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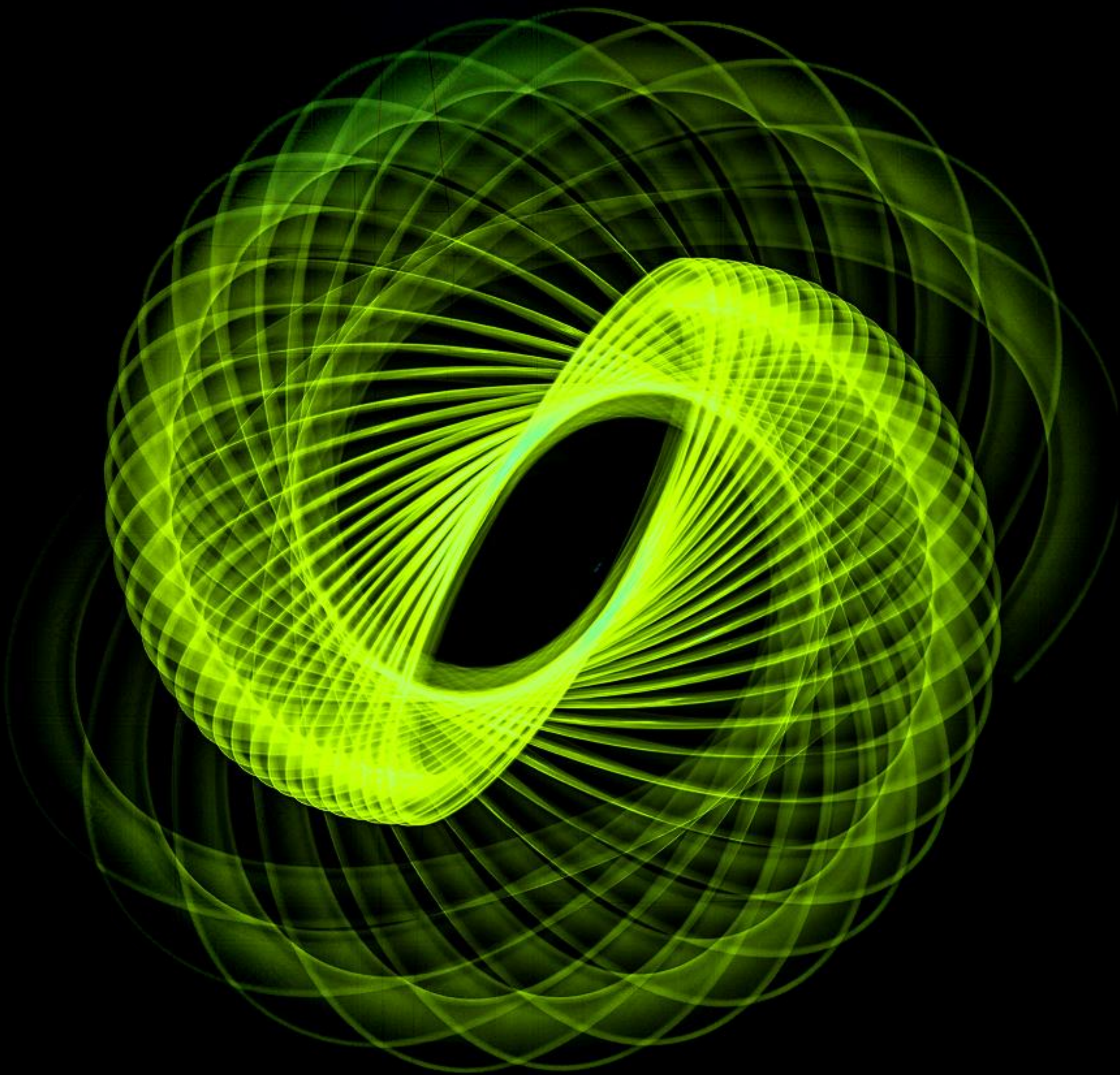

Economic Insights

Exploring Sub-Saharan Africa’s emerging risk landscape

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Understanding sub-Saharan Africa's (SSA) evolving risk landscape is an imperative in order to manage risks and opportunities in a way that is both opportunistic and sustainable.

Commodity crash exposing macroeconomic weaknesses

Structural risks, long evident in SSA economies, were exposed by the end of the commodity super-cycle. One of the consequences was a slowdown in real GDP growth, which arguably bottomed out last year at a mere 1.4%, compared to an average of 5.3% per annum (p.a.) over the preceding decade, as reported by the International Monetary Fund (IMF).

The normal response from policymakers to an exogenous (i.e. external) macroeconomic shock (like falling commodity prices) would be a combination of fiscal and monetary stimulus.

However, the global financial crisis of 2008 that started in the US had lasting repercussions across the world, with many SSA governments choosing to stimulate the economy via looser monetary and fiscal policy stances.

While this helped to mitigate the effects of the global financial crisis, this also limited the options to use the same tools when SSA faced a commodity-price crisis a few years later.

Currency risk exacerbated by rising debt levels

While the continent is showing signs of being on a path to recovery in 2017, it is a tentative recovery, and a path that has many potholes. Multiple years of fiscal and current account deficits meant that governments had to incur external debt.

World Bank data show that SSA's total external debt increased from US$282.9bn in 2010 to almost US$454bn by the end of 2016 – representing an increase of some 60%.

These debts require interest payments, and given that they are denominated in foreign currency, this means that countries are even more susceptible to exchange rate risk than they already were.

Weakening local currencies are translating to rising interest payments, which are becoming increasingly burdensome. This places more pressure on governments to increase their debt levels in order to meet interest payments, which could potentially lead to a debt trap.

Financial sector under increasing pressure

In line with rising debt in the public sector, the financial sector in SSA is also facing mounting pressure. IMF noted in its May 2017 SSA regional economic outlook that the combination of lower real GDP growth and uptick in government arrears *"has resulted in a widespread increase in nonperforming loans, triggering higher provisioning, straining banks' profits, and weighing on solvency"*.

A thriving and – more importantly – stable financial sector is systemically vital for the ongoing development and growth of SSA. Should the financial sectors in pockets across the region continue to deteriorate, or even fail, then long-lasting negative consequences are sure to follow.

Additional structural risks

As mentioned earlier, structural factors that were exposed by the commodity-price slumps continue to place strain on SSA economies, and carry their own risks. On top of the lack of diversification and over-dependence on commodity exports that directly led to the slowdown across the region, there are additional structural risks that need to be taken into account.

These include extreme weather conditions (listed as the most likely global risk by the World Economic Forum in its 2017 Global Risks Report), interstate conflicts, failure of national governments, a lack of infrastructure, unemployment or underemployment, and terrorism.

While these risks are relatively confined to specific countries or geographical regions, they do hold the potential for spreading (also known as contagion or spillover risk). As such, investors and businesses alike must be cognisant of these risks when formulating their strategies.

External risks

Furthermore, there are potential risks emanating from outside of the continent that could potentially have adverse effects on the SSA region. Uncertainty in global financial markets does not bode well for Africa, since investors generally seek calmer waters in times of turbulence.

This is known as a flight to safety, which traditionally sees higher debt costs in emerging and developing markets. Upticks in geopolitical risk are key drivers of flights to safety.

US fiscal and geopolitical uncertainty

Arguably, the current United States (US) administration is one of the key factors affecting global uncertainty in financial markets. Fiscal reform was at the forefront of the Donald Trump presidential campaign, with financial markets welcoming this potential driver of US real GDP growth.

However, with the failure of healthcare reforms, there is increased uncertainty about whether or not fiscal reform will indeed happen.

Additional uncertainty remains regarding the extent of protectionist action that could be taken by the US – which might potentially start a trade war with China.

More recently, President Trump escalated tensions with North Korea, which saw investors retreat to safe-haven destinations. Further rhetoric, or even action, regarding military action between the two nations would likely see more financial flows towards traditionally safer assets.

Brexit negotiations

Another key driver of uncertainty stemming from the developed world is the ongoing separation of the United Kingdom (UK) from the European Union (EU). Negotiations around the so-called Brexit process officially started in June, but little progress on the manner of the exit has been achieved so far. The 'hardness' or 'softness' of Brexit could have lasting implications for global financial markets, and indeed, for the future of the EU itself.

Rising Chinese debt levels

Arguably, another risk stemming from an external source that could affect SSA is China's rising debt levels. In an effort to stimulate the economy, the Asian giant is seeing rising long-term risks, with Moody's Investor Services downgrading the country's sovereign debt rating in May 2017. The probability of a debt crisis in China has risen as the country's shadow banking system has grown.

The Financial Times reported in June 2017 that the shadow finance sector accounts for some 80% of China's GDP, compared to only 10% of GDP a decade earlier. Given China's rapidly rising trade and investment flows with SSA, a debt crisis could have devastating consequences for the region.

Key takeaway

Overall, SSA is on the cusp of regaining its foothold as a premier investment destination. However, the region's path to recovery is fragile, and requires subtle manoeuvring.

The lines between mitigating risk and capitalising on investment opportunities have become increasingly difficult to discern, and those seeking to benefit from the SSA region must carefully weigh their strategic options.

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