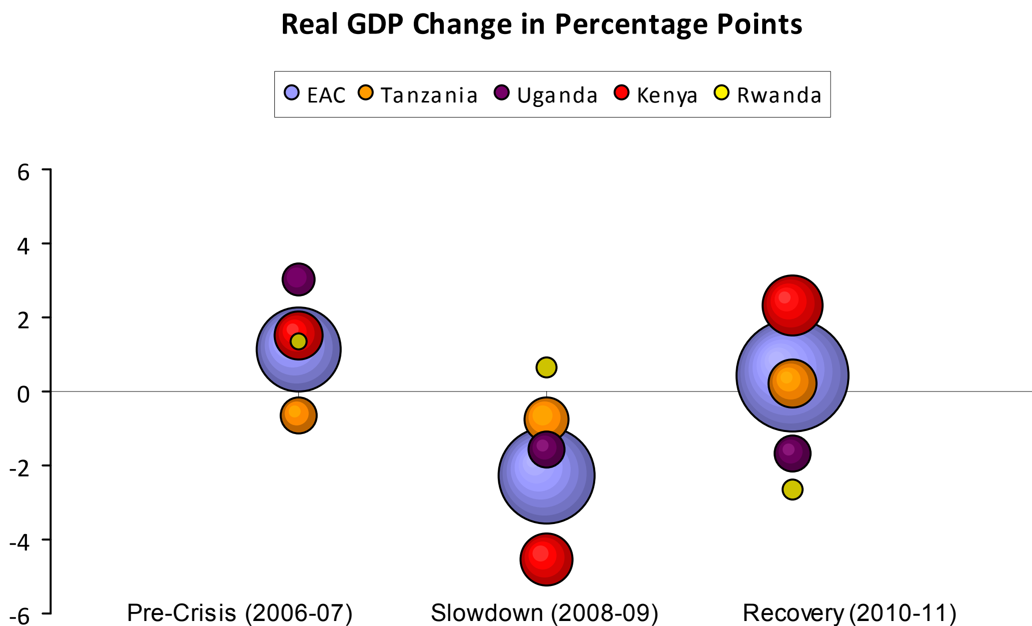
Figure 17. The Expected Recovery

Real GDP Change in Percentage Points



- Kenya is the only country with an expected V-shaped recovery in the region. Having been greatly impacted by both domestic and external shocks, the economic deceleration is expected to be largely reversed in the coming two years, as the shocks are not expected to impart permanent effects on growth.

- In Tanzania, growth is expected to recover only gradually in the coming years, with only a mild rebound to precrisis levels.

- In Uganda, the slowdown in growth is expected to be more protracted, reflecting not only the impact of the crisis but likely also some convergence to longer-term growth. The growth rates experienced precrisis were the highest in the region and likely above potential.

- In Rwanda, where growth rates appear to have been the least affected so far, projections suggest the economy will be affected with some lags, as growth is projected to decline in the coming years. As for Uganda, the growth rates experienced precrisis were likely above potential.

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The catch-up is partly supported by the fact that the EAC economies have been quite resilient to the external shocks. This resilience reflects favorable developments in the years prior to the crisis, when countries attained high growth rates while keeping their current account and fiscal deficits manageable, kept inflation stable or in decline, reduced debt, increased foreign reserves, and strengthened policy frameworks.

Although the precise pace of the projected recovery remains highly uncertain, it seems that it might take some time, at least few years, for growth to catch up to precrisis levels (Figure 18).[2] For some countries such as Uganda and Rwanda, growth will not return to precrisis levels simply because growth then was above potential. For other countries, this reflects a number of forces at play:

- The resumption in global growth is not expected to significantly ease the financing pressures facing countries in the region.
- World trade is projected to remain subdued, implying a loss of potential markets for countries in the region.
- Except for Kenya, the strength of the recovery will depend on aid prospects, a key financing source for most of the EAC.

As economic activity picks up, adjustments to macroeconomic policy stances may be needed to foster a sustained strong recovery. Strong policies over the past decade have created room in the EAC countries for countercyclical policies in the face of the global slowdown. However, as growth recovers, part or all of the stimulus may need to be withdrawn in order to preserve macroeconomic stability. In particular, a tightening of the monetary and fiscal stances is likely to be necessary to avoid the emergence of inflation pressures or the buildup of external or financial sector vulnerabilities. At the same time, the unwinding of the stimulus will also help create room for maneuver to counter future possible shocks.

The unwinding of the fiscal stimulus will have to be conducted while preserving and possibly creating additional fiscal space for infrastructure spending. In EAC countries, as elsewhere in Africa, there is no doubt that the infrastructure gap is acting as a constraint on growth and development. Creating fiscal space for stepped-up infrastructure spending should therefore remain a priority. In the first place, efforts should be made to create fiscal space without incurring any debt. Further improving domestic revenue mobilization through tax policy and administration reforms is therefore paramount. Then, additional borrowing could be envisaged in countries

[2]Pre-crisis growth refers to growth in 2005–07.

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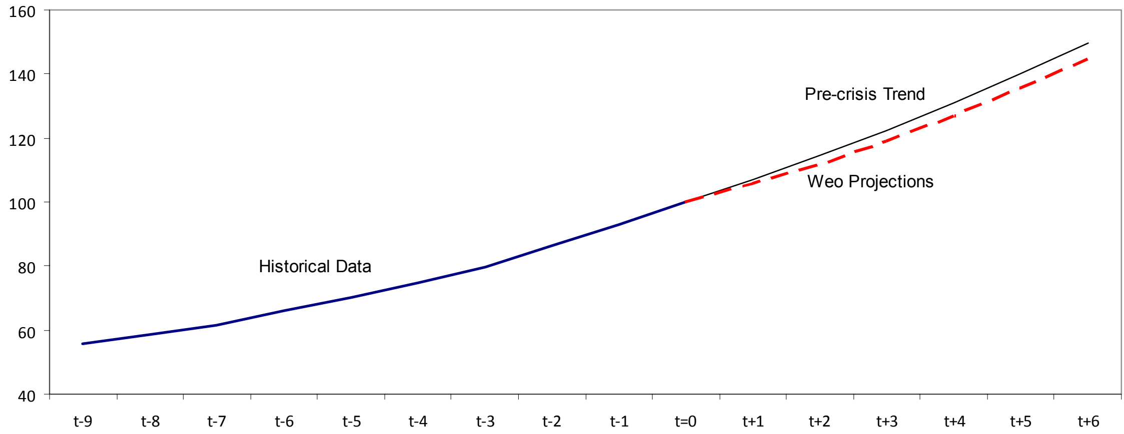
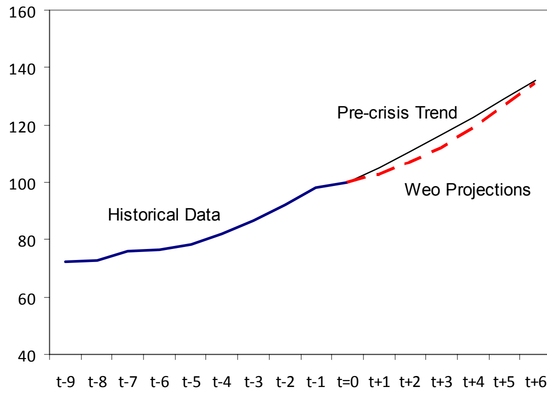
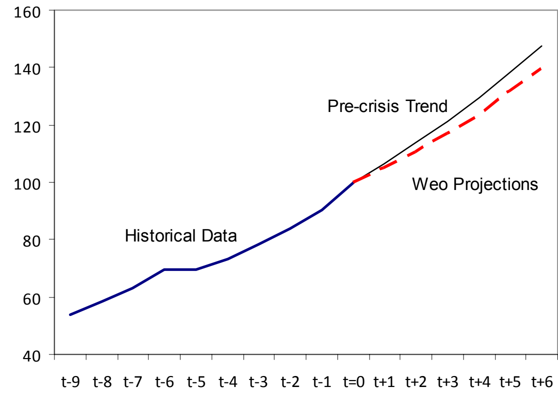
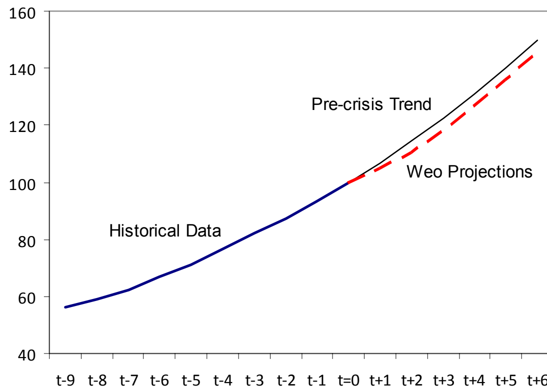
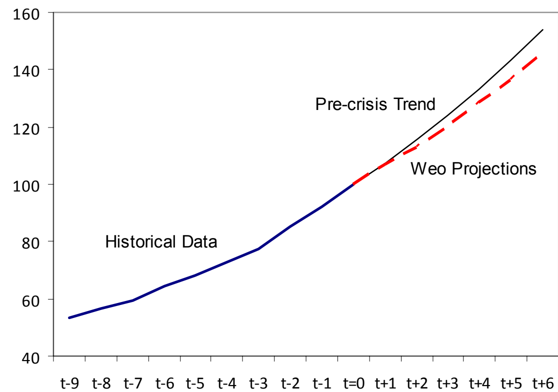
Figure 18: Growth Prospects in EAC











Source: IMF, World Economic Outlook and Staff Calculations

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where debt sustainability is not at risk. In this case, the various possible financing options should be compared with a view to limiting risks and safeguarding resources. Encouraging greater private participation either through direct investment or public-private partnership arrangements is also an option.

The policies implemented in reaction to the crisis should not derail the reform momentum of the past decade. Progress in liberalizing EAC economies, in opening up to the world economy, and in the areas of public financial management, financial sector reform, and the business environment have started to bear fruit. Sustaining the reform effort will be crucial to boost growth over the medium term.

In addition to the domestic policy and reform agendas, accelerating regional integration could also help foster progress in these areas and boost growth. Regional integration can accelerate the pace of economic growth by fostering efficient cross-border investment and trade flows. It can also help create economies of scale and boost productivity and domestic and foreign investment. Progress has been made in the EAC toward a custom union, but more can be done to reduce tariff and non-tariff barriers, create a single market, and develop harmonized regional financial markets.

Enhanced policy coordination across EAC countries could be particularly valuable in the following areas:

- *Infrastructure.* The development of regional infrastructure could help generate economies of scale.

- *Food security and agricultural policies.* Enhanced cooperation would also facilitate dealing with food crisis, and implementing policies to enhance agricultural productivity in the region could help. By contrast, unilateral export bans such as those put in place in some countries in the past couple of years risk exacerbating food shortages in some countries while reducing incentives for investment in those experiencing excess supply.

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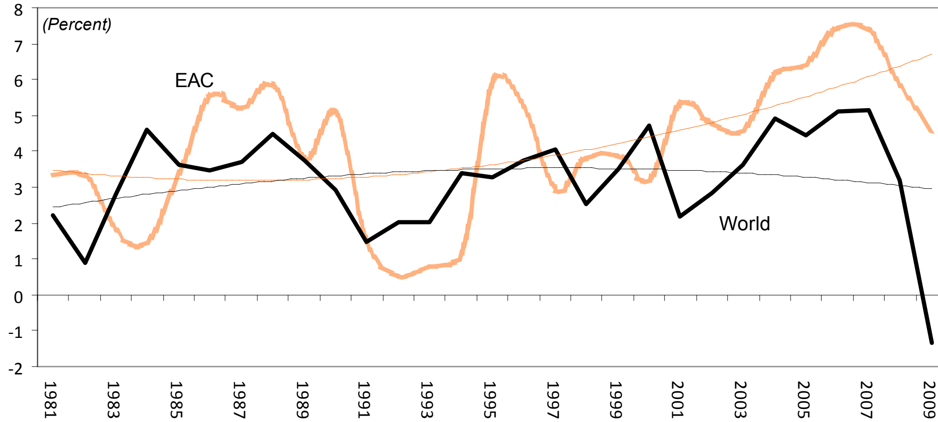
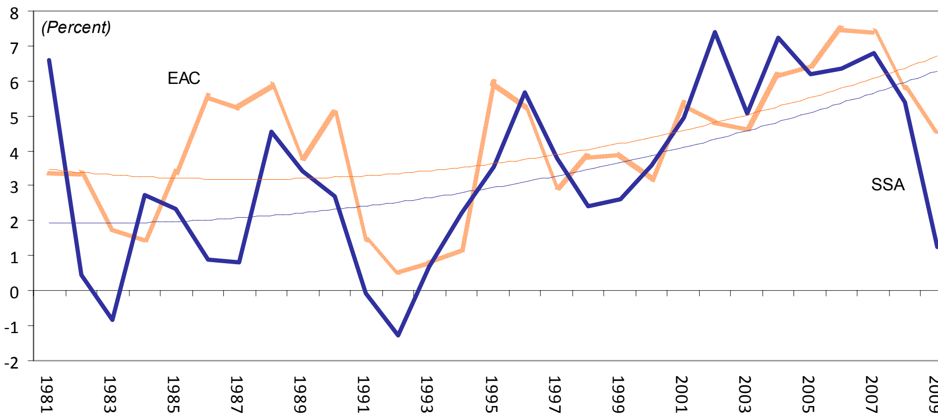
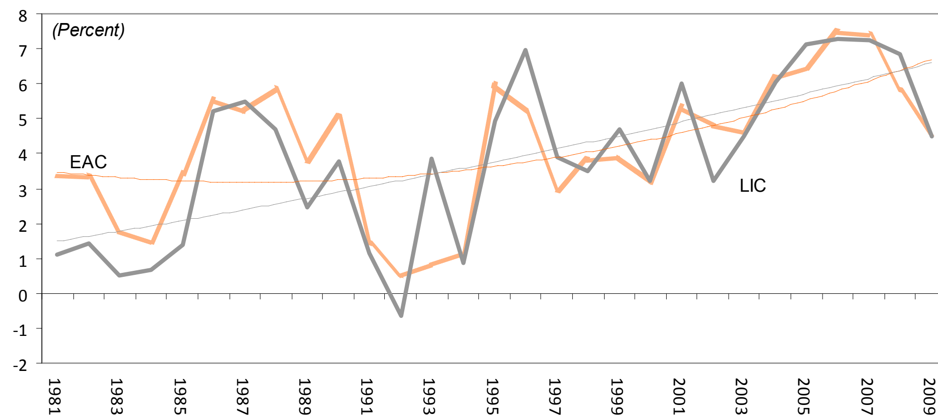
Appendix—Figure I

Real GDP Growth







Source: IMF, World Economic Outlook

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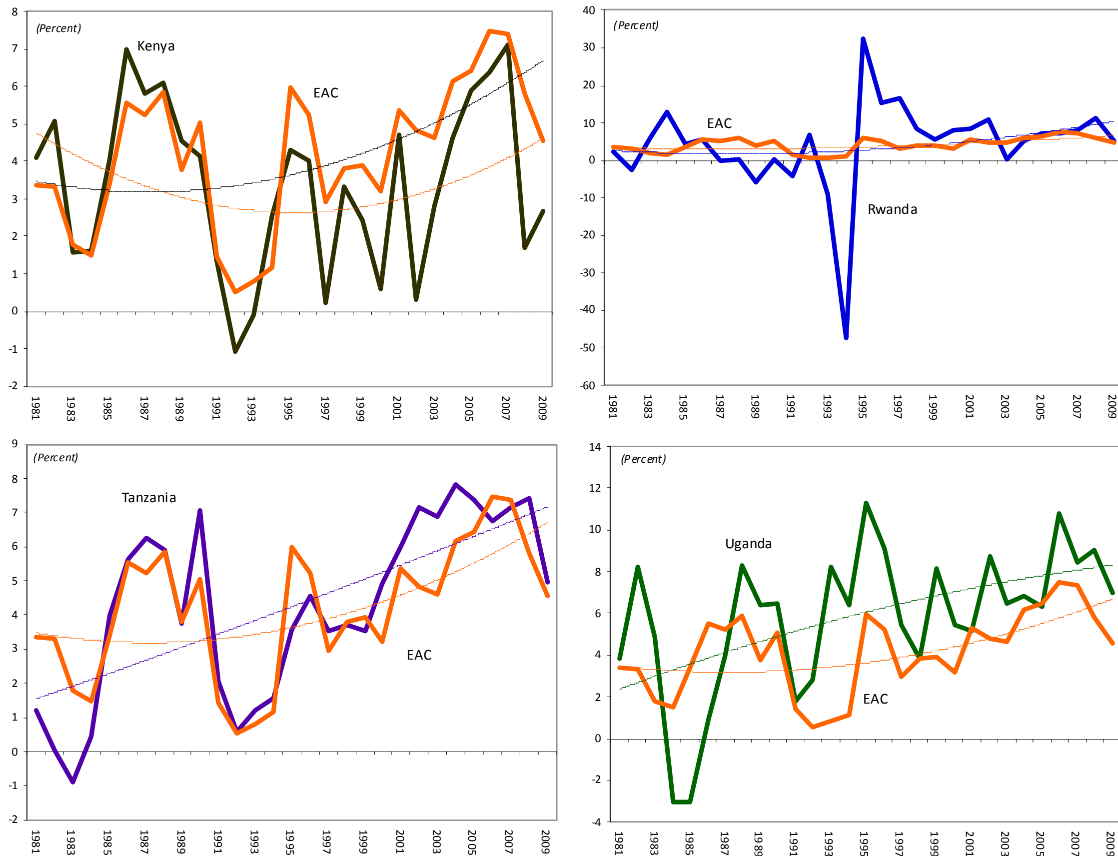
Appendix. Figure I *(cont.)*



Source: IMF, World Economic Outlook.

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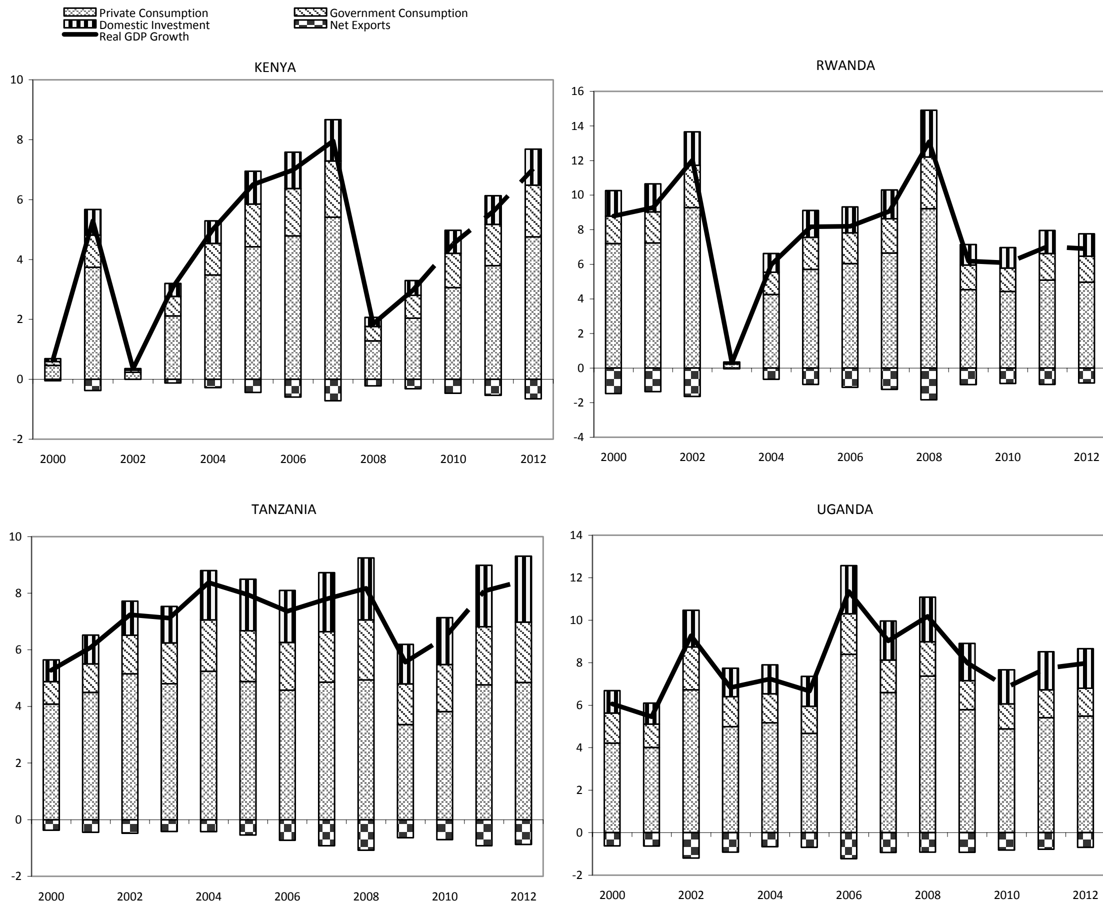
Appendix. Figure II



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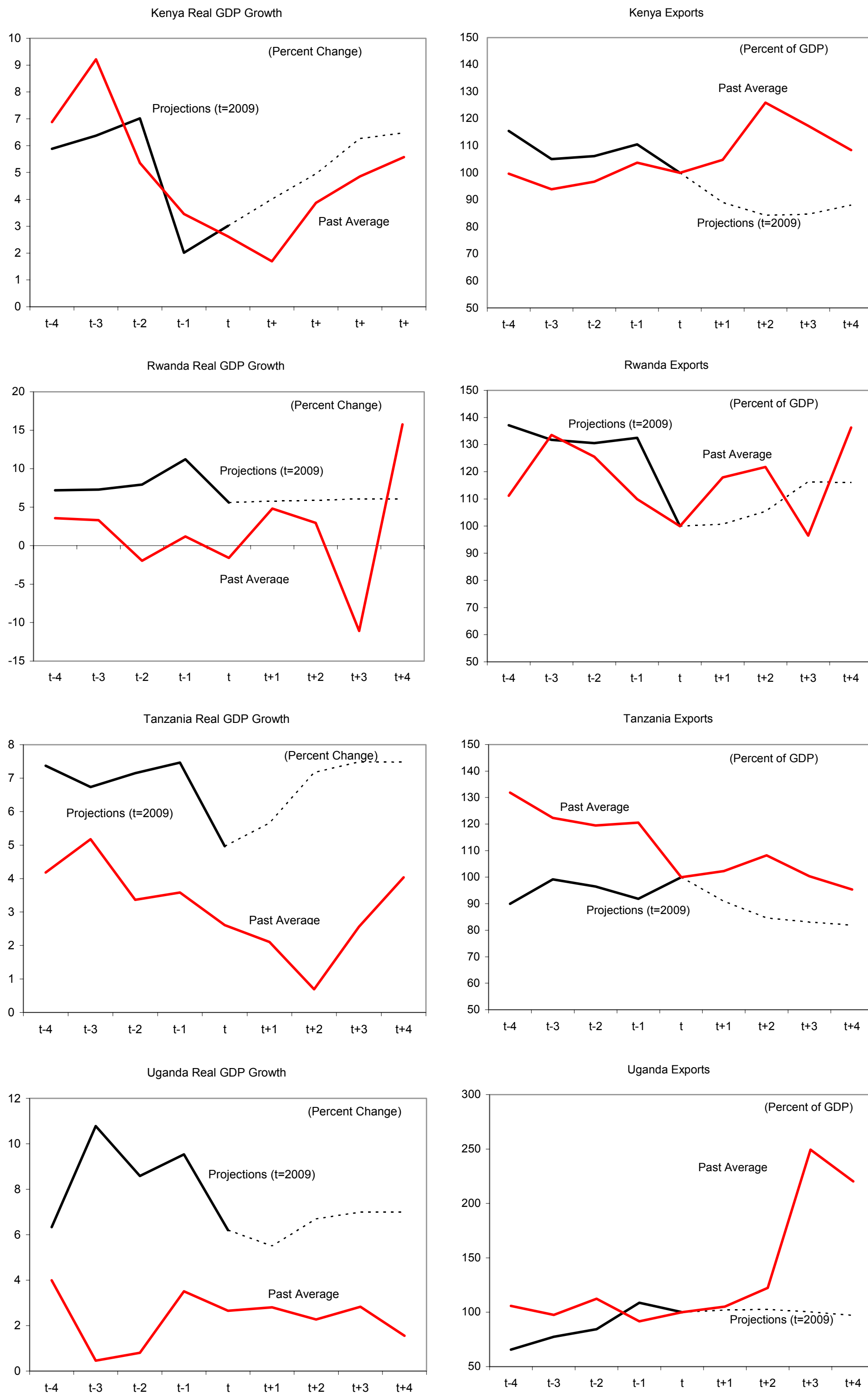
Appendix Figure III



Source: IMF, World Economic Outlook

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