Research @ Citi Podcast, Episode 7: The Big Picture Across Africa

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Guest: David Cowan, Chief Africa Economist, Citi Research

Transcript:

Lucy Baldwin (00:03)

Welcome to the Research @ Citi Podcast. I'm Lucy Baldwin, Global Head of Research at Citi. In each podcast episode, we bring you our thought-leading views and analysis across asset classes, sectors, and economies from around the globe. Now, let me hand you over to our host today.

Elise Badoy (00:22)

It's Elise Badoy. I'm Head of Europe, UK, Middle East and Africa Research at Citi. We're recording from London and I'm with David Cowan, our Chief Africa Economist. We're going to very excitingly look at Africa and hopefully come back with a number of key ideas. David published one of our most-read reports last year at the back end of 2023, where he looked at really a new growth model for Africa, and that really is the case for investors to look at the continent and be involved in it from an investment perspective. David, tell us more about that.

David Cowan (00:57)

Yeah, thanks, Elise. So yes, I'm in London. I'm on one of my periodic breaks from touring around Africa. So what we argue in that model is that broadly, we don't believe that Africa — or I don't believe, Citi Research doesn't believe — that Africa will follow a traditional model, as we've seen, where you move through agriculture, manufacturing, services. And we talk a lot more about how Africa can develop its service industry and will partially by-step the manufacturing sector that you've seen, particularly the Asian manufacturing sector export-led growth. But we're actually a bit more optimistic about Africa, and two particular things that we think will be very transformative for it. Anyone who's looked recently and seen these new UN population forecasts that were published last week will be very clear that, look, Africa is about the only place in the world which is going to have really significant positive population growth. And in fact, what you're seeing, particularly uniquely, is that this population growth is happening at a time when the world population is starting to shrink, and how that relationship evolves going forward will be very important. Africa is going through a very normal demographic transition. But that critical point — Japan, South Korea, Italy — all these countries are going to have shrinking populations, and they're going to need labor from somewhere else in the world.

The second thing is, and I think this is particularly important and what we at Citi even get very excited about, is this idea that somehow Africa has got this leapfrog technology. The beauty is that if you come to it late, you can adopt technology much faster. And that was clearly the case with the mobile phone boom when it happened in Africa. But we think it's going to be the case in a lot of other things going forward. So the combination of those two things creates what is now still globally a very small market — it's only about three-and-a-half percent of GDP, right? — but it will become a much bigger market. And, if you want to think about this — it either scares you to death or it makes you super optimistic — is that Nigeria will be after China, India, the third or fourth largest country in the world, right? The United States may stay ahead of it. The United States may shrink behind it, right? But that's the sort of the market opportunity that potentially comes as part of this. So that's why we broadly remain optimistic on Africa, even though it's currently quite a small part of the global economy.

Elise Badoy (03:14)

So David, that's incredibly optimistic and very, very interesting. However, being an equity analyst, obviously, I'm very aware that there's been a number of headlines about multinationals withdrawing from Africa in recent years. That's particularly true about Nigeria. What should we make out of this? Because that's sort of tempering everything you've said, or is there something new happening here?

David Cowan (03:35)

I think you hit the nail on the head, right? So the answer to that, Elise, is that — and this is where we'll get into a much longer discussion — is that actually, the reality is that since COVID, we've had a really difficult time in Africa. And so what I'm going to tell you, look — we're talking about 50 countries. There's a lot of different stories involved, right? But there still is a core story. And when you think about that core story, you can then work out where other countries stand off that core story. So what is that core story and why have we got to a situation we've got to? So, the first thing is, it's very clearly that, look, I think you can date Africa's problems where we got now back to 2007, where Gabon and Ghana entered the Eurobond market. Now, you might say we're going back a long way to understand that, but we have to go back there, right? So what happened is Gabon and Ghana came to — this is the first time that African governments had issued any large amount of private sector debt. There had been a very little bit issued in the late 1970s, early 1980s by Nigeria and Côte D'Ivoire, but broadly, this was the first time. So you had this money, particularly in the African middle income countries, coming in. And remember, after the global financial crisis, rates were very low, so they could borrow quite cheaply. At the same time, in a globally changing economy, China started to lend to Africa. So you see this wall of Chinese money coming in, right? And so you have this extra finance. Now, what that allowed is that African fiscal deficits started to deteriorate over time. Now, initially, it doesn't really matter because you're in a world of low interest rates, and borrowing is cheap, right? And Chinese money is actually middle sort of cheapness, right? But both reached a peak at certain points. The Eurobond issuance reached a peak in about 2012, Chinese lending reached a peak in 2017–18. Now, all this continued, and then suddenly you go into COVID. Now, COVID gave you a license to print fiscal deficits, right? Everyone in the world suddenly could run a big fiscal deficit, right? So why should Africa be excluded from any of this? Everyone runs a big fiscal deficit, and the debt stocks went up.

Now, the problem came as when you're on this deteriorating trend, do you come out? Initially, it didn't matter. The IMF lent quite a lot of money to Africa at quite cheap interest rates, and you could keep the party rolling for a bit. But unfortunately, no one had foreseen Vladimir Putin's invasion of the Ukraine. So what happens then is inflation goes up globally, and then also in Africa, inflation goes up, interest rates go up. And essentially out of that, you see then defaults. This whole deterioration in your debt stocks had led to defaults, so Zambia defaults, Ghana defaults. Then away from Africa, Sri Lanka defaults. Then the market starts to ask itself, who will default next? So where do they go? They run the dragon that runs you from Sri Lanka to Pakistan, then back to Africa. Will Kenya default, will Egypt default, will Tunisia default, will Nigeria default? Now, that's fine. Because remember, Eurobond borrowing costs have gone up, China has stopped lending quite a bit to Africa in face of its own domestic woes, its lending has collapsed, right? Now, when a country defaults, I'm speaking as an economist here. If you're a bondholder, you've got some other issues, but as an economist, when a country defaults, what I would tell you is, for the average person in the street, not a lot changes. If you lived in Lusaka or Accra, you would go to work the next day, the sun would still be shining. But what does happen is that your currencies collapse. So the kwacha collapses, the CD collapses, all these currencies, the rupees in Pakistan and Sri Lanka collapse. So then you have this knock-on effect of all these collapsing currencies around you. Now, you also had a very strange situation in Africa. The two of the biggest economies that were in that default trajectory I was talking about, Egypt and Nigeria, refused to let their currencies collapse. So they try and hold their currencies. But the cost of holding their currencies is you have a big backlog of FX demand that builds up. It reached about 10 billion dollars. So people actually couldn't get their money out of the country. So if you went to your bank, you came, do all that and said, I want this many dollars, they would say, sorry, it's not available. And so that became a huge problem, and this existed for much of 2022–23. And that refers a little bit to what you were alluding to, Elise, as negative sentiment, right? If you can't get your money out of the country, you are starting to worry about your investment decisions.

Now, fortunately, this year, the dam broke. So it broke for two reasons. The first is that the markets believed that the Federal Reserve would start easing monetary policy. So Côte D'Ivoire could come back to the market, Benin came back to the market, Kenya came back to the market and refinanced its debt obligation, so it was not facing default. The second thing is that both the Central Bank of Egypt and the Central Bank of Nigeria just devalued their currencies. Now, these are big devaluations, right? You're looking at EGP having moved from 17 to 32 and is now trading at around 46 to 48. The naira has moved from 464 to 1,600, roughly, where it's trading at the moment. These are ginormous currency moves. And what I would say to people is, look, you can see me. I've got quite a lot of gray hair. I'm quite an old man, right? The last time I saw currency moves this far and this fast was when I wore a younger man's clothes, I think that Bob Dylan says, right? And essentially, I was walking around the shores of Lake Victoria writing a PhD. Now, during that time in Tanzania, they devalued the shilling from 100 to 400. The naira a little while earlier had been moved from 2 to 22, so now it's at 1,600, right? There's a lot of other examples I could give you of how far currencies moved. And they also were associated with the defaults at the time. Remember, this was the last time Africa defaulted. Now, the current defaults are just much more complicated. Because in the default at last time, remember Africa was just defaulting to essentially Europe, the U.S., and Japan. Now it's defaulting to China, and now it's defaulting to other places like Israel. So resolving these defaults has become much, much more complicated, but we have actually started to make progress in that.

Elise Badoy (09:49)

And so, David, maybe I should interrupt you here because, of course, stay tuned, we want to talk about China and the U.S. and perhaps speak on specific countries like South Africa. But before I do that, you've gone into a technical point. We've talked about exchange rates and exchange rate policy. Can you talk specifically about exchange rate policy as well? From a technical point, what should we know about the actual FX policy?

David Cowan (10:14)

Yes, so look, when your currency collapses on these scales, what you tend to see is that you will always find an inflow of dollars. So you see that people eventually say: Look, this currency looks cheap enough, I will provide foreign exchange at that price. The problem with an exchange rate, remember, is what is an exchange rate and what is your policy? Now, on one hand as an economist, you'd say an exchange rate is just a price. But it's a very important price in any economy. It's a price that influences lots of other prices. And so what you now have to see is that you've let your exchange rate move, you've found a new equilibrium. The question is, how do you let it move going forward — without it impacting or without leaving it in a way that we go back to a situation where you saw in Egypt and Nigeria in the last few years where you have big currency backlogs? The thing that scares investors most is not that a currency is moving, it's that I can't get foreign exchange. That is the biggest worry for any investor in anywhere in the world, right? And that's what we saw. So we now need to move to that situation. But the key to moving to that situation is to go back and fix the fiscal deficits, which was the cause of the problem. So you need to fix them.

Now, how do you fix fiscal deficit? There's two ways. You either cut spending or you raise taxes. Now, the last time Africa defaulted, you cut spending. You had all these strongmen: J.J. Rawlings in Ghana. Arap Moi. Ibrahim Babangida in Nigeria, and they cut spending. This time the IMF has this new program that you're going to try and close fiscal deficits by raising revenue. And in their mind, you have this very clear path where you go from Ghana that collects 14% of GDP in revenue, to Kenya and Zambia, which collects 17, 18, to Mauritius that collects 23, to South Africa, Morocco, Namibia, Botswana that collect 27, 28. We're not asking a country to collect developed countries' level of revenue, right? But there. The trouble is that this policy has seemed to have failed at the first stage. Why do we see that? Because anyone who opens up the newspaper knows what happened in Kenya in the last few weeks, right? You have these protests against it. So the argument is, you need to fix the fiscal, get that under control, and then move to more flexible exchange rate regimes going forward. That is where the battle is now. And that's still to be played out over the course of the next few years. But what we have done is have a huge exchange rate adjustment in many countries that provides an entry point for investors. And that's pretty critical in all of this, right? You have not seen these currencies move — this is a once in a 30 year move in currencies, once in a 35 year move in currencies, right? And so the question you're asking now is, did some of those multinationals exit too early, or is this the buying opportunity of a lifetime, right? This is like the big conundrum we're asking and trying to deal with out there at this point.

Elise Badoy (13:05)

And then obviously, so we've talked about change is good for investors. There's obviously investment opportunities. We're talking about this now. And obviously, investors, I mean, I grew up during the Cold War, and obviously, it was a bilateral world. We're now in a multilateral world. And Africa obviously has been obviously benefiting from multiple types of investors. And so here is my question about, obviously China, the U.S., political competition, how does it fit into the picture now? India, Latin America. Who are the investors in Africa, who owns Africa, who doesn't own Africa?

David Cowan (13:45)

Africans own Africa, I hope. *[laughs]*

Elise Badoy (13:48)

Exactly. Exactly. Who owns Africa — is it Africa? And so that's the question. What are these political influences and what should we make out of that? What are the latest trends and what should we know?

David Cowan (14:00)

I think we're in what I sometimes call a bilateral–multilateral world. How about that, right? You can't deny that the U.S. and China are still pretty big players in this game, right? And if you want to see that writ large in front of anyone across Africa, you can see that both of them are recommitted. So the Chinese built their first railroad in Africa under Mao in the 70s: the Tazara Railway, that goes from Dar es Salaam to Zambia. They are now eventually starting to put money back into that. At the same time, the U.S. and the European Union have announced building of this Lobito corridor that runs from Lobito on the Angolan coast and then comes into DRC and eventually should terminate in Zambia. Both are targeted at the strategic extraction of copper and cobalt from the DRC, right? This is the new battle over minerals in the world, or green minerals, as we would say, right? But within that, you then have all these multilateral players involved, right?

So I argue quite often that India, I think, for example, brings companies that are most suited to understanding African consumers. Their own country base means that they understand poor rural consumers as well as urban consumers, right? Then you have Turkish companies who are particularly good at building infrastructure, for example, and they have very high risk tolerance, right? So we see all these different players. We've seen Brazil withdraw, but maybe Brazil comes back. It feels affinity to Angola and Mozambique — its lusophone cousins, right? So you're seeing this. And at the same time, remember, what you're seeing in this is that trade is shifting southwards. So the BRICS, of which South Africa is a central part, then that's where you see the real growth of trade from India, through South Africa, to Latin America, and obviously China on the other side, right? So I think you're seeing all these things playing out.

The battle for African governments is really sometimes to be transactional: to pick your partners or the best partner for each project, right, and what you want to do. I mean, that will be a huge challenge for them in terms of trying to derive benefit from all these global trends.

Elise Badoy (16:04)

And so, David, obviously, we've seen some form of attempts at fiscal consolidation. You've talked about, you know, I'm coming back a bit on the technical aspect of things. You know, any hopes of that is that an opportunity for investors or is that actually not needed? What's your view?

David Cowan (16:22)

I mean, look, the fiscal policy is important, right? And unfortunately, raising taxes does have some implications for investors, right? How would you raise taxes? Now, the argument will be in Africa. It's all about the informal sector and how you tax the informal sector, I suspect. What we know from numbers is that the formal sector is larger in Africa at this stage of development than what we saw in LatAm or in Asia, right? So that's a separate battle. But I still am not upset or worried that taxing will undermine growth. I mean, one thing I point out, you've seen this inflationary surge in 2022, you've seen the defaults, you've seen the currency moves. What we continue to see is growth in Africa, maybe not as much growth as we want, but certainly growth. And the point is when you're just starting taxing the informal sector, it's not the same way, it doesn't slow down growth. It's really about removing or rebalancing income channels and things like that, right? So I remain quite positive that the fiscal policy, although it will have some cost on some investors, is still really a factor that doesn't fundamentally alter my growth projections, or not significantly, right? Your growth projections are driven much more by fundamental economic changes happening on the continent, and in particular demographics helps that, right? Remember, this is the only place in the world with positive demographics, right? And that points you to a growth model, right? One of the things I've always argued for people investing in Africa is that there's two target markets. I've always been very anti this idea of a middle class in Africa. What I think there is is there's a consuming class in Africa. A lot of people will consume a lot of products — you get your price right, you can sell a lot of products. Or you target the business-to-business market, where you're trying to deal with other businesses who work in Africa. I think both can be very profitable. Eventually, we may see the emergence of a middle class, but at this point, I'm not, that's not where I really foresee big growth potential over the coming years.

Elise Badoy (18:27)

So, David, then, my question really is, you tour the world, you meet investors. Obviously, you go to Africa, you understand it very well. But when you talk to non-specialists, what is the biggest misconception? What are the things the question you get and you'd hope people would know about this?

David Cowan (18:43)

First thing, I think, is that I think many investors overrate political risk in Africa, right? I think that's one of the important things, right? Before we came on air, you made a comment that there are many headlines on Africa. But when there are headlines they're often related to negative political outcomes, right? And one of the points I would stress to people all the time is, look, I don't think you attract the same amount that there's virtually a civil war going on in Myanmar, right? If there's an African civil war going on, it seems to attract far more political headlines. So I think people overrestimate political risk in Africa. The second thing is, and I think this is quite a complicated one, how people get over it, is that actually, if you average the amount, you can earn very good returns in Africa. One of the problems we have though is that your returns can be very, very volatile. So you suddenly can make a good, really good couple of years, then you have a really couple of bad years, and then you have a medium year. Now, overall, that's something that I think it's something that's very difficult to get through with investors, right? Because you've suddenly had two good years and head office is ringing up saying, "Hey, guys, you've got to perform that well," right? And then it doesn't work out the same way. So I think one of the things that we need to understand more is the volatility of returns. And that's something actually that I've never really understood, in that I don't really know, for example, was LatAm at certain times of development also experiencing very volatile rate of returns, or Asia? But that's one thing I have noticed in Africa. There's two things, I think, that people need to get their minds around. It's those two things when investing in Africa.

Elise Badoy (20:11)

Thank you very much, David. And hopefully, our listeners can really go and find your publicly available report published at the back end of 2023. Thank you very much.

David Cowan (20:21)

Thank you, everyone.

Lucy Baldwin (20:23)

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