

# Economic Insight: Africa

Quarterly briefing Q1 2016

Welcome to the latest edition of ICAEW's *Economic Insight: Africa*, the quarterly economic forecast for the economies of the sub-Saharan Africa region prepared directly for finance professionals whose work focuses on Africa. This edition was produced by Oxford Economics, ICAEW's partner and acknowledged expert in global economic forecasting, and NKC African Economics.

This issue of *Economic Insight: Africa* aims to provide insight on the dynamics influencing growth in sub-Saharan Africa over the past few years and explores the continent's prospects over the rest of the decade.

## Growth after commodities

In summary, we find that:

- the Chinese slowdown, and consequent effects on commodity prices, are resulting in changes in the structures of African economies;
- net energy importers, especially in East Africa, begin with an advantage on this score;
- the services sector in particular is an important driver of growth; and
- foreign direct investment (FDI) and innovation in these sectors are leading to some exciting business developments.

## What lower commodity prices mean

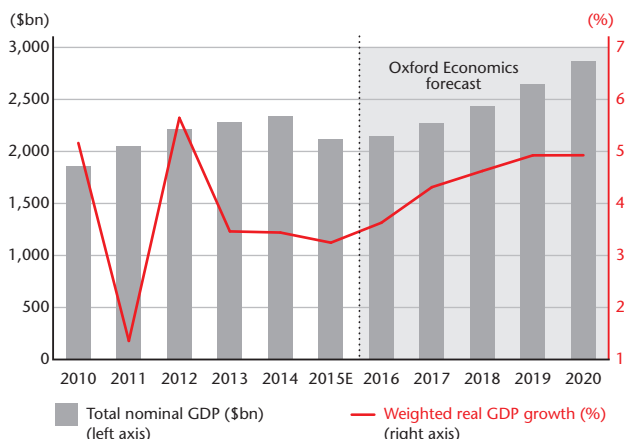
The world economy is shaping up to look very different in the second half of this decade than it did in the first half, and the difference will have particularly important ramifications for economic development in Africa. Old models of growth driven by exports of unbeneficiated raw materials are obsolete, so Africa's economies will increasingly need to create a hospitable environment for companies in the manufacturing and services sectors to drive growth. The rest of this report will examine the changes underway, and what these changes will mean for economic growth in Africa over the next five years.

From 2010 to the first half of 2015, growth in the developed world was modest. These economies were only able to soften the hit to the demand side of the economy through quantitative easing (QE), which channelled artificial liquidity into asset markets. At the same time, China's economy was growing by an average of 8.5% per year in 2010-14 and its state-owned companies kept buying raw materials and building up reserves, especially metals. These processes propped up African economies. QE funds found their way into African asset markets, boosting capital inflows and allowing countries to balance trade account deficits.

Still-strong Chinese demand, meanwhile, kept commodity prices high. In the more resource-dependent economies this demand resulted in trade surpluses and abnormally strong currencies, which meant that consumers could buy from abroad and domestic manufacturing stagnated.

Weighted real GDP growth on the continent averaged 3.7% over the 2010-15 period, with several strong performances (such as Ethiopia, Mozambique, Rwanda and Tanzania) being offset by lacklustre growth by some of the larger economies (such as South Africa). That average was also dragged down by Libya's staggering 61% contraction in output in 2011.

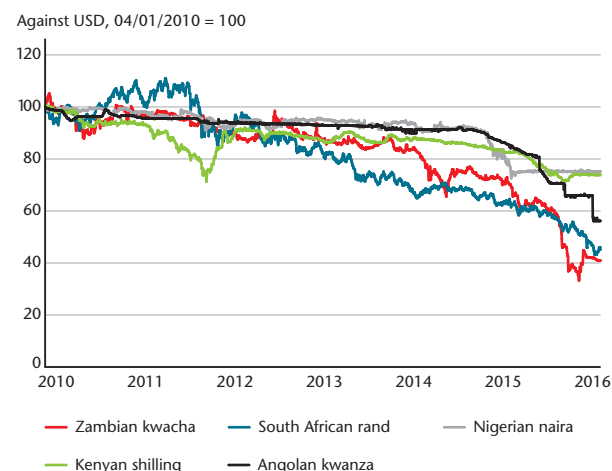
**Figure 1: GDP in Africa, 2010–20**



Source: WEO, NKC Research

The generally benign picture changed drastically in 2014-15, when sudden deleveraging in China removed the support for commodity prices, which essentially collapsed. This dynamic will be examined in more detail in another section of this report but, to summarise, the effect was seen in sharply reduced export revenues, sliding currencies, inflation and lower fiscal revenues.

**Figure 2: Currency depreciation 2014–2015**

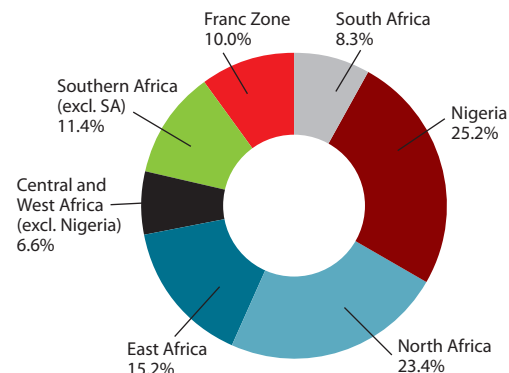


Source: Bloomberg

Looking ahead, Africa's weighted real GDP growth is projected to average 4.3% during 2015-20, accelerating slightly from 3.6% in 2015 to 4.9% by 2020. Nigeria, the largest economy on the continent, is projected to contribute significantly to Africa's economic expansion – the West African powerhouse

is forecast to expand at an average real rate of 4.8% p.a. between 2015 and 2020, contributing over 25% to the continent's forecast growth in this timeframe. The second-largest economy, South Africa, is only expected to grow by an average 2.4% p.a. over the same period, which is why its contribution to overall growth, at 8.3%, will be just over half its share of the continent's output.

**Figure 3: Contributions to GDP growth, 2015–20**



Source: WEO, NKC Research

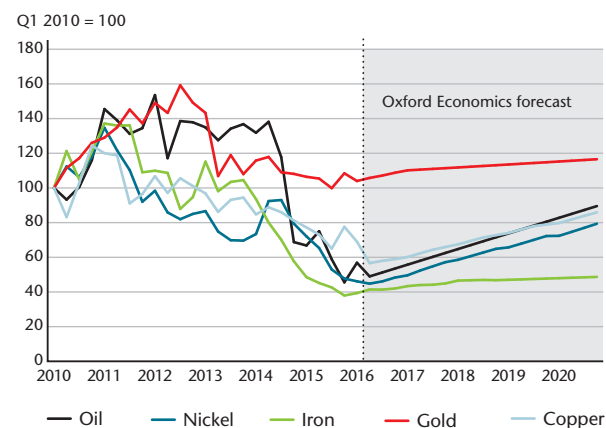
### Stagnating or slowly rising commodity prices

Africa is the most commodity-dependent continent on earth, partly because manufacturing still accounts for a relatively small share of output. Most goods are exported in a raw state without being processed, refined or having had value added to them in other ways (unlike, for example, several Middle East oil exporting economies, which have extensive petro-chemicals sectors).

Africa is, therefore, especially susceptible to swings in global commodity prices. The commodity price boom of 2000 and the early-2010s ensured an influx of cash for Africa's main commodity exporters, as well as a boom in foreign investment in a range of natural resources.

As with other regions, the commodity that has the biggest impact on African countries' finances is oil: Africa is home to some major oil exporters, including Angola, Gabon, Nigeria and Algeria. During the boom years, plentiful oil revenues permitted governments in these countries to significantly increase public sector wages and infrastructure. Unfortunately, easy money meant that these governments had little incentive to implement structural economic reforms to boost private sector development; indeed, Africa's main oil exporters operate in the most challenging business environments in the world.

**Figure 4: Commodity prices**



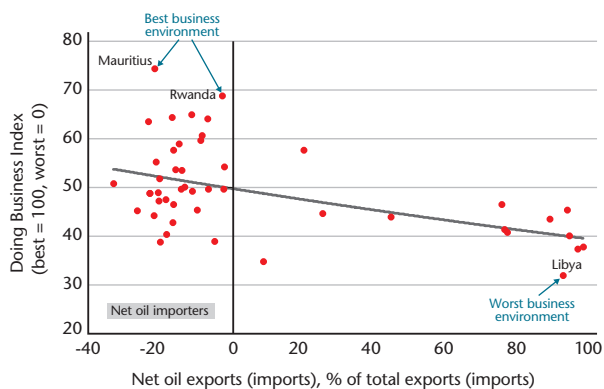
Source: Oxford Economics/Haver Analytics

When global oil prices started collapsing in mid-2014, export and fiscal revenues plummeted, leading to a rapid deterioration in oil producers' current account and fiscal balances, a decline in foreign exchange reserves and significant pressure on their currencies. As these countries depend on imports for most of their consumer goods, these measures are having a severe impact on consumers and are likely to lead to higher price inflation.

On the upside, the majority of African countries are net oil importers; their current accounts have therefore benefited significantly from the drop in oil prices. This dynamic is most pronounced in East Africa, as petroleum attributes a significant share of total imports for these economies – for example, oil accounts for a third of all imports in Tanzania. Oil importers in other parts of the continent are also benefitting – one North African economy gaining from the fall in energy prices is Morocco, where the current account deficit narrowed from 7% of GDP in 2013 to an estimated 2.2% in 2015. Consumers are also benefiting from lower global oil prices, although some of these benefits are being eroded by rapidly-depreciating currencies across the continent. Furthermore, even when denominated in Zambian kwacha, the worst-performing currency over the past year, global oil prices have still halved since mid-2014.

Throughout most of the rest of East and Southern Africa, the oil price has fallen by more than 60% in local currency terms. In turn, this has a positive impact on purchasing power, by improving consumers' ability to spend on other products. Over the short term, East and Southern African consumers will be pressured by a drought this year, which has been inflating food prices, but once the weather improves the true benefits of lower global oil prices should filter through to consumers.

**Figure 5: Doing Business score**



Source: World Bank, Trade Map, NKC Research

Africa's net oil importers also tend to have better business environments than the oil producers: Figure 5 shows that the African countries in which the World Bank's Doing Business score is highest are all to the left of the y-axis, that is, they are net oil importers. Unlike their oil-producing peers, these countries have had to attract investment into other sectors to grow, and have experienced subsequent improvements in their business environments. In some cases, such as Rwanda's (which has the second-highest Doing Business score in Africa after Mauritius) these improvements have been the fruit of deliberate policy choices.

For instance, in the Rwandan capital Kigali, authorities have declared some parts of the city car-free zones as part of the country's green growth strategy. Authorities plan to extend the car-free zone to incorporate Kigali's entire fast-growing central business district in coming years.

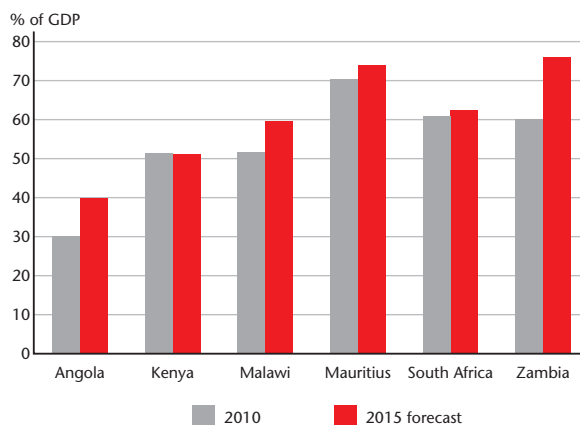
Rwanda's green economy approach is guided by the country's green growth and climate resilience strategy that was launched in 2011. Such a strategy affects numerous economic sectors, including construction (supporting the construction of environmentally-friendly green homes), utilities (rainwater management systems that help ease pressure on water use), and power (increasing use of renewable energy).

The East Africa region more generally is embracing the use of renewable energy to leapfrog older power generation technologies, while also reducing the need to extend the national energy grid to remote villages. Kenya is now the seventh highest producer of geothermal power globally after it recently unveiled the second phase of the Olkaria geothermal plant, which added an extra 140 MW to the plant's capacity. Olkaria is now the biggest single-turbine geothermal plant in the world, with a capacity of some 280 MW. In Ethiopia, the 1,870 MW Gibe III hydroelectric project began trial electricity generation in August last year, while the country's Grand Ethiopian Renaissance Dam (GERD), which is expected to generate 6,000 MW at full capacity, is expected to be completed sometime in 2017. In addition, Off-Grid Electric has implemented its M-Power solar solution in Rwanda and Tanzania, with the aim of reaching one million homes in the latter alone.

### Sectoral rebalancing towards services

Africa stands at the threshold of a large-scale rotational shift towards the services and manufacturing sectors, driven by a rising middle class, government policies, greater integration into the global economy and technological advancement. The services and manufacturing sectors' rising contribution to GDP are both a natural extension of economic maturity and born out of necessity. The prolonged commodity price slump has provided the impetus for sectoral rebalancing away from the extractive sector, towards a greater diversification of the economic base.

**Figure 6: Services as % of GDP, selected African economies**



Source: NKC Research

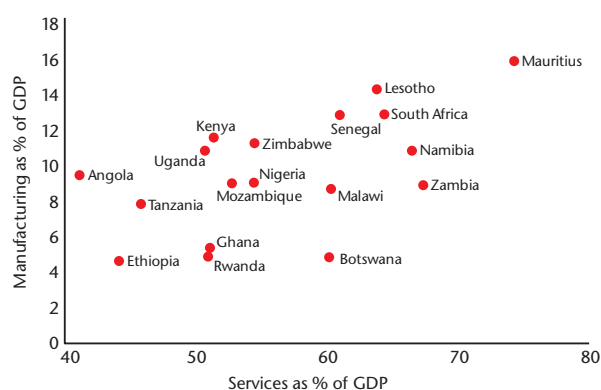
A sectoral rebalancing from investment-driven capital goods as a primary driver of economic growth, towards a domestic consumption-based growth model offers significant upside potential and first-mover advantage to the private sector. This will be driven by a broad-based shift towards improved investment attractiveness on the back of increased government incentives, low penetration levels, continued development of transport, power and social infrastructure and (to a lesser extent) increased consumer disposable income.



The role of government support and institutional reform in sectoral rebalancing cannot be overstated. Government support of infrastructural and human skills development forms the cornerstone of inclusive economic growth and includes policies aimed at lifting the standard of education and improved female labour force participation. These innovations ultimately underpin the rotational shift towards enhanced formal sector development from subsistence farming and artisanal mining.

For the foreign investor, this socioeconomic shift opens the door to a wide spectrum of services and manufacturing opportunities. Although growing at a fast pace, the contribution of the manufacturing sector to GDP in Africa remains minimal. A retraction in extractive sector opportunities, due to low global commodity prices, therefore could provide scope for development of downstream activities. Moreover, development of the manufacturing sector will provide a country with the means to increase the direct benefit derived from its natural resources, including improved tax potential and a larger set of job opportunities.

**Figure 7: Economic diversification in Africa**



Recognising this potential, African countries have stepped up support of manufacturing sector development by increasing free trade zones and offering a menu of fiscal incentives. Multinational companies have taken note: retail giant H&M sources materials from Ethiopia, while General Electric tapped Nigeria for the manufacturing of electrical goods. In turn, multinational companies that have set up manufacturing facilities in Ghana include consumer goods producer Unilever, health care product manufacturer PZ Cussons, Denmark-based dairy and fruit juice maker Fan Milk, as well as Indian vehicle manufacturer Mahindra.

Against a backdrop of plunging global oil prices, Nigeria's burgeoning manufacturing sector is now one of the major driving forces behind the country's economic growth. Subsequently, automotive manufacturing is becoming a more prominent subsector with Nissan delivering its first 'made-in-Nigeria' cars during early 2015. Furthermore, the construction materials and agro-processing subsectors pose strong growth potential, thanks to readily-available raw materials and government-driven infrastructural development programmes.

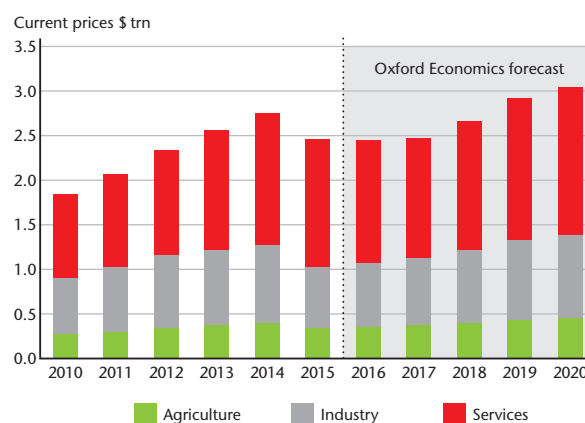
While institutional reform has laid the groundwork for investment attractiveness and labour force skills development, private funding is a key catalyst of sectoral rebalancing in Africa, which is particularly true of private equity (PE). Whereas previously, African PE fund managers expertly manoeuvred the growth-capital and natural resource wave over the past two decades, a new set of opportunities has opened up on the back of the changing face of the African consumer.

A strong population dividend and an emerging middle class of consumers will be the driving force behind the next wave of African PE opportunities, consolidating an improvement in socio-demographic indicators, economic reform and a need for new innovation. This is particularly applicable to the financial and telecommunications services industry. The African continent's improved infrastructure and a favourable demographic dividend have attracted foreign investors to the information & communication technology (ICT) sector over the past decade, a trend which is set to continue on the back of favourable investment incentives and still-low market saturation. In turn, the fast-growing consumer retail sector has drawn substantial foreign interest.

The food retail sector remains among the most underpenetrated in the world and offers significant upside potential to investors with an eye for value chain development. In turn, insurance penetration levels remain low and the industry is dominated by life insurance; presenting an opportunity for micro-insurers to sell low-cost products to the poor. In the past few years, the advent of mobile money has also brought a new dimension to Africa's insurance industry. Given that mobile phone penetration has increased sharply in recent years (for example, reaching 150 mobile phones per 100 population in South Africa by 2014, according to the World Bank's *World Development Indicators*), buying insurance on a mobile phone is an exciting growth area as it offers a more affordable way for Africans, especially in remote regions, to gain access to insurance products. It only needs the cooperation of telecommunications companies, banks and insurance companies.

Improved disposable income will encourage the prospects for consumer-facing goods and services, thereby increasing the appeal of local businesses within this sector to foreign investors.

**Figure 8: Forecast change in Africa's GDP structure**



Source: NKC Research

Innovation in financial services – popularised as FinTech – has erupted as a primary global investment opportunity and has recorded rapid growth over the past five years as technological innovation allowed digitally-active consumers to streamline and improve on traditional banking services. The online financial sector has also taken off in Africa, answering a need for quality financial services and tailor-made solutions to structural challenges including frequent power disruptions and poor rural infrastructure. FinTech significantly contributed to the ease of transferring money and remitting earnings, acquiring insurance and attaining credit. Mobile banking has enabled peer-to-peer lending on a larger scale, extending on a traditional saving and credit scheme known as stokvels in Southern Africa.

## Trends, challenges and selected countries

As in anything, an opportunity is sometimes difficult to distinguish from a crisis. Despite growth in the secondary and tertiary sectors examined in this report, it should be expected that urban job creation will grow at a slower pace than urban populations in most cities and that a major problem in Africa – that of large underemployed and poor populations living in slum conditions – will persist. There are also of course, particularly difficult challenges in a number of countries related to security and terrorism that undermine business and consumer confidence and economic activity. These will both remain major challenges for governments for some years to come.

As with the challenges posed by the sectoral rebalancing, responsible and far-sighted policymaking is the only thing that can make a difference here and even where it is present, issues will persist. The essential difference between the first half of the decade and the second is one of scale: future growth in Africa will be concentrated in fewer places, different countries and different sectors than before. As such, business opportunities in Africa will increasingly become a local or sectoral story, rather than a continental or regional one, based on external drivers. Good policymaking will, therefore, become ever-more important.

The **South African** economy has come under severe strain of late as the economic transformation in China has dampened demand for the country's premier export commodities. These factors have combined to send the currency crashing to all-time lows.

We expect real GDP growth to slow to 1% this year and average about 2% p.a. during 2017-20. In this context, faced with uncertain revenue prospects and capacity problems in the power sector, the government has opened up the energy supply business to independent power producers, and this looks set to be a profitable venture in Africa's biggest consumer of electricity.

The weak rand can be expected to boost other sectors, too. Many companies in South Africa's creative economy, including advertising and the film industry, successfully compete against rich-world rivals; these companies' offerings now look even more competitive on price. As imported manufactured goods become more expensive, it might be that some entrepreneurs will take advantage of the country's skilled workforce and generally good infrastructure environment to start up factories.

In **Nigeria**, crude oil accounts for roughly 80% of total exports. The sharp decline in global prices for the commodity adds severe pressure on the nation's external and fiscal balances. The Central Bank of Nigeria (CBN) has introduced capital controls as part of an import-substitution strategy. Meanwhile, President Muhammadu Buhari has highlighted that the expansionary 2016 fiscal budget will prioritise interventions aimed at diversifying Nigeria's economy, with agriculture and mining identified as strategically important industries. For the moment, however, the tight forex liquidity conditions associated with the CBN's stance on the naira have already deterred foreign investment and foreigners will continue to tread cautiously until the naira is devalued.

In **Kenya**, the East African giant's relatively diversified economy and comparatively low commodity dependence bode well for the country's economic growth outlook. However, Kenya continues to face its own idiosyncratic challenges. More specifically, the country's precarious fiscal situation is the primary reason why both Standard & Poor's and Fitch Ratings downgraded the country's outlook from stable to negative last year. That being said, the Kenyan Government has taken some important steps towards fiscal consolidation by preparing a supplementary budget that plans to reduce both development and recurrent public spending (relative to the original budget) in the current fiscal year.

While fiscal consolidation still needs to be actualised, and elections in 2017 could lead to some fiscal slippages, the government's recognition of economic concerns and explicit will to address these issues instil confidence in the country's economic outlook. Overall growth prospects remain positive, with the Kenyan economy expected to expand by around 6% p.a. during the 2017-20 period.

## Oxford Economics

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