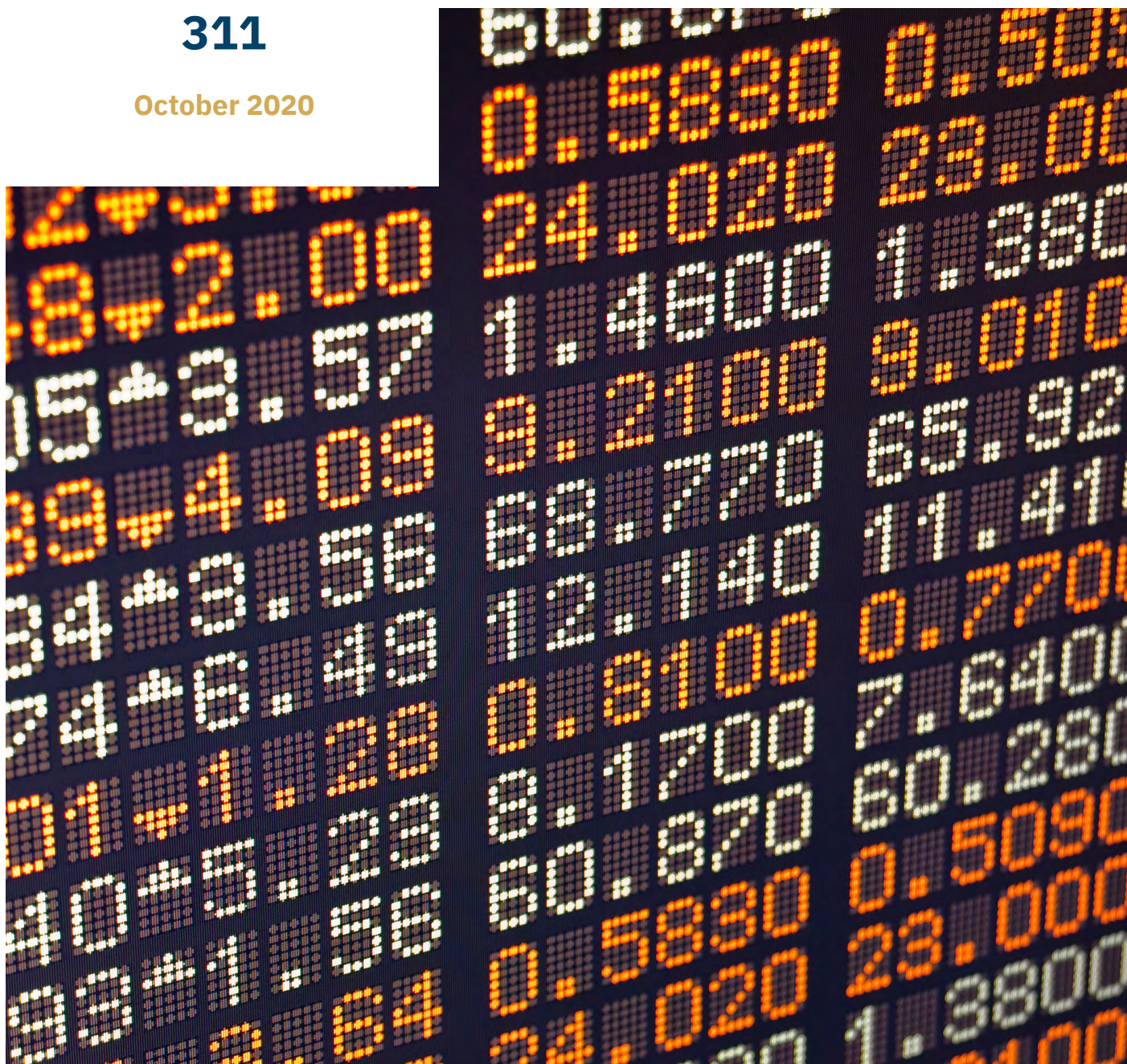


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Impact of Covid-19 on Financial Stability in Africa

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African perspectives
Global insights

Abstract

Covid-19 has been very damaging to global equity and debt markets, especially in developing markets with riskier assets. The impact on developing markets has been exacerbated by falling commodity prices and depreciating currencies. The turbulence in financial markets, together with the negative effects of economic lockdowns, has prompted fiscal and monetary authorities in most countries to enact economic stimulus packages and other liquidity-boosting measures to safeguard financial stability. With Africa's economic outlook revised downward, financial instability is still a major risk owing to huge capital outflows, trade disruption, reduced foreign direct investment and funding shortages. Remittances have dried up and, as households and businesses become distressed, default rates are on the rise, risking the sudden stop of credit markets. Creditors are increasingly unwilling to lend off the back of weakening borrowers' credit quality and low investor and business confidence. For African countries, the cumulative effects of the pandemic crisis are a projected recession amid widening fiscal deficits, falling government revenues and soaring debt servicing costs. In the midst of this, ratings agencies have been downgrading countries by revising downward their speculative-grade default forecasts to recessionary levels and increasing market-implied defaults. Macroeconomic resilience, particularly in Africa, is being tested by both the health and economic impact of Covid-19; a virus that is still largely unknown as its impact becomes more severe and lengthier than initially anticipated. While the most vulnerable countries are in dire need of assistance from the international community to mitigate the economic impact of Covid-19, central banks are fundamental to maintaining financial stability on the continent. It is therefore more important than ever for African governments to strengthen monetary, fiscal and financial policy interventions to forge economic recovery plans as the pandemic is brought under control.

Introduction

Covid-19 has plunged economies across the world into an emerging recession of unknown depth, resulting from disrupting international trade and commerce. This in turn has placed immense pressure on capital markets across the world, posing a serious threat to the stability of the global financial system. The resultant global financial panic has been particularly acute in Africa, as borrowing costs have risen dramatically off expectations of widespread defaults. There has been an abrupt decline in commodity prices and large foreign financial outflows, coupled with lockdowns and travel bans that have frozen labour markets and economic activities. This has put emerging and frontier economies under severe stress, as many of them entered the Covid-19 crisis with weaker initial economic conditions given their socio-economic challenges. This has been the first wave of the impact of the novel coronavirus, which has also led to the forecasting of a major global economic crisis for 2020 as the world economic outlook is revised downwards.

The second-round impact of Covid-19 will manifest itself in sovereign credit rating downgrades as countries feel the effects of declining fiscal revenues and foreign exchange receipts. This will be coupled with widening fiscal deficits and rising ratios of debt to gross domestic product (GDP) as countries accumulate more debt to mitigate the economic effects of the pandemic. These second-round impacts will exacerbate domestic shocks in developing economies that are most at risk of defaulting on their debt repayments, causing credit markets to freeze up.¹ Most of these countries already have a severely constrained fiscal policy space with debt at significantly higher levels and wider structural budget deficits. These countries currently tend to rely heavily on foreign portfolio investors and external funding, further putting them at risk.²

Financial instability is therefore a serious risk right now – specifically in Africa, a continent where many countries have underdeveloped financial systems and infrastructure.

Africa's economic successes have often been supported by financial market development. Financial sector development is necessary to allow the economy to engender financial innovation and promote efficiency in the financial system, potentially leading to higher economic growth. Sub-Saharan Africa's financial system is largely dominated by the banking sector, where there is little competition. As such, any systemic bank failures could have serious financial contagion repercussions for the continent. However, the concentration in the African banking sector is also a means through which policy can be better targeted, and through which widespread exposure to financial stress can be limited. Regional blocs on the continent have been working towards financial integration for the effective mobilisation of capital, and positioning stock exchanges to attract greater global flows.³ Although there are large variations across countries, African countries have taken remarkable steps to develop and enhance their relative financial sectors in the last decade, and there are major opportunities to harness. Policies and incentives that boost market activity, mergers, new regulations and innovative financial products have contributed to the expansion of financial markets across the continent. Nurturing the growth of African businesses requires an open and enabling investment environment, the access to finance that capital markets provide and financial stability. The European Central Bank defines the latter as a condition in which the financial system is capable of withstanding shocks and the unravelling of financial imbalances. Macroprudential policy aims to preserve financial stability and is used to address the emergence of possible systemic risks in the financial system.

It is against this backdrop that this paper seeks to highlight the impact of Covid-19 on financial stability in Africa, an economic region that has lost significant access to external debt financing as portfolio flows have reversed sharply, putting pressure on

1 CountryRisk.io, *The Second Wave: The Impact of Covid-19 on Sovereign Ratings* (Zürich: CountryRisk.io, 2020), https://countryrisk.io/static/pdf/CountryRisk_Covid_Impact_on_Ratings_May_2020.pdf.

2 AU, *Impact of the Coronavirus (COVID-19) on the African Economy*, report (Addis Ababa: AU Commission, 2020), <https://www.tralac.org/news/article/14483-impact-of-the-coronavirus-covid-19-on-the-african-economy.html>.

3 Benedicte Vibe Christensen, "Financial Integration in Africa: Implications for Monetary Policy and Financial Stability" (Working Paper 76, Bank for International Settlements, Basel, 2014), <https://www.bis.org/publ/bppdf/bispap76c.pdf>.

Nurturing the growth of African businesses requires an open and enabling investment environment, the access to finance that capital markets provide and financial stability

less creditworthy borrowers. This is followed by a discussion of the effects of Covid-19 on financial stability in a global context. The paper then examines the impact of the pandemic on financial stability on the continent, focusing on African equities, debt and credit markets. As fears of the virus's becoming a global pandemic rose in early 2020, spreads rose in the credit market while prices of equities dropped dramatically. It also looks at the reaction of rating agencies to Africa's economic woes, as well as other outflows on the continent as Covid-19 spreads. The paper then examines growing financial integration in Africa as the pandemic has caused market liquidity deterioration, including in those markets that have been known to be very deep. It concludes with policy recommendations on enhancing financial stability in Africa to support sustainable and inclusive economic growth and development.

Overview of global financial stability in the context of Covid-19

The Covid-19 outbreak is primarily a health crisis and humanitarian disaster. It poses unprecedented health risks and is placing global healthcare systems under immense pressure. This health crisis has spilled over into an economic disaster; one that poses an immensely difficult trade-off between considerations of public health and broader socio-economic welfare. This crisis is also one that has revealed many deep tail risks and exposed several financial market fragilities.⁴ Principal among these is corporate credit risk, sovereign default risk and a sudden realisation of the flight-to-credit-quality phenomenon. This crisis is fundamentally distinct from those that have preceded it in that it did not emanate from the financial sector and subsequently impacted the real economy. Instead it derived from a synchronised sudden stop in the real global economy whose fallout has worked its way into financial markets and resulted in widespread global financial dislocation. Given the nature of the crisis, the near-term economic and financial reaction will be determined by the path of the virus and behavioural responses to it.

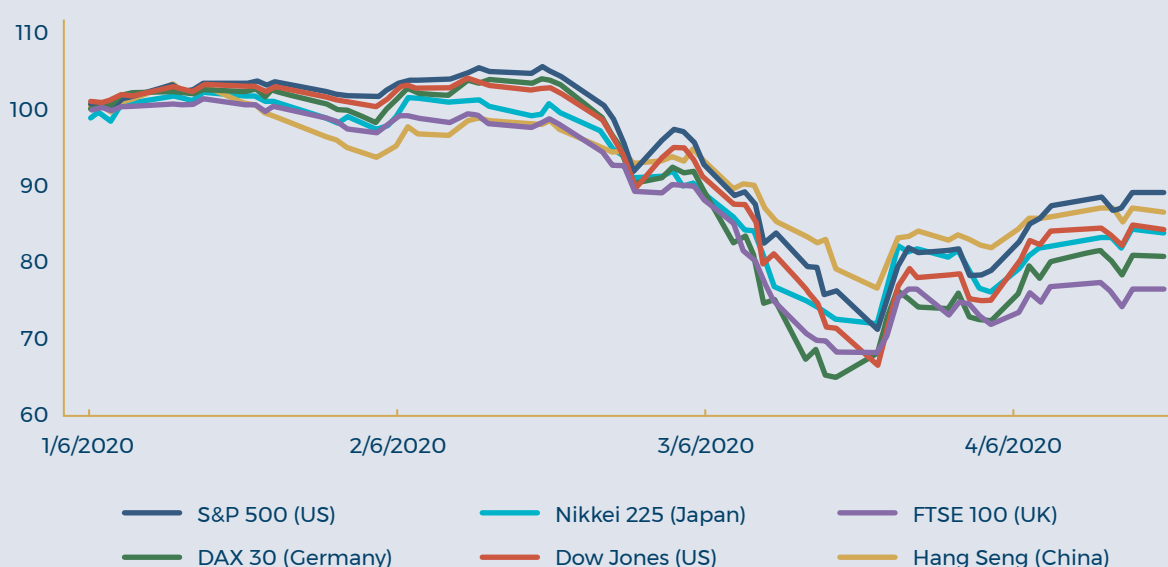
Following the spread of the virus beyond China's borders, global financial conditions tightened dramatically, market volatility spiked, and funding markets shut down. Fears

⁴ International Monetary Fund, *Global Financial Stability Report: Markets in the Time of COVID-19* (Washington: IMF, April 2020), <https://www.imf.org/en/Publications/GFSR/Issues/2020/04/14/global-financial-stability-report-april-2020>.

of widespread default have manifested in a highly risk environment.⁵ Policymakers have scrambled to inject liquidity into global markets with massive fiscal and monetary stimulus packages. For example, South Africa’s economic stimulus package for the 2008 global financial crisis (GFC) was 2.9% of GDP, compared to the Covid-19 economic stimulus package of 8.6% of GDP. The impact of the economic shutdown, coupled with the chaotic reaction of market participants, has resulted in pervasive instability and severe dislocation in financial markets.⁶

As Covid-19 spread beyond China’s borders, equity markets experienced a sudden decline as investors fled to safe-haven assets.⁷ The volatile response to the crisis has in part been a function of the prevailing pre-Covid-19 financial and economic environment. Years of low rates and easy money have resulted in a precipitation of risky shadow banking constructions, which are heavily reliant on current cash flows and exist under relaxed regulation. These assets are highly exposed to corporate default.

Figure 1 Select equity index movements (*Base period = Jan 2019)



Source: Authors’ own compilation using data from Yahoo Finance, “S&P 500”, <https://finance.yahoo.com/quote/%5EGSPC/history?p=%5EGSPC>; Yahoo Finance, “DAX Performance Index”, <https://finance.yahoo.com/quote/%5EGDAXI/history?p=%5EGDAXI>; Yahoo Finance, “Hang Seng Index”, <https://finance.yahoo.com/quote/%5EHSI/history?p=%5EHSI>; Yahoo Finance, “Nikkei 225”, <https://finance.yahoo.com/quote/%5EN225/history?p=%5EN225>; Yahoo Finance, “Dow Jones Industrial Average”, <https://finance.yahoo.com/quote/%5EDJI/history?p=%5EDJI>; Yahoo Finance, “FTSE 100”, <https://finance.yahoo.com/quote/%5EFTSE/>

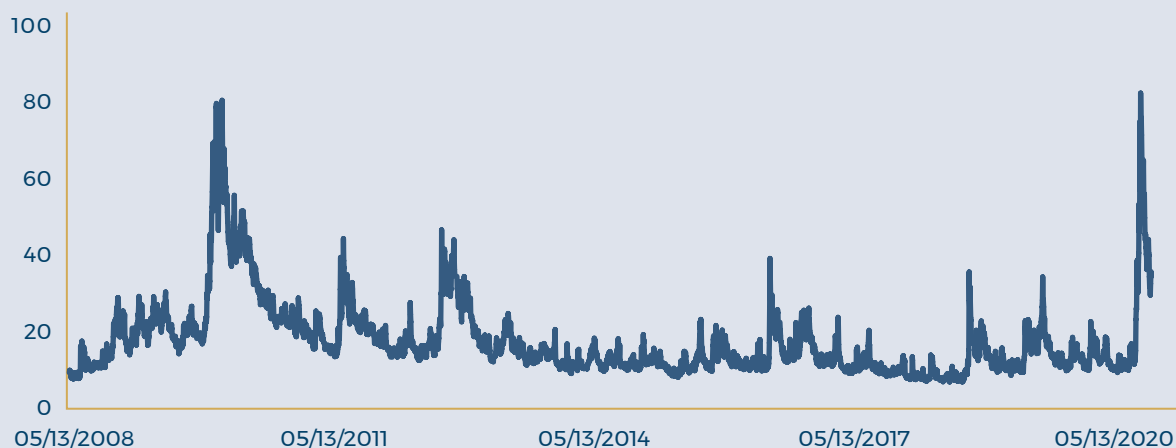
5 Organisation for Economic Cooperation and Development, *Coronavirus: The World Economy at Risk*, interim economic assessment (Berlin: OECD, March 2, 2020), <https://www.oecd.org/berlin/publikationen/Interim-Economic-Assessment-2-March-2020.pdf>.

6 IMF, “Policy Responses to Covid-19”, July 24, 2020, <https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19>.

7 OECD, *Coronavirus: The World Economy*.

The volatility that financial markets experience as a result of the Covid-19 pandemic is made evident by the VIX index (see figures 1 and 2), which has reached levels higher than those just prior to the 2008 financial sector crash. The VIX index gives information about the level of activity in the US options market and is a useful proxy for near-term risk sentiment.

Figure 2 Global VIX index (May 2008 – May 2020)



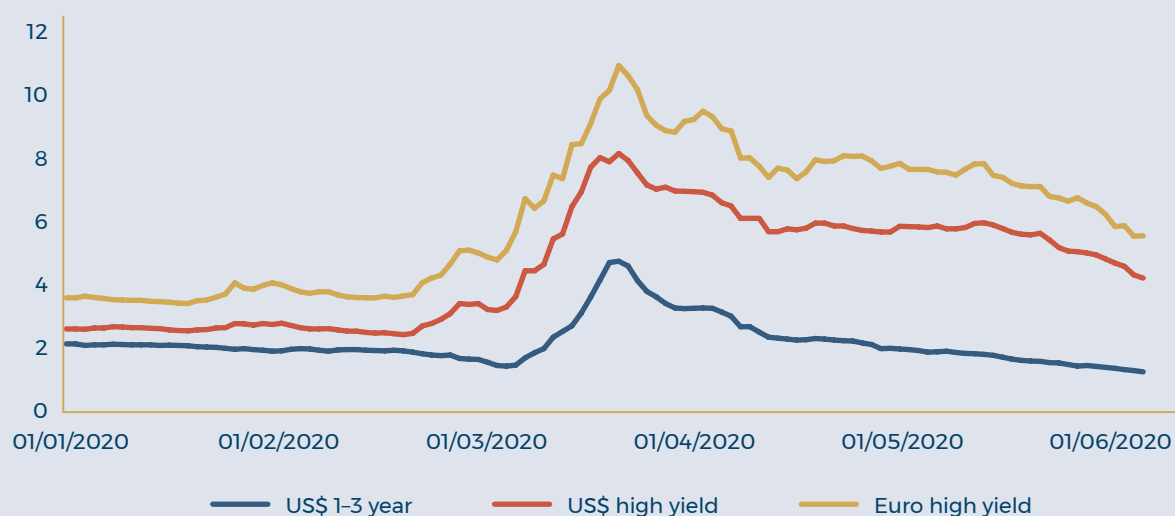
Source: Chicago Board Options Exchange, "VIX Index Charts & Data", <https://www.cboe.com/vix>

During the period between this and the 2008 GFC, corporate debt increased markedly while the quality of credit dropped to historic lows.⁸ This greatly increased the risk of corporate and sovereign default; a risk that is now being realised as a result of the Covid-19-induced financial crisis. Moreover, the structural shifts caused by the legislative response to the GFC have had the unintended consequence of diminishing banks' ability to respond adequately to heightened volatility and stronger liquidity demands.

Perhaps the most prominent source of financial market instability early in the crisis was the sudden shortages that arose in the dollar funding market. There are several reasons for this phenomenon, the main one being the dramatic rise in demand for dollars as investors fled to the safety and liquidity of cash and dollar-denominated assets, and the simultaneous pricing-in of credit and liquidity risks in global currency and funding markets. The near-term funding market stalled, money markets were reluctant to lend, and commercial paper issuance was scarce, only adding to the dollar shortage. The dramatic scarcity of dollars, coupled with global risk-off sentiment, led to sudden spikes in credit spreads across most debt markets, while funding costs rose dramatically (see Figure 3).

⁸ IMF, *Global Financial Stability Report*.

Figure 3 Select credit spreads (*Base year = Jan 2020)



Source: Authors' own compilation based on data from Federal Reserve Economic Data, "ICE BofA US High Yield Index Option-Adjusted Spread", <https://fred.stlouisfed.org/series/BAMLH0A0HYM2>; FRED, "ICE BofA Euro High Yield Index Effective Yield", <https://fred.stlouisfed.org/series/BAMLHE00EHYIEY>; FRED, "ICE BofA 1-3 Year US Corporate Index Option-Adjusted Spread", <https://fred.stlouisfed.org/series/BAMLCIA0C13Y>

While there was a dramatic spike in volatility within the financial sector and broader macroeconomic environment in the immediate aftermath of the pandemic's becoming a global crisis, markets already appear to have begun recovering. As the rate of market deterioration slows, the worst tail risks will be priced out and markets will begin to recover before the real economy does. However, it is too early to be certain, especially given the uncertain future of oil prices and potential for geopolitical fallout once the worst of the virus has passed.⁹

Impact of Covid-19 on financial stability in Africa

Equities, commodities and currency markets react to Covid-19

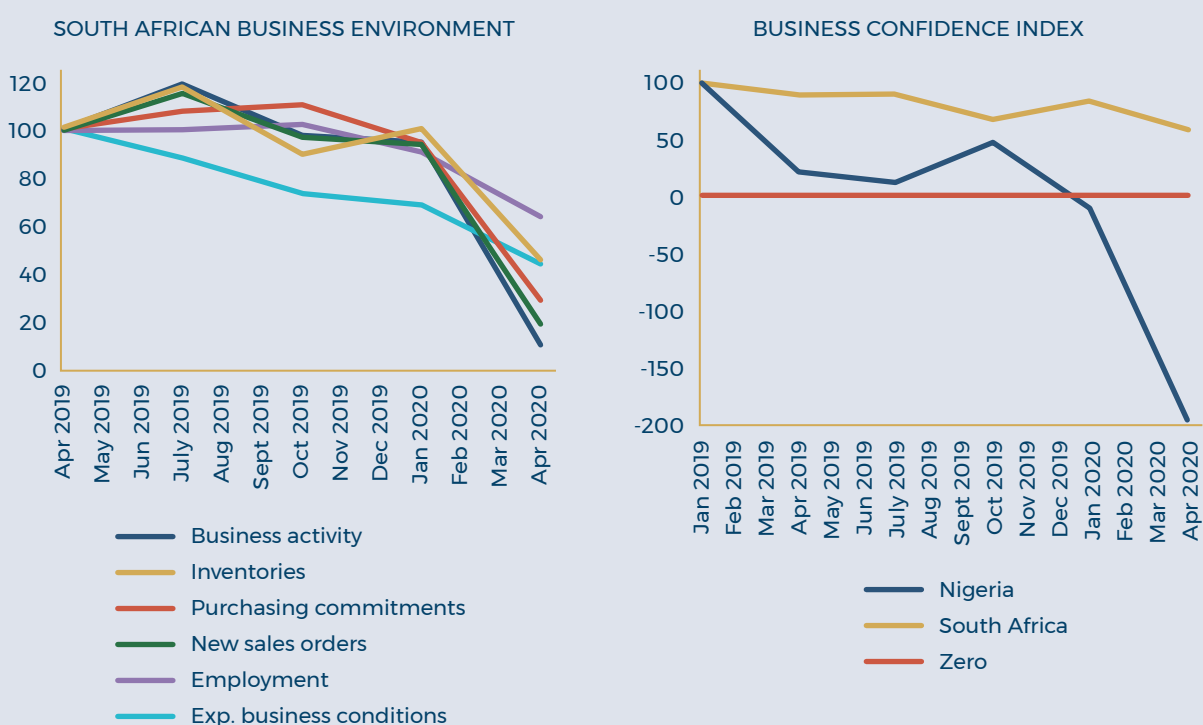
In order to fully understand the impact of the pandemic on African equities, and ultimately the continent's financial stability, it helps to look at a number of fundamental factors that contribute to African economic and financial performance. The ultimate severity of this crisis, and its long-term effects, will largely be shaped by another major factor in Africa's

⁹ World Economic Forum, *COVID-19 Risks Outlook: A Preliminary Mapping and Its Implications*, report (Geneva: WEF, 2020), <https://www.weforum.org/reports/covid-19-risks-outlook-a-preliminary-mapping-and-its-implications>.

vulnerability – limited fiscal space. It is this inability of African economies to fund their recovery in the wake of the health and economic crises caused by the pandemic that has largely driven investor sentiment. While wealthier economies have the luxury of historically low borrowing costs, most developing nations will face difficulty and great expense in creating the fiscal space necessary to fund health system expenditure, revenue losses and economic stimulus packages. This fiscal shortcoming presents a difficult moral trade-off between life, livelihoods and debt – something that most African states are grappling with as the virus spreads.

The economic fallout from imposed containment provisions is immense. South Africa and Nigeria, Africa’s two largest economies, provide insightful case studies. Both have been relatively hard hit by the virus (particularly the former) and their economic activity has stalled significantly. Business productivity and confidence have plummeted, as made evident by the plots in Figure 4. The nature of the African crisis ensures that financial market outcomes are inextricably linked with the real economy, and feedbacks between the two will continue as the pandemic plays out.

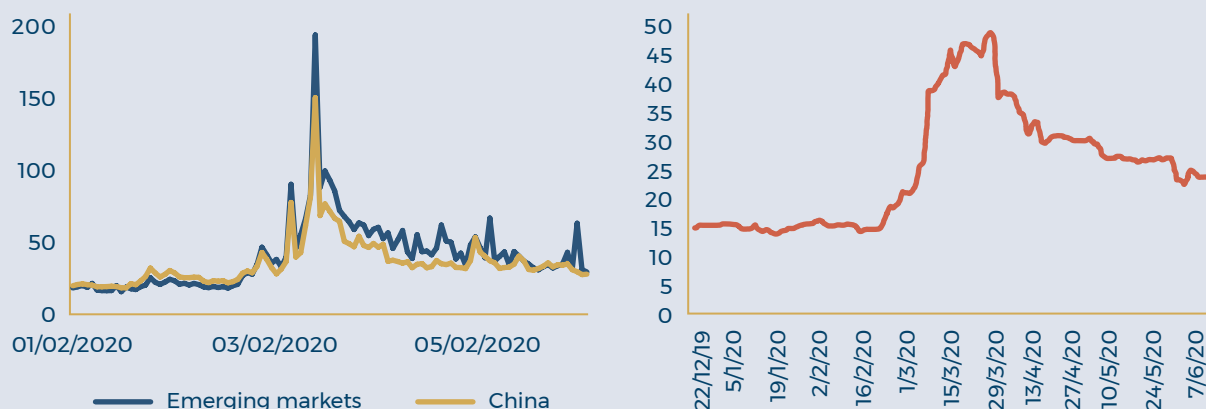
Figure 4 Select African business activity and sentiment indices
 (*Base year = Apr 2019, Jan 2019)



Source: Authors' own compilation using select data from Bureau of Economic Research, "RMB/BER Business Confidence Index", <https://www.ber.ac.za/BER%20Documents/RMB/BER-Business-Confidence-Index/?doctypeid=1050>; CEIC, "Nigeria Business Confidence Growth", <https://www.ceicdata.com/en/indicator/nigeria/business-confidence-growth>

The impact of the pandemic on broad emerging market volatility is clear in Figure 5, which shows the VIX sub-indices for both China and emerging markets (EMs).¹⁰ VIX indices are created using information from options market activity – markets that allow investors to deal in contracts based on securities. Simply, VIX reveals the activity in the buying and selling of option contracts. It is evident that EMs’ and China’s volatility is largely synchronised, indicating the existence of either common drivers or a dynamic interplay. However, given China’s role in global markets and the nature of developing economies, it is likely this graph reveals the reliance of developing economies on the global market and supply chain behaviour, and possibly the interconnectedness of financial markets. As the Chinese economy stalled owing to the spreading pandemic, and global production and supply chains were impacted, the developing world experienced an initial spike in volatility driven by investor uncertainty and pessimism. There have been several subsequent spikes in investor uncertainty-driven behaviour since, as the pandemic spread throughout the developing world and further tail risks were realised. In addition, Figure 5 plots the South African Volatility Index (SAVI). This plot shows that volatility in African markets spiked suddenly in early March, as the pandemic became a global health crisis.

Figure 5 VIX Volatility sub-indices (emerging markets & China) (right) & South African Volatility Index (left)



Source: CBOE, "VIX Index Charts & Data", <https://www.cboe.com/vix/>; *Financial Times*, "SA Volatility IDX", <https://markets.ft.com/data/indices/tearsheet/summary?s=JSAVI:JNB>

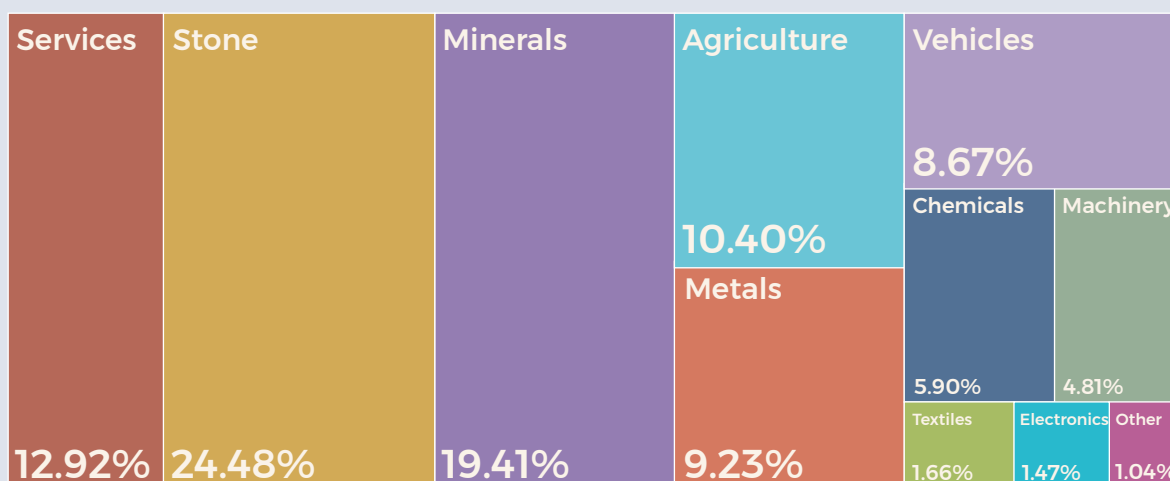
The economic fallout from the virus containment measures is a result, in part, of the extent to which African downside exposure is based largely on international events. In the early stage of the crisis, output contractions in China, coupled with its significant role in global commodity exports and supply chains, put negative pressure on already slightly depressed

¹⁰ Chicago Board Options Exchange, "VIX Index Charts & Data", <https://www.cboe.com/vix/>.

commodity prices.¹¹ Figure 6 shows the exposure of Africa’s four largest economies to changes in global commodity demand and prices. The drop in commodity prices has had a relatively direct link through to financial market activity and its fundamental volatility in the African context. This volatility arises, in part, from the reliance of many major African economies on commodity exports. A breakdown in the export market would engender widespread risk of corporate and sovereign default, and heightened financial market instability.

Figure 6 South African, Nigerian, Algerian and Egyptian export components (2017–2018)

SOUTH AFRICAN

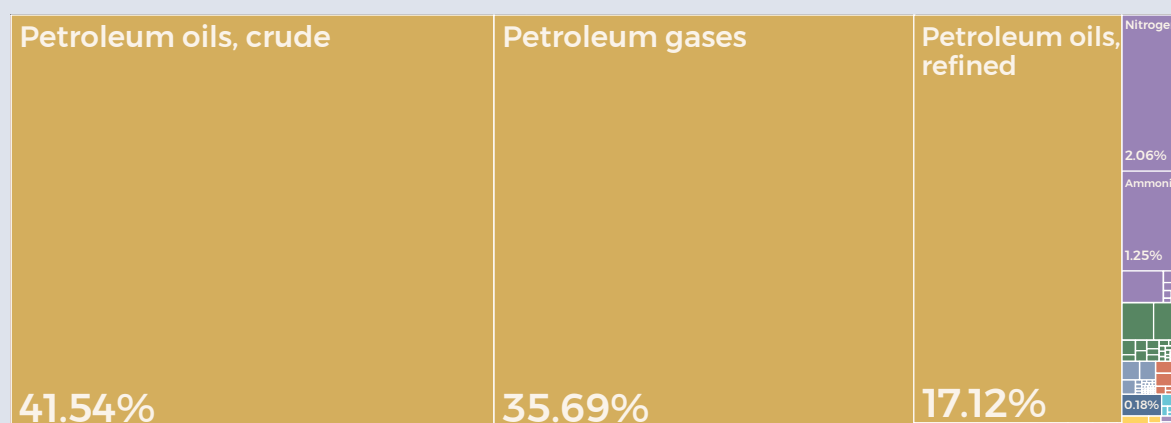


NIGERIAN

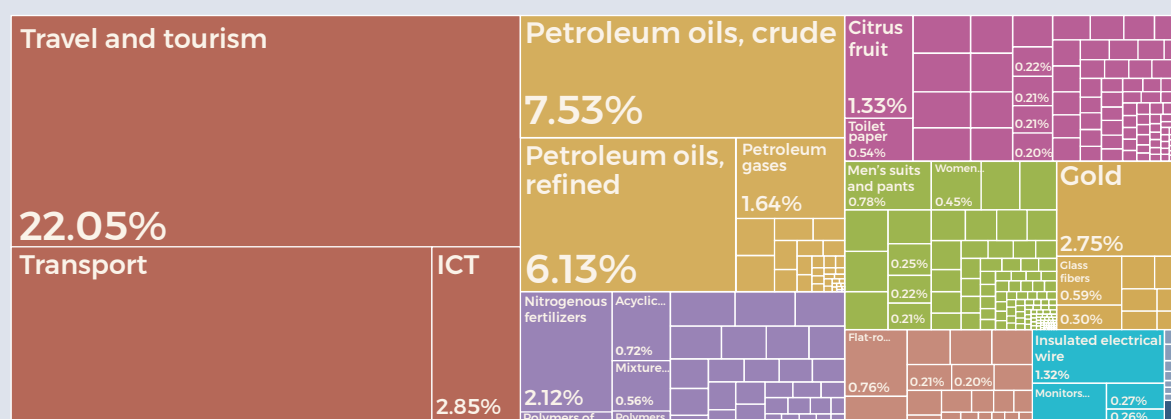


¹¹ Shawn Donnan et al., “A Covid-19 Supply Chain Shock Born in China Is Going Global”, *Bloomberg*, March 20, 2020, <https://www.bloomberg.com/news/articles/2020-03-20/a-covid-19-supply-chain-shock-born-in-china-is-going-global>.

ALGERIAN



EGYPTIAN



Source: Authors' compilation using Atlas of Economic Complexity, "Data Downloads", <https://atlas.cid.harvard.edu/data-downloads>

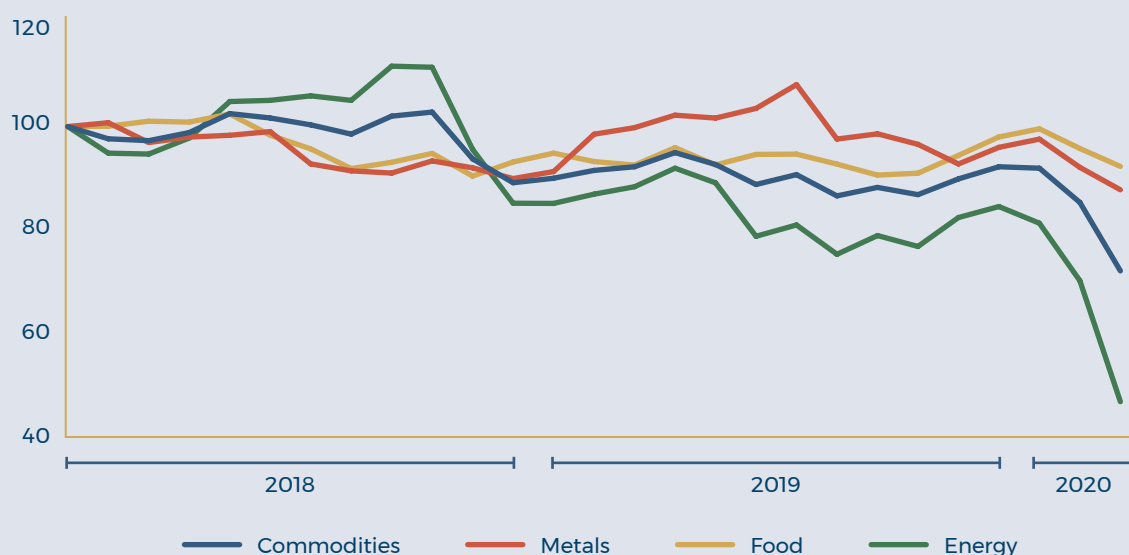
This idea can be extended to again highlight the importance of sufficient fiscal space. In the Nigerian case, for example, dramatic declines in oil revenue will greatly worsen the government's already-reduced ability to fund the necessary fiscal and monetary stimulus packages. The fallout from this pandemic has the potential to stretch out fiscal budgets beyond their current bounds.

As the virus spread beyond China's borders and global production stalled, commodity prices dropped precipitously. The demand shock was particularly acute in the market for energy. The Covid-19-induced financial crisis has since resulted in the largest fall in energy demand in 70 years, dwarfing the impact of the GFC.¹² Further comparisons with that crisis period reveal the full scale of this price drop, its severity, and possible longer-term impacts. Prices in 2008 were on an upward trajectory off the back of a commodity super-cycle. The current

¹² IMF, *Global Financial Stability Report*.

fall in prices is taking place with prices already at a relatively low level.¹³ Figure 7 shows the gentle downward trend in commodity prices prior to the rapid pandemic-driven downturn.

Figure 7 Global commodity price changes (*base year = Jan 2018)



Source: Douglas Broom, "5 Things to Know About How Coronavirus Has Hit Global Energy", World Economic Forum, May 18, 2020, <https://www.weforum.org/agenda/2020/05/covid19-energy-use-drop-crisis/>

The full extent of the commodity price drop that has occurred during the pandemic is demonstrated by the plot in Figure 8.

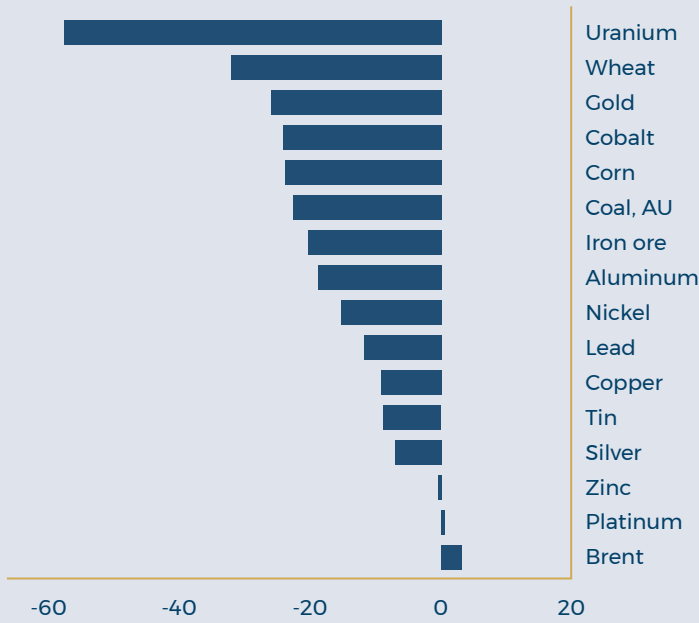
The impact of the pandemic on the oil market has been the most dramatic. The sudden stop of oil demand coupled with discord among OPEC member states, and subsequent supply trouble, led to extreme price behaviour. Moreover, oil futures indicate that prices are likely to remain suppressed until 2023.¹⁴ The exact trajectory of the recovery is uncertain, with some analysts now labelling the projected recovery a 'Nike swoosh' shape - indicating a prolonged and slow upward recovery.¹⁵ This potentially prolonged recovery could ensure there is heightened instability in African financial markets for an extended period of time as the funding environment remains uncertain. This instability would be particularly acute in the funding markets. The full extent of the impact of this oil price drop is demonstrated in Figure 9. This shows borrowing costs for African oil exporters, which have risen substantially owing to increased uncertainty about the ability of these nations to effectively manage their own fiscus.

¹³ IMF, *Global Financial Stability Report*.

¹⁴ IMF, *Global Financial Stability Report*.

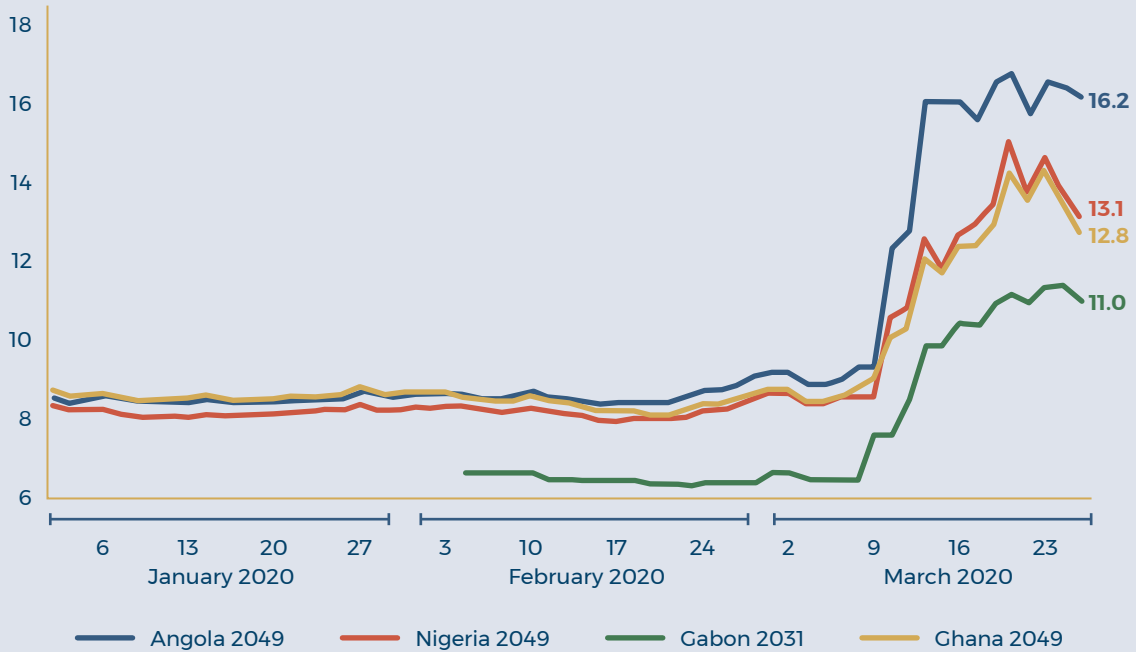
¹⁵ Peter Beech "Z, V or 'Nike Swoosh' - What Shape Will the COVID-19 Recession Take?", WEF, May 19, 2020, <https://www.weforum.org/agenda/2020/05/z-u-or-nike-swoosh-what-shape-will-our-covid-19-recovery-take/>.

Figure 8 Global commodity price changes (*base year = Jan 2018)



Source: International Monetary Fund, *Global Financial Stability Report: Markets in the Time of COVID-19* (Washington DC: IMF, April 2020), <https://www.imf.org/en/Publications/GFSR/Issues/2020/04/14/global-financial-stability-report-april-2020>

Figure 9 Euro bond yield for African oil exporters (Angola, Nigeria, Ghana and Gabon)



Source: WEF, "5 Charts that Show the Global Economic Impact of Coronavirus", 31 March, 2020, <https://www.weforum.org/agenda/2020/03/take-five-quarter-life-crisis/>

The energy price shock has had serious implications for African currency valuations and, in some cases, the ability to maintain sufficient foreign exchange reserves. Nigeria, for example, has had to put in place measures designed to maintain its foreign reserves in an attempt to support the value of the naira.¹⁶ The volatile depreciation experienced by most African economies is mostly because of the flight from African currencies and non-dollar denominated debt and other assets. However, it is important to bear in mind that these reserves are in place largely for emergency assistance, and this is an emergency. Therefore, the maintenance of some level of reserves should not take precedence over the creation of, and appropriate use of, adequate fiscal space.

The global easy pre-coronavirus investment environment has, in part, been the cause of the current levels of financial instability. Importantly, this easy investment environment extended to Africa to a certain extent. The long-running low yields in the developed world, coupled with easy and cheap money, ensured widespread investment in Africa and increased sales of local currency assets. This led to a reliance by African economies, sovereigns and corporates on foreign investment activity.¹⁷ These phenomena resulted in the volatile market corrections experienced during the pandemic as all of these factors suddenly reversed and investor sentiment rapidly became pessimistic.

Figure 10 plots the dollar exchange rate for select African currencies. It is evident that the South African rand has depreciated during the pandemic period. It has lost about 25% of its value against the US dollar. This is to be expected to a certain extent, as the rand is a leading emerging market currency and is highly vulnerable to, and influenced by, international events and foreign investor sentiment. Most other African currencies remained relatively stable. This is owing, in part, to currency pegs (in the Nigerian case, for example) and local currency bond purchases by many African central banks. As a result, local currency bond yields fell substantially without having a large impact on exchange rates or inflation expectations.¹⁸

The uncertainty created by the pandemic and the sudden onset of global risk-off sentiment resulted in large and sudden portfolio outflows from emerging markets. After an initially strong start to the year, supported by a risk-on environment and a search for yield, portfolio flows reversed. As of March 2020, about 3.5% of total asset holdings has flowed out of emerging markets, with equity outflows occurring first, followed by debt assets.¹⁹ Despite rate cuts and other policy measures by developed economies, volatility in non-resident flows to equity and bonds has spiked.

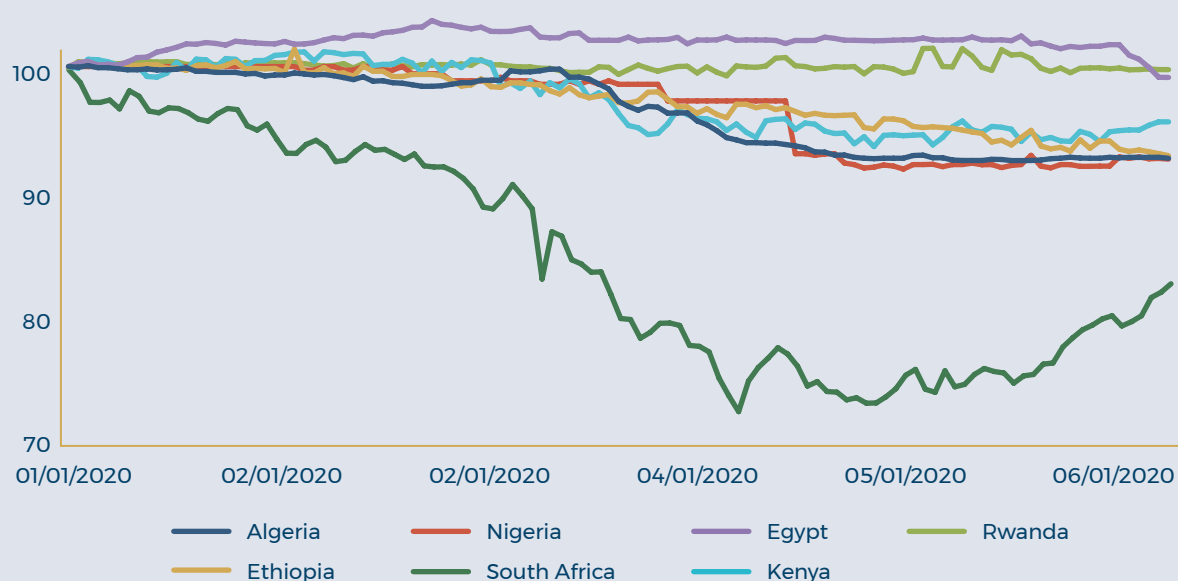
16 Chijioke Oluocha, "Nigeria Suspends Foreign Exchange Sales to Retail Currency Traders", *Reuters*, March 26, 2020, <https://www.reuters.com/article/health-coronavirus-nigeria-currency/update-1-nigeria-suspends-foreign-exchange-sales-to-retail-currency-traders-idUSL8N2BJ8OL>.

17 IMF, *Global Financial Stability Report*.

18 Yavuz Arslan, Mathias Drehmann and Boris Hofmann, "Central Bank Bond Purchases in Emerging Market Economies", *BIS Bulletin* 20 (June 2, 2020), <https://www.bis.org/publ/bisbull20.htm>.

19 IMF, *Global Financial Stability Report*.

Figure 10 Select African currency exchange rates
(\$, *base year = Jan 2020)



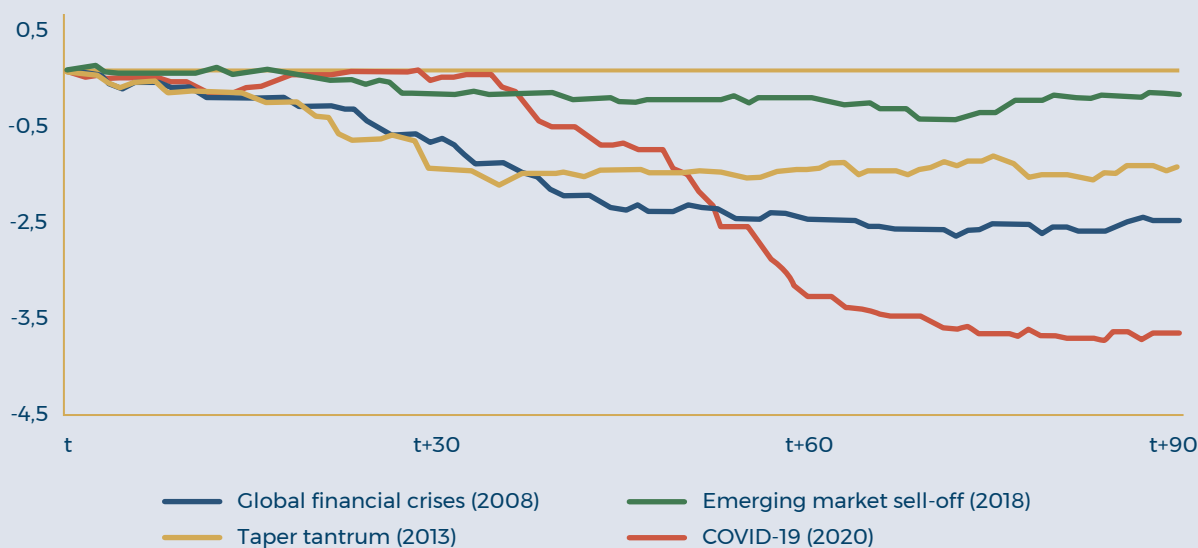
Source: Authors' own compilation using exchange rate data from Investing.com, "USD/DZD - US Dollar Algerian Dinar", <https://za.investing.com/currencies/usd-dzd>; Investing.com, "USD/EGP - US Dollar Egyptian Pound", <https://za.investing.com/currencies/usd-egp>; Investing.com, "USD/ETB - US Dollar Ethiopian Birr", <https://za.investing.com/currencies/usd-etb>; Investing.com, "USD/KES - US Dollar Kenyan Shilling", <https://za.investing.com/currencies/usd-kes>; Investing.com, "USD/NGN - US Dollar Nigerian Naira", <https://za.investing.com/currencies/usd-ngn>; Investing.com, "USD/RWF - US Dollar Rwandan Franc", <https://www.investing.com/currencies/usd-rwf>; Investing.com, "USD/ZAR - US Dollar South African Rand", <https://za.investing.com/currencies/usd-zar>

African equities dropped dramatically off the news of the spreading pandemic as risk-off investor sentiment rapidly set in. As is evident from Figure 12, major African equity indices lost 10–30% of their value within a two-week period in early March. This drop is unprecedented in terms of both magnitude and speed, as well as the severe volatility that it caused in equity markets. This event highlighted the vulnerability of African equity markets to common global market shocks. It also remains to be seen how individual nations' exchanges will react as the pandemic hits home, and the virus reveals further unforeseen idiosyncratic risks. Recently, in African nations that experienced an early import of Covid-19 cases, equity markets have begun to rebound strongly, reflecting the temporary nature of the shock. The major stock exchange indices for South Africa, Kenya, Namibia, Morocco and Tunisia had begun returning to their respective pre-Covid-19 levels at the time of writing.²⁰ Figure 12 shows the reactions of select African stock indices during the pandemic. This specific group is selected for the diversity in their market capitalisation and sophistication.²¹

20 Bloomberg, "JSE All-Share Index Data", June 2020, <https://www.bloomberg.com/quote/JALSH:IND>.

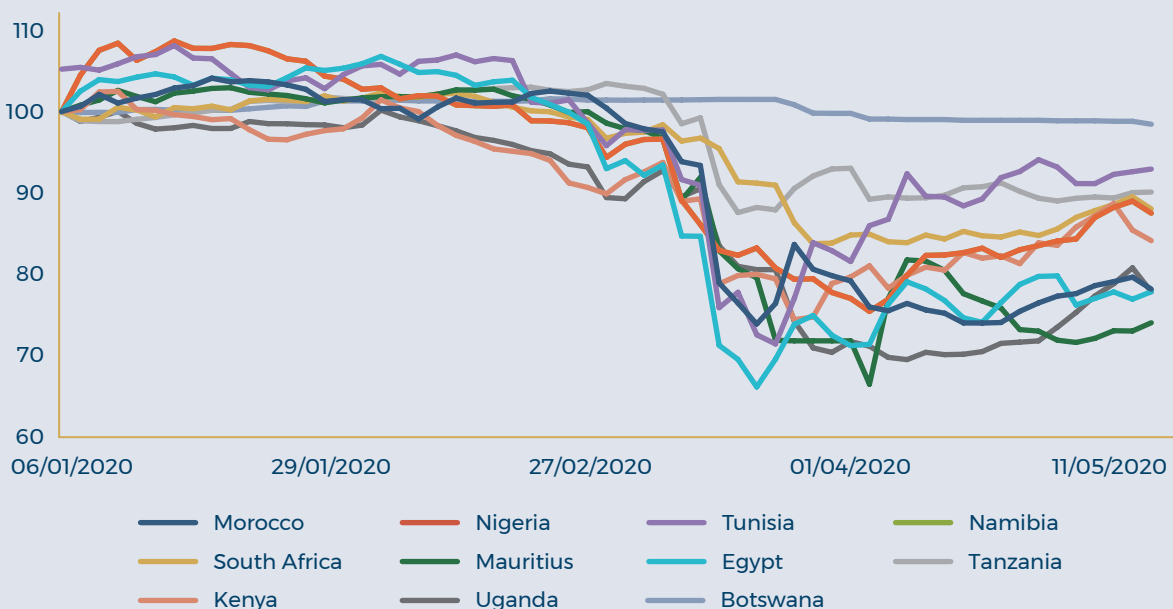
21 World Bank, "DataBank: Africa Development Indicators", <https://databank.worldbank.org/source/africa-development-indicators/Series/GCI.8THPILLAR.XQ>.

Figure 11 Emerging market portfolio flows for select economic events



Source: IMF, *Global Financial Stability Report: Markets in the Time of COVID-19* (Washington DC: IMF, April 2020), <https://www.imf.org/en/Publications/GFSR/Issues/2020/04/14/global-financial-stability-report-april-2020>

Figure 12 Select African equity indices (base year = Jan 2020)



Source: Authors' own compilation using equity data from Investing.com, "Moroccan All Shares", <https://za.investing.com/indices/masi>; Investing.com, "South Africa 40", <https://za.investing.com/indices/investing.com-south-africa-40>; Investing.com, "EGX 30", <https://www.investing.com/indices/egx30>; Investing.com, "Namibia All Shares", <https://www.investing.com/indices/namibia-all-shares>; Investing.com, "NSE All Share", <https://ng.investing.com/indices/nse-all-share>; Investing.com, "Kenya NSE 20", <https://www.investing.com/indices/kenya-nse-20>; Investing.com, "Semdex", <https://www.investing.com/indices/semdex>; Investing.com, "Tanzania All Share", <https://www.investing.com/indices/tanzania-all-share>; Investing.com, "Tunindex", <https://www.investing.com/indices/tunindex-historical-data>; Investing.com, "Uganda All Share", <https://www.investing.com/indices/uganda-all-share>

An interesting case study of African equity market reaction to Covid-19 is that of Tanzania (Dar es Salaam Stock Exchange). The state halted the release of Covid-19 statistics on 29 April, and President John Magufuli has since stated that the country is 'coronavirus free'.²² On Friday 5 June, markets reacted to this uncertainty with a day of zero trading on the Dar es Salaam Stock Exchange; not a single share was traded, in a serious case of disconnect between buyers and sellers.²³ This is an extreme and unprecedented example of prevailing uncertain investor sentiment. Moreover, it is likely driven by the lack of official communication from the government.

This event highlights the unique challenges that African equity markets will face in the coming weeks and months as the pandemic becomes a reality. It remains to be seen how African governments will react to idiosyncratic shocks such as binding fiscal constraints, widespread default, overwhelmed healthcare systems and possible social unrest, and how this reaction will impact equity markets. Large-scale stimulus packages will help ease investors' concerns. However, it is unclear how capable most African states will be in this regard, given the extreme limits of fiscal space.

African economies have experienced extreme outflows of equity portfolios. Investors have fled the potential losses due to currency depreciations, extreme debt build-up and possible corporate default

Overall, African economies have experienced extreme outflows of equity portfolios (see Figure 12). Investors have fled the potential losses due to currency depreciations, extreme debt build-up and possible corporate default. However, while events in the equity market have been extreme, the bond market has experienced a more varied investor response owing to its more complex nature.

Covid-19 affects bond and credit markets in Africa

In recent years, bond issuance has grown in importance relative to bank loans in emerging market economies²⁴ (EMEs), with greater international participation increasing foreign holdings of local currency bonds. Government bond prices play an important role in local financial conditions as a benchmark against which other assets, such as corporate bonds

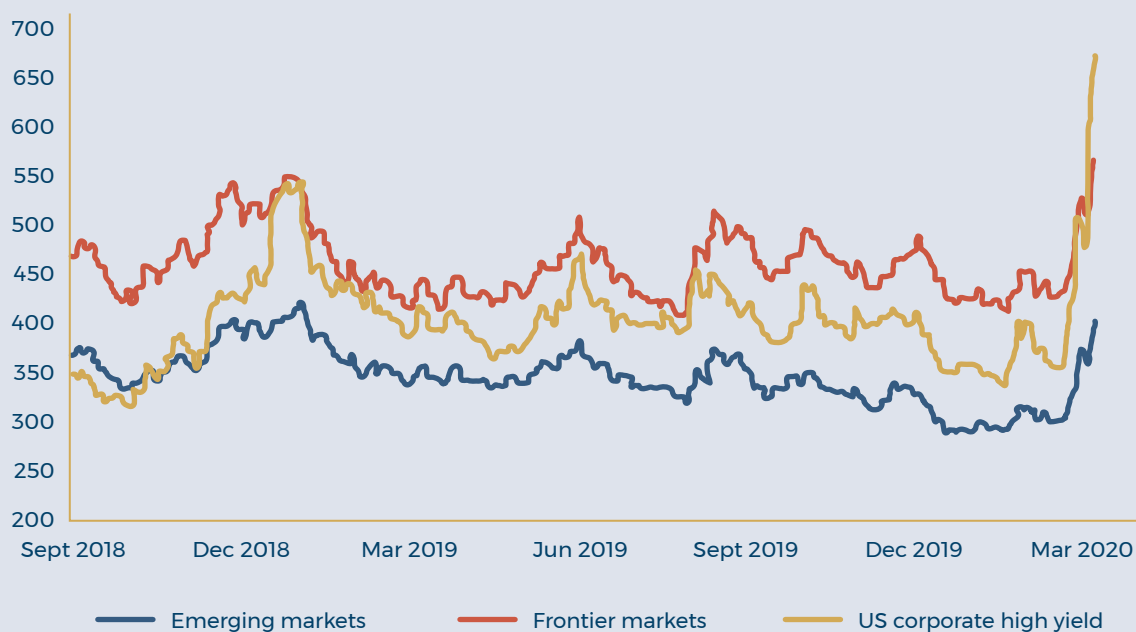
22 "Coronavirus: John Magufuli Declares Tanzania Free of Covid-19", *BBC News*, June 8, 2020, <https://www.bbc.com/news/world-africa-52966016>.

23 Josephine Christopher, "Tanzania: Shock and Surprise as Dar es Salaam Stock Exchange Records Zero Trading," *All Africa*, June 8, 2020, <https://allafrica.com/stories/202006090065.html>.

24 In Africa these economies include South Africa, Morocco, Nigeria and Kenya.

and loans, are priced.²⁵ The shock to global financial markets, including that to credit markets – which seized up as a result of the Covid-19 fallout – caused many investors to switch from risky assets (ie, equities) to US government bonds because they are perceived as safe-haven assets. This investor behaviour resulted in a sharp sell-off of assets in March 2020, with global equity markets losing significant value and spreads (for bonds and credit markets) rising to the 2008 GFC levels. Figure 13 shows widening spreads in developing and frontier bond markets, indicating investors’ declining appetite for riskier markets. The Covid-19-induced financial shock has been both faster and more severe than the GFC and even the Great Depression.²⁶ Credit markets typically show signs of distress before the equity market and as such are used to gauge the relative strength or weakness of the economy. Credit markets are also larger than the equity market. Thus, the state of the credit market is an indicator of the relative health of other funding markets and the economy as a whole.²⁷

Figure 13 Capital flight in developing and frontier markets due to Covid-19



Source: Tobias Adrian, “Monetary and Financial Stability during the Coronavirus Outbreak”, IMF (blog), March 11, 2020, <https://blogs.imf.org/2020/03/11/monetary-and-financial-stability-during-the-coronavirus-outbreak/>

25 Peter Hördahl and Ilhyock Shim, “EME Bond Portfolio Flows and Long-Term Interest Rates during the Covid-19 Pandemic”, *BIS Bulletin* 18 (2020), <https://www.bis.org/publ/bisbull18.pdf>.

26 Kevin Lings, “COVID-19: Its Impact on Economies and Financial Markets”, STANLIB, March 9, 2020, <https://www.stanlib.com/2020/03/09/economic-and-financial-market-impact-of-covid-19/>.

27 Simon Jessop, “Credit Market a Bigger Systemic Risk than during 2008 Crisis: Bank of England”, *Reuters*, July 12, 2017, <https://www.reuters.com/article/us-britain-boe-financial-stability-idUSKBN19X20G>.

These developments are already being reflected in sovereign bond yields, which have dropped in developing countries that have fewer, and more difficult, choices about how to confront the pandemic. As in EMEs, African local currency bond markets experienced portfolio outflows and huge spikes in long-term interest rates surpassing GFC levels. EME bond fund outflows during the first nine weeks totalled close to \$30 billion, which is three to six times higher than those experienced during the GFC. When normalised for market size, the outflows are around 10–50% larger than those during the GFC.

Developing countries' bond markets differ in their depth and liquidity levels.²⁸ In most African markets, where bond market liquidity is much lower than that in EMEs, the same amount of bond outflows and the corresponding amount of bond sales are likely to have a larger impact on bond prices.

The outflows caused long-term interest rates to surge and currencies to depreciate in the majority of African markets. Local currency bond markets have a higher degree of foreign participation, causing greater sensitivity of yields to bond flows. During Covid-19 this has strengthened, causing markets with high foreign bond market participation to have larger yield increases for any given bond portfolio outflow. Domestic investors have stepped in to purchase larger amounts of bonds as foreign investors exited these markets because of the Covid-19 crisis, thereby amplifying the price impact as yields rise substantially to entice domestic bond investors. However, the Bank for International Settlement has stated that long-term interest rates retreated (somewhat) faster compared to the GFC, owing to interventions by central banks such as quantitative easing (ie, buying bonds on the secondary markets), relaxation of accounting and capital rules to release additional money for lending, etc. Malawi reduced its domestic currency Liquidity Reserve Requirement (LRR) by 125 basis points to 3.75% (aligned with the foreign currency LRR) and introduced an Emergency Liquidity Assistance framework to support banks in the event of worsening liquidity conditions and to provide support to banks on a case-by-case basis. The Bank of Botswana reduced its rate by 50 basis points to 4.25% to support the domestic economy, and reduced the primary reserve requirement from 5 to 2.5% to inject liquidity.²⁹

In addition, the reintroduction of swap lines by the Federal Reserve eased the pressure on interest rates by stabilising EME exchange rates and bond portfolio flows. Duration swaps allow central banks to auction long-term securities in exchange for short-term ones in order to stabilise conditions in local currency bond markets when long-term securities are under great selling pressure and there is market demand for short-term securities. The provision of liquidity amid ensuing solvency concerns and temporary relaxing of regulations by central banks has allowed domestic investors to intervene and buy local currency bonds, thus aiding stability in these markets.³⁰ Countries with high exchange rate volatility have been

28 Hördahl and Shim, "EME Bond Portfolio Flows".

29 IMF, "Policy Responses to Covid-19".

30 Hördahl and Shim, "EME Bond Portfolio Flows".

experiencing a stronger impact on bond yields owing to bond flows, driven by investors' seeking to avoid exchange-rate risk.³¹

African currencies have been losing value as a result of Covid-19. The central bank adjusted the Nigerian naira's official rate, implying a 15% devaluation, as oil prices crashed and the currency hit record lows (from NGN³² 365 to NGN 375 to \$1).³³

Governments, regulators and central banks must continue to coordinate policy on a continental level to help maintain financial stability and address imminent problems

Aggressive stimulus packages introduced by advanced and emerging economies' central banks, going beyond conventional interest rate cuts, have resulted in synchronised actions that have helped generate the monetary space needed by developing economies. This increased space will enable them to use monetary policy instruments and macroprudential policy to respond to domestic cyclical conditions, which should further limit financial strains in countries facing external funding shocks. Governments, regulators and central banks must continue to coordinate policy on a continental level to help maintain financial stability and address imminent problems such as rising corporate leverage, increasing bank risk exposure, growing sovereign exposures and emerging cross-country distortions to competition in product and capital markets. Developing countries with large informal sectors will have to use new digital technologies³⁴ to ensure that basic financial services are available to their populations, including businesses. In addition, targeted social and financial relief support to both citizens and the business community at large (in particular small and medium-sized enterprises [SMEs]) should be continued in order to maintain the economic ties between workers, firms, lenders and borrowers, thereby keeping intact the economic and financial infrastructure of society.³⁵ Developing countries have rapidly been developing digital payment services in recent years, which provide an opportunity to improve the delivery of targeted relief programmes within the economy.

31 Hördahl and Shim, "EME Bond Portfolio Flows".

32 Currency code for the Nigerian naira.

33 Chijioke Oluocha, "Nigerian Naira Slides to 3-Year Low on Black Market after Oil Price Crash", *Reuters*, April 21, 2020, <https://www.reuters.com/article/nigeria-currency/update-1-nigerian-naira-slides-to-3-year-low-on-black-market-after-oil-price-crash-idUSL5N2C900M>.

34 WEF, "Impact of COVID-19 on the Global Financial System: Recommendations for Policy-Makers Based on Industry Practitioner Perspectives" (Policy Paper, WEF, Geneva, April 2020), http://www3.weforum.org/docs/WEF_Impact_of_COVID_19_on_the_Global_Financial_System_2020.pdf.

35 Arnoud Boot et al., "Corona and Financial Stability 3.0: Try Equity – Risk Sharing for Companies, Large and Small" (Policy Letter 81, Leibniz Institute for Financial Research SAFE, Frankfurt, 2020), https://safrankfurt.de/fileadmin/user_upload/editor_common/Policy_Center/SAFE_Policy_Letter_No_81_final4.pdf.

Banks are going into this Covid-19 pandemic stronger than they were compared to the GFC, as they have greater capital and liquidity cushions. Despite the re-pricing of bank share prices owing to investors' concerns over their profitability, there is a probability of financial stability risks stemming from the banking sector. Nevertheless, the speed at which this crisis destabilised financial markets warrants strengthened macroprudential policy oversight to monitor bank activities closely, as well as other possible threats outside the banking sector (eg, stock market activities). It is vital to preserve the banking sector's financial strength and overall transparency.³⁶ Macroprudential policies are more important now to prevent excessive build-up of risk, make the financial sector more resilient and limit contagion effects.

In the cause of promoting financial stability, macroprudential authorities will do well to encourage banks to allow distressed borrowers to renegotiate their loan terms

Central banks are the only institutions in developing countries that have balance sheets large and strong enough to prevent the collapse of the private sector through the use of monetised deficit-financed interventions. In instances where they are financed through standard government debt, interest rates would have to rise sharply.³⁷ In the cause of promoting financial stability, macroprudential authorities will do well to encourage banks to allow distressed borrowers to renegotiate their loan terms (while absorbing the costs of such restructuring by drawing on their capital buffers). Banks must continue to lend to illiquid but still-solvent SMEs. In parallel, authorities should tightly monitor the banking sector's asset quality to determine the amount of fiscal support (eg, equity injections) that will be required should the effects of the downturn persist.

In markets characterised by low creditworthiness or relatively higher financial stress, investors (especially foreign) react strongly during a crisis, which has been the case with the Covid-19-induced financial crisis. It is therefore crucial to enhance efforts to improve the creditworthiness of African economies, as it is an important requirement for maintaining the resilience of developing country bond markets during market turmoil. African capital markets can position themselves to strategically attract international inflows and crowd in domestic investors in a sustainable manner by continuing to improve their product offerings, technological capabilities and regulations. This will allow them to attain the desirable level of competitiveness that will help them to live up to their economic and

36 Tobias Adrian, "Monetary and Financial Stability During the Coronavirus Outbreak", IMF (blog), March 11, 2020, <https://blogs.imf.org/2020/03/11/monetary-and-financial-stability-during-the-coronavirus-outbreak/>.

37 Nouriel Roubini, "This Is What the Economic Fallout from Coronavirus Could Look Like", WEF, April 6, 2020, <https://www.weforum.org/agenda/2020/04/depression-global-economy-coronavirus/>.

social mandate. It is for this reason that this policy insight calls for the development of African capital markets in order to strengthen their long-term resilience against a sharp deterioration in global financial conditions, as is happening during Covid-19. If local markets were functioning efficiently and their liquidity were improved, local bond markets could be strengthened and thus less sensitive to portfolio flow pressures. One way of developing and deepening local capital markets is fostering a strong domestic institutional investor base. This can result in greater financial resilience and an enhanced ability to withstand global funding shocks.

This paper calls for the development of African capital markets in order to strengthen their long-term resilience against a sharp deterioration in global financial conditions, as is happening during Covid-19

In addition, there is significant concern about the lack of liquidity in international credit markets, as credit spreads sharply widen owing to banks and investors' adjusting their risk assessment to take account of the deteriorating economic environment. Lack of access to affordable credit in African countries with vibrant private lending markets will severely damage the global economy, posing a further threat to financial stability. Most African central banks reacted by cutting interest rates. For instance, the Central Bank of Egypt announced a huge 300 basis point cut in March 2020. Adding to these woes was the sharp fall-off in the oil price and systematic downward revisions to global growth estimates, which all culminated in significant pressure on emerging markets. For example, Nigeria's All Share Index registered its worst performance for a decade and the Johannesburg Stock Exchange's (JSE) All-Share Index lost more than 5% in March 2020 as overseas investors pulled out. In Kenya, the pandemic fallout cut shareholder wealth by KES³⁸ 458 billion (\$4.2 billion) in a month and the benchmark Nairobi Securities Exchange 20 Share Index shed 66.75 points. This is a concerning trend given that fiscal policy in African countries has been highly pro-cyclical until now.³⁹ Currencies in these markets weakened significantly – eg, the rand has lost almost 13% since the beginning of 2020.⁴⁰

The volatility in debt markets induced by the spreading pandemic is also a function of the pre-Covid-19 macroeconomic and financial environment. After the GFC, emerging market portfolios became increasingly popular in the environment of low rates and easy money coupled with the prevailing low asset returns in the developed world. As a result, there were large financial flows into the developing world, with significant portions going to Africa's

38 Currency code for the Kenyan shilling.

39 Andrew Christian, "How Major Stock Exchanges in Africa Are Reacting to the Coronavirus Pandemic", We Tracker, March 26, 2020, <https://weetracker.com/2020/03/26major-stock-exchange-africa--coronavirus>.

40 Lings, "COVID-19: Its Impact".

strongest growth economies (Ethiopia and Rwanda, for example). African lenders became increasingly reliant on this foreign financing, and thus more leveraged, often incurring non-local currency debt. This reliance on foreign financing heightened the vulnerability of borrowers in these economies to both idiosyncratic and common shocks. Intuitively, more foreign participation during normal times will ensure increased foreign influence during downswings in the form of mass outflows.⁴¹ Therefore, before the pandemic had spread to the continent, and before any form of health crisis had emerged, African economies were faced with the potential for severe economic crises.

Sovereign credit ratings plunge during Covid-19

To mitigate the economic fallout from the coronavirus, most governments and international organisations have unveiled highly variable fiscal and monetary stimuli that dwarf the 2008 GFC rescue packages.⁴² The size of the financial intervention has been dependent on the country's existing debt burden and the risk of its potential insolvency. More than 100 countries – an unprecedented number – have asked the International Monetary Fund (IMF), which has \$1 trillion at its disposal, for emergency support as the global economic outlook deteriorates and corporate bankruptcies continue to rise.⁴³ Many countries have started to see their ratings lowered and CountryRisk.io forecasts that post-Covid-19 downgrades could average declines of three investment grades for weaker economies and one grade for countries with strong fundamentals. From a debt sustainability perspective, the downgrades are a result of the immediate economic contraction; the initial debt-to-GDP ratio; the accumulation of new debt, which widens current fiscal deficits; and the real interest repayment on debt. If economies follow a V-shaped recovery, the number of actual downgrades could be low. However, in the event of a protracted economic deterioration, there could be more yet to materialise.⁴⁴

South Africa's debt was officially ejected from the FTSE World Government Bond Index (which tracks investment-grade debt and is followed by funds valued at \$3 trillion) on 30 April after it was downgraded to a junk rating by Moody's Investors Services in March 2020. JSE data shows that South African bond market outflows reached ZAR⁴⁵ 60 billion (\$3.2 billion) from January to April 2020, with foreign investors reducing their holdings from 43% to 33% of the debt.⁴⁶ Both Fitch and S&P Global Ratings have maintained South Africa's sub-investment grade or junk with a negative outlook, warning that the impact of Covid-19

41 IMF, *Global Financial Stability Report*.

42 Ziyad Cassim et al., "The \$10 Trillion Rescue: How Governments Can Deliver Impact", McKinsey and Company, June 5, 2020, <https://www.mckinsey.com/industries/public-sector/our-insights/the-10-trillion-dollar-rescue-how-governments-can-deliver-impact?cid=other-eml-alt-mip-mck&hlkid=6fa95c1dcf014319b92adc5d4cd8de8c&hctky=10240944&hdpid=e51e8cf0-eb41-4b30-a8c8-a9d3020cefaa>.

43 IMF, *World Economic Outlook, April 2020: The Great Lockdown* (Washington DC: IMF, April 2020), <https://www.imf.org/en/Publications/WEO/Issues/2020/04/14/weo-april-2020>.

44 CountryRisk.io, *The Second Wave: The Impact*.

45 Currency code for the South African rand.

46 Colleen Goko, "South African Bonds Rally Exit from Index Is Finished", *Bloomberg*, May 4, 2020, <https://www.bloomberg.com/news/articles/2020-05-04/south-african-bonds-rally-as-wgbi-exit-becomes-a-mere-memory>.

could see the economy shrink amid its 'already deficient growth and fiscal outcomes'.⁴⁷ The downgrade has a huge impact on the country, as the cost of borrowing has increased. The country's debt assessments are now at the lowest level since it first obtained credit ratings in 1994. Furthermore, S&P lowered the outlook on South African banks to negative – this includes the 'critical' Development Bank of South Africa. The ratings agency's policy is not to rate financial institutions above the foreign currency sovereign ratings, owing to the direct and indirect impacts sovereign distress would have on banks' operations.⁴⁸

Covid-19 has triggered rating downgrades for seven of the 19 rated sub-Saharan countries since March 2020, including some of Africa's biggest economies

Covid-19 has triggered rating downgrades for seven of the 19 rated sub-Saharan countries since March 2020, including some of Africa's biggest economies.⁴⁹ S&P and Moody's downgraded Ghana's economic outlook to negative, with the latter affirming the country's long-term local and foreign currency issuer and foreign currency senior unsecured bond ratings at B3. Ghana is vulnerable to shocks because of its high reliance on external financing both in local and in foreign currency, and very weak debt affordability. It received a \$1 billion (1.5% of GDP) disbursement under the IMF's Rapid Credit Facility in addition to the \$3 billion Eurobond it issued in January 2020.⁵⁰ Moody's and Fitch downgraded Angola to B-, with a stable outlook reflecting the impact of lower oil production and lower oil prices together with a sharp depreciation of the kwanza (which has increased debt levels and debt servicing costs while reducing international reserve level). S&P revised Nigeria's outlook to negative, citing the size of its debt and falling reserves, among others. Fitch downgraded Nigeria's long-term foreign-currency Issuer Default Rating (IDR) to 'B' (with a negative outlook) and the Zambian IDR to 'CCC'.⁵¹ These downgrades are attributed to rising risks emanating from Covid-19 and these governments' ability to find funding to cushion their economies while continuing to service their current debts. Figure 14 shows global sovereign credit risk rankings based on a wide range of key macroeconomic variables. It is clear that African countries currently have the highest credit risk globally.

47 Standard & Poor's Rating Agency, "Government Expresses Disappointment over S&P Downgrades", *SABC News*, April 30, 2020, <https://www.sabcnews.com/sabcnews/government-expresses-disappointment-over-sp-downgrades/>.

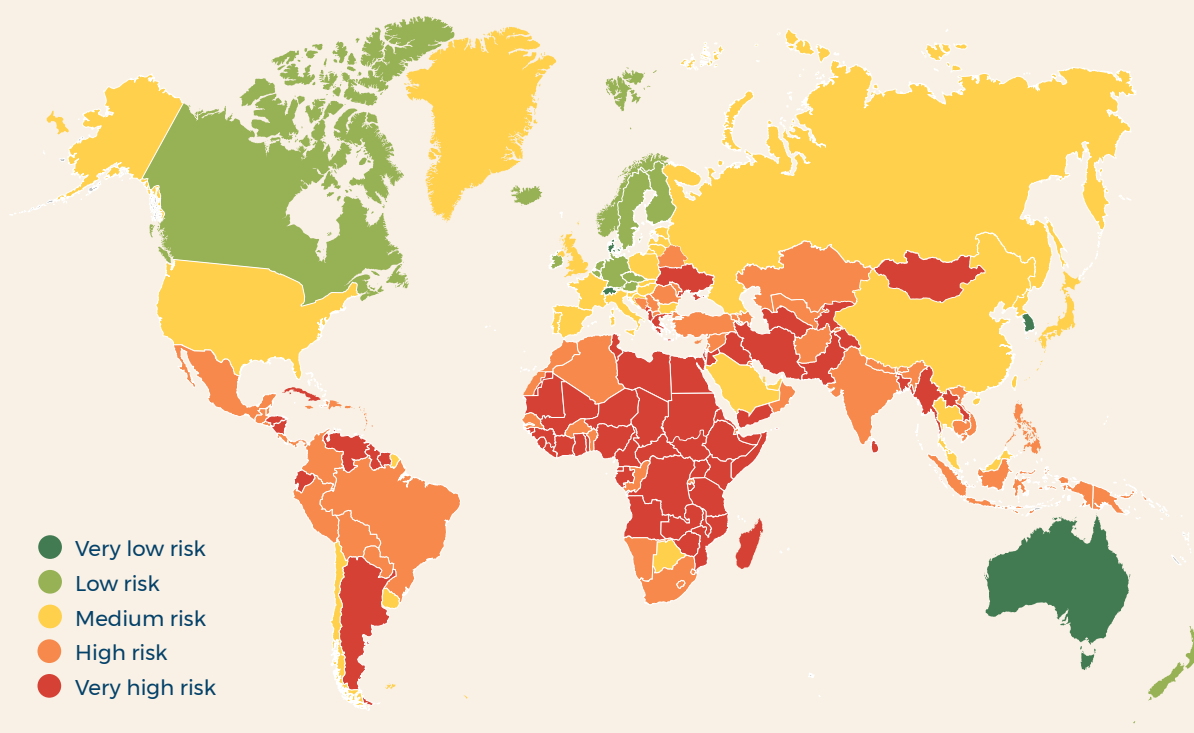
48 Nyakallo Tefu, "S&P Downgrades SA Outlook, Warns Debt Rating Unlikely to Improve", *Eyewitness News*, November 23, 2019, <https://ewn.co.za/2019/11/23/s-and-p-downgrades-sa-outlook-warns-debt-rating-unlikely-to-improve>.

49 Fitch Ratings, "Fitch: Outlook on sub-Saharan Sovereigns Is Negative", *African Markets News*, June 13, 2020, <https://www.african-markets.com/en/news/africa/fitch-outlook-on-sub-saharan-sovereigns-is-negative>.

50 Trading Economics, "Ghana: Credit Rating", June 2020, <https://tradingeconomics.com/ghana/rating>.

51 Ridle Markus (Africa Strategist at Absa Corporate and Investment Banking), interviewed by *Consumer News and Business Channel (CNBC) News Africa*, March 9, 2020.

Figure 14 Global sovereign credit risk map



Source: CountryRiskio, *The Second Wave: The Impact of Covid-19 on Sovereign Ratings*, May 2020, https://countryriskio/static/pdf/CountryRisk_Covid_Impact_on_Ratings_May_2020.pdf

Credit rating agencies should suspend their assessments for developing countries until global production and supply chains return to pre-Covid-19 levels. When there are downgrades, asset managers sell sovereign debt, which unnecessarily increase the cost of capital when economies are already facing headwinds owing to the pandemic.

Credit rating agencies should suspend their assessments for developing countries until global production and supply chains return to pre-Covid-19 levels

Other flows brought on by Covid-19

Many African countries rely heavily on foreign sources of financing for their current deficits. Typically, these are foreign direct investment (FDI), portfolio investment, remittances, official development assistance and external debt, because domestic revenue mobilisation

remains low. African countries also face persistent current account imbalances because of their trade deficits. Remittances have been the largest source of international financial flows since 2010, accounting for about a third of total external financial inflows as the most stable source of flows. The spread of the coronavirus has led to a downward revision of global economic prospects and this could negatively affect remittances flowing to Africa. These sources of external funding are now anticipated to contract. The expected drop in global FDI flows will be between -5% and -15%, while expenditure on infrastructure could drop by at least 25% owing to lower tax revenues and difficulty in mobilising external resources. It is estimated that Africa could lose up to 20–30% of its fiscal revenue,⁵² which could result in an inability to service debt – or even default. Losses in tax revenues and external funding to finance domestic growth and development programmes, coupled with the external value of the local currency falling, will lead to a deep depression on the continent. Left with no options, governments will turn to international markets, which may increase countries' debt levels. Most countries in Africa will qualify for global relief facilities and humanitarian funds set up to fight Covid-19 – eg, the UN \$2 billion fund set up to help the world's poorest countries. One-third of African countries are already, or about to be, at high risk, owing to recent sharp increases in their debt levels. Normally, debt should be used for productive investment; however, given current circumstances, countries need external finance to support their weak healthcare systems and buffer their economies against the effects of the pandemic. An implosion in the stock of external debt and servicing costs is imminent, as is debt restructuring by those unable to repay their creditors. The World Bank and IMF have established facilities targeted specifically at aiding vulnerable countries during the Covid-19-induced global financial crisis. However, more can be done by the international community in terms of financial assistance (eg, introducing debt moratoria and restructuring, deferring interest repayments, etc.) for many emerging and developing countries to help them deal with the economic effects of the pandemic.

An implosion in the stock of external debt and servicing costs is imminent, as is debt restructuring by those unable to repay their creditors

Countries with commercial debt from emerging economies will need to refinance. It has been reported that credit default swap rates on five-year sovereign issues have increased – for example, by 408% year-on-year in late March in Angola, 270% in Nigeria and 101% in South Africa.⁵³ The UN Conference on Trade and Development's ranking of the top 100 multinational enterprises (MNEs) is an overall indicator of investment trends. More than two-thirds of these companies have issued statements on the impact of Covid-19 on their

⁵² AU, *Impact of the Coronavirus*.

⁵³ AU, *Impact of the Coronavirus*.

business, indicating that they are slowing down capital expenditures in affected areas. Forty-one of these companies have issued profit alerts and indicated that lower profits will translate into lower reinvested earnings, which is a major component of FDI. Earnings estimates for 2020 have been revised downwards by an average of 9% for the top 5 000 MNEs, which account for a significant share of global FDI. The profit guidance of MNEs based in developing countries has been revised downwards by 16% with Africa having a revision amount of 1% compared to 18% in Asia⁵⁴ – an indication that MNEs based in emerging markets are more at risk.

Financial integration in Africa

Many African countries were not severely directly affected by the GFC because of their relatively underdeveloped financial systems and limited financial integration with global financial markets.⁵⁵ The banking system was characterised by a lack of financial infrastructure (eg, credit rating agencies), as shown by a relatively large interest margin, low competition in the domestic banking sector, riskiness of lending and somewhat weak property rights. This has changed – countries have since come to realise that financial development and integration are indispensable if they wish to grow their economies. There has been increasing integration of financial markets promoted by regional initiatives in East and Southern Africa and the spread of pan-African banking groups. Improving financial depth on the continent will enhance the effectiveness of monetary policy. Private sector credit relative to GDP and the intermediation of deposits to lending are some of the indicators of financial depth.⁵⁶ Banks dominate the financial system on the continent and pan-African banks (PABs)⁵⁷ have been increasing their share of domestic banking. For instance, South Africa has an advanced regulatory architecture and its total financial assets are the largest in Africa (236% of GDP, including banking, pensions, insurance, etc.). The number of PABs has increased significantly in recent years, with South African, Moroccan, Nigerian and West African Economic and Monetary Union banks emerging. Ecobank has the most widespread presence with operations in over 30 sub-Saharan countries, while Standard Bank (South Africa) is the largest group by asset size. Three Moroccan banks have a large footprint in francophone West and Central Africa. Most of these PABs are systemically important in their home and host countries.⁵⁸ Although these well-capitalised banks account for a large share of deposits and are important participants in the payments system, there may be weaknesses in regulations and supervision that are not keeping up with the innovation and sophistication of foreign bank activities.⁵⁹

54 AU, *Impact of the Coronavirus*.

55 Shimelse Ali, "Impact of the Financial Crisis on Africa" (International Economic Bulletin, Carnegie Endowment for International Peace, Washington DC, 2020), <https://carnegieendowment.org/2009/04/15/impact-of-financial-crisis-on-africa-pub-22995>.

56 Christensen, "Financial Integration in Africa".

57 Banking groups domiciled in Africa with subsidiaries in several countries.

58 Paul Henri Mathieu et al., "Drivers of Cross-Border Banking in sub-Saharan Africa" (Working Paper 19/146, IMF, Washington DC, 2019), <https://www.imf.org/en/Publications/WP/Issues/2019/07/11/Drivers-of-Cross-Border-Banking-in-Sub-Saharan-Africa-46998>.

59 Christensen, "Financial Integration in Africa".

Given the rising dominance of PABs on the continent, their supervision is particularly important because they account for a major share of the deposits of banking systems. Leading economies such as Nigeria and South Africa have developed and implemented cross-border supervision frameworks in line with the [Basel recommendations](#) (eg, high capital requirements for systematically important [“too big to fail”] banks with foreign operations, etc.). It is crucial that central banks strengthen their supervisory activities during the pandemic – if a systematically important PAB were to experience serious financial problems, the central banks in both the host and home countries should consider taking up the role of lender of last resort by providing emergency liquidity, thereby preventing possible contagion effects in the rest of the region or continent. South Africa is the only African country that is a member of the [Financial Stability Board](#) and has used this platform to raise concerns over the impact of financial reforms that have had unintended consequences for African countries. For example, the decline in correspondent banking due to Basel III requirements for de-risking has affected lower-income countries by making it harder to remit, with a knock-on effect on financial inclusion. However, South African banks potentially benefited from this situation as it has led to greater concentration in the provision of remittance services, which are now largely being done by South African financial service providers.

It is crucial that central banks strengthen their supervisory activities during the pandemic – if a systematically important PAB were to experience serious financial problems, the central banks in both the host and home countries should consider taking up the role of lender of last resort

Despite the fact that African countries are at different stages of financial development, integration into the global system will influence the arbitrage between domestic and foreign financial assets. African countries have launched many regional integration initiatives to reap the benefits of scale in strengthening their economies. SADC has embarked on a finance and monetary integration road map that introduced financial market infrastructures (such as payment clearing houses, securities depositories, real-time gross settlement systems, etc.), thereafter inter-linking the financial infrastructures of SADC states. The biggest success to date has been the implementation of the [SADC Integrated Regional Electronic Settlement System](#) (SIRESS), a regional electronic payment system developed by SADC member states to settle cross-border transactions faster without having to rely on intermediary banks from outside the region. SIRESS is an extension of the unified South African banking system in the SADC region, and has now been extended to 10 other SADC countries. Madagascar announced plans in 2018 to participate in SIRESS, while the admission of Comoros into SADC is expected to be a natural progression to joining SIRESS. SIRESS is housed at the South African Reserve Bank and its current settlement currency

is the rand. The next priority is to add the US dollar as a trading currency to SIRESS, while other SADC and non-SADC currencies will be considered as the payment system progresses.

The East African Community has been leading in financial integration on the continent. It established a customs union in 2005, a common market in 2010 and a monetary union. It has harmonised the regulatory environment for financial banking and services and is in advanced stages to develop a common payment and settlement system that will allow settlement in local currencies. Kenyan private banks have been leading the regional integration of their banking sector and the success of mobile banking in the country has spread to the rest of the region, helping to broaden financial inclusion.

It is important for African countries to maintain domestic and regional financial stability, strive to keep markets open and functioning, and preserve the financial system's capacity to finance growth

Regional integration in Africa, as well as the spread of pan-African banking, contributes to deepening financial markets, making monetary policy more effective and enhancing financial inclusion. This has the potential to support financial stability and growth potential. Although Africa has suffered few banking crises in the past that had a continent-wide impact, with Covid-19 there is no room for complacency, especially since the financial sector has developed significantly and its interconnectedness with the global financial market has grown since the GFC. It is therefore important for African countries to maintain domestic and regional financial stability, strive to keep markets open and functioning, and preserve the financial system's capacity to finance growth. Markets continued functioning in South Africa and Nigeria during lockdown – the JSE was granted an exemption by government to continue operating with trading hours unamended while the Nigerian Stock Exchange went on remote trading after shutting down its trading floors when it did not get an exemption.

Conclusion

The impact of Covid-19 on economies, healthcare systems and livelihoods has been immediate and profound. The near-term path, and eventual end, of the pandemic remains uncertain. Globally, there has been a significant sell-off in equity markets; a major widening of high-yield corporate and emerging market sovereign spreads; and a reversal of portfolio flows to emerging, developing and frontier market funds, particularly in the

case of hard currency bonds and equities. As financial markets have started rebalancing portfolios towards safe assets and cash, dollar funding shortages have emerged. Financial conditions in developing economies are getting tighter and currencies have depreciated sharply (especially in commodity-exporting countries) as the coronavirus spreads across the continent. Not all African states have been able to respond equally to the rapidly worsening risk sentiment by enacting fiscal and monetary policy stimulus packages to help offset the tightening in financial conditions. Moreover, African countries entered the pandemic period with weaker economic conditions, ranging from simultaneous health crises, severe external demand shocks and high debt levels to falls in commodity prices, persistent tighter financial conditions, deteriorating fiscal positions and sluggish economic growth. The combined effect of the increased demand for safe-haven assets and tighter financial conditions has pushed up credit spreads for many emerging market and developing economies. In tandem with the already looming debt crisis in several African countries, this has meant that those countries cannot afford the fiscal stimulus packages needed to avert possible severe health and economic crises.

The spread of Covid-19 and its impact on financial markets is extremely concerning from an investment perspective. Just as equities face headwinds, so too does the bond market in Africa. In a trend that emerged prior to the GFC and that has continued since, foreign buyers have been incrementally shifting bond holdings to higher-yielding but lower-quality debt. Foreign activity is also heavily influenced by ratings agencies and their grading of domestic debt. The introduction of significant Covid-19-related uncertainty and volatility has caused investors to panic, thereby causing instability in the financial system. That is why it is important for developing countries to implement broad-based stimulus and liquidity facilities to reduce systemic stress in their financial systems. This will help to boost confidence in the market and prevent an even deeper contraction in demand, thereby bolstering expectations for an eventual economic recovery.

Policy recommendations

- African countries should continue efforts to develop their capital markets in order to strengthen their long-term resilience to sharp deteriorations in global financial conditions, as happened during the GFC and as is happening again with the Covid-19-induced global financial crisis.
- African governments, regulators and central banks must continue to coordinate macroeconomic policy on a continental level to help maintain financial stability and address imminent problems such as rising corporate leverage, increasing bank risk exposure, growing sovereign exposures and emerging cross-country distortions to competition in product and capital markets.

Other useful insights

- African states are highly vulnerable to common global shocks and have already experienced significant impacts from such shocks. They will need to take drastic steps to, as much as possible, lessen the severity of idiosyncratic shocks, the most prominent of which is an overwhelmed healthcare system. Therefore, in the immediate term, lockdown periods should be used to prepare the healthcare system and increase its capacity for both testing and treating. Preventing a domestic health crisis should be the policy priority of all African nations, as such a crisis will inevitably lead to a prolonged and deep economic contraction.
- The pandemic is not a permanent shock; it will pass. Therefore, in the near term, fiscal space must be created without regard for typical prudential norms such as concerns over growing debt burdens and potential credit rating downgrades. Such prudential failures are inevitable during such a crisis, and concerns over these factors must not hamper actions designed to save lives and livelihoods in the near term. Monetary and fiscal measures should be used to channel liquidity to domestic SMEs, households and informal workers. Ideally, debt should be secured at a short-term maturity (two years) from the domestic market as much as possible before moving to foreign lenders and institutions such as the IMF.
- The first priority for fiscal spending should be to target healthcare services and people, followed by firms and banks. The nature of the crisis should shape fiscal spending. As the central source of this economic crisis is health-related, spending on healthcare systems must take precedence. Thereafter, extant national transfer systems must be expanded in order to inject cash directly into the households most at need. Spending can then be directed to firms through extended line of bank credits from commercial banks supported by central bank financing.

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