Africa's Terms of Trade after the Crisis

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African LDCs are a group of 33 countries characterized by economic, social and cultural diversity, but also by widespread poverty and structural weaknesses in their economic, institutional and human resources, often compounded by geographical handicaps. The outward orientation of their economies and their dependency on few commodities exports in particular makes them vulnerable to external shocks such as world price and currency exchange rate fluctuations. In this context, terms of trade have been an important tool to analyze African LDCs' participation in world trade. In 2009, African LDCs' aggregated terms of trade were less favorable compared to 2006 levels, and significantly less compared to 2008 levels. In 2010 a modest recovery is observed. This is in part due to the recovery of export earnings to pre-crisis levels. In the context of increasing commodity prices, there is cause for cautious optimism for African LDC terms of trade in the near future. Nonetheless, they remain vulnerable to future strong terms of trade shocks due to the limited diversification of export products.

Terms of trade are a measure of the changing price levels of a country's exports and imports over time. A positive evolution indicates that a country's export prices are increasing faster than its import prices, and thus it is able to import more goods for an equal or lesser quantity of exports compared to earlier periods. Conversely, declining terms of trade indicate that import prices are rising more quickly, and thus the country must export a larger quantity of goods in order to import the same amount as before. When terms of trade change, it can have significant consequences for the consumption and investment patterns and – in the long run – on growth prospects. A shock to the terms of trade, as seen during the world economic crisis of 2008, can significantly curtail the ability of LDCs to import key products or finance investments. On the other hand, an improvement in the terms of trade can provide LDCs with fiscal space to diversify and develop their economies. Thus the trade are an important measure of economic performance of countries.

Recent developments

The terms of trade of African LDCs will differ with the composition of imports/exports of individual countries as well as the changes in the value of the currency of both exporting and importing countries. Thus, when assessing African LDC terms of trade after the crisis, it is important to specify the partner countries in question. Concerning the share of imports coming into African LDCs, as well as the main markets for African LDC exports, the EU27, China and the US constitute the biggest trading partners (ITC Trade Map 2009).

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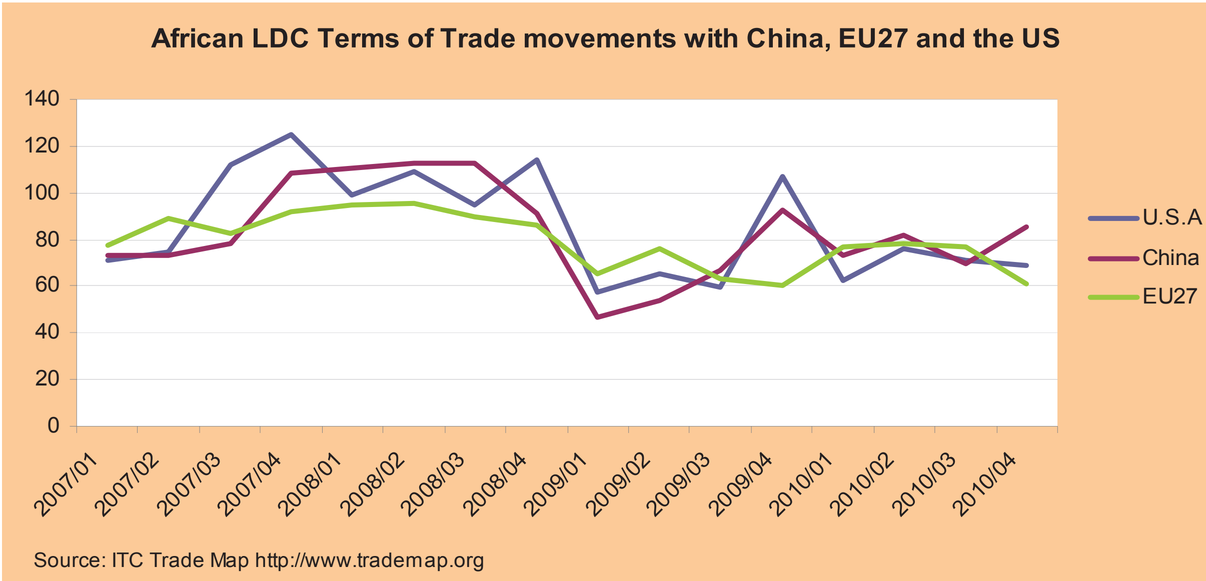


The terms of trade of African LDCs with these three countries (see Figure 1) show a steady rise throughout 2007, with the rise slowing in 2008 and facing a steep downward trend from Q3 of 2008 onwards. The steep drop, reaching its lowest point in Q1 of 2009 shows the extent of the negative impact of the global financial crisis on African LDCs. The fall in the terms of trade is indicative of the sharp drop in the value of goods exported. There has been a slow recovery from Q2 of 2009 onwards. However, the terms of trade levels in 2010 remain generally below the peak of 2007-2008.

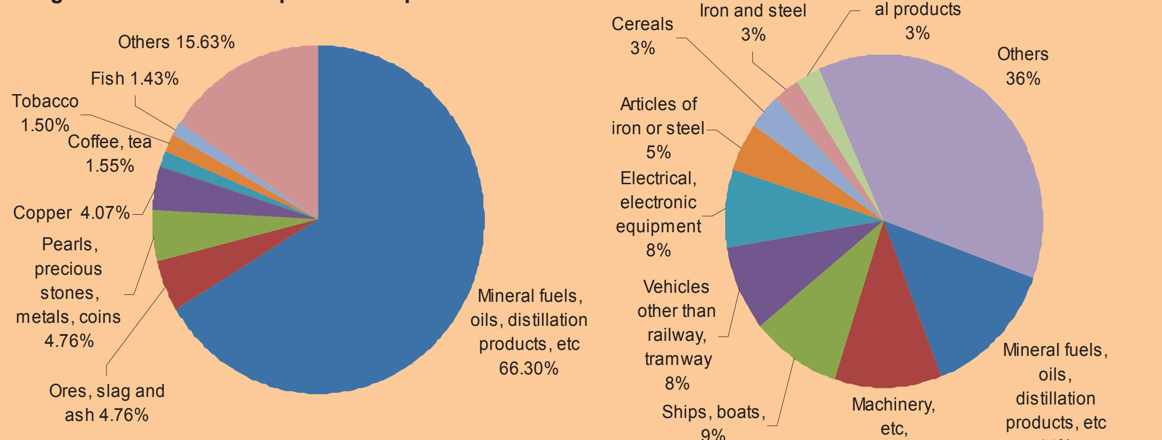
Terms of trade between African LDCs and the EU27 have moved less favourably as compared with other partners for the time period assessed. While the decline from Q2 2008 up to Q1 of 2009 followed the trend of the group as a whole, albeit more gradual, the terms of trade in the periods Q2 to Q4 of 2009 showed a decline, in contrast to all other partners assessed for the same period. In 2010 one can observe a relatively stable level in the terms of trade. Figure 2 shows the trend of private participation in infrastructure.

African LDCs' terms of trade with the US have shown more fluctuations than those with the EU. The terms of trade level for African LDCs in 2007 improved steadily up to Q4 of 2007, after which the levels fluctuated above base year levels (2006), followed by the dramatic drop after Q4 2008 indicative of the impact of the global financial crisis. Throughout 2009 the terms of trade showed signs of recovery with a jump in Q4 of 2009 to pre-crisis levels. In 2010 the terms of trade of African LDC vis-à-vis the US have fallen and are back to their low levels of early 2007.

The terms of trade with China showed a sharp decline in 2008, largely due to the drastic drop in oil export earnings, though have since steadily recovered in the post-crisis period. African LDCs exhibited increasing terms of trade throughout 2007, reaching a peak in Q3 2008. In Q1 2009, the terms of trade with China reached the lowest point out of all partners assessed. The improving African LDC terms of trade trends with China flattened out in 2010.

The sharp drop in the terms of trade movement with both China and the U.S.A. in the beginning of 2009 reflects the drop in oil prices from 2008 (97.7 US$/b, Brent Oil) to 2009 (61.9 US$/b, Brent Oil).[2] The terms of trade movement with the EU on the other hand, shows much less volatility compared to the other two partners assessed. This is in part due to the more diverse composition of exports of African LDCs to the EU27 (including a much higher share of agricultural commodities).

Figure 2: African LDC Exports and Imports in 2009



Source: ITC Trade Map http://w w w .trademap.org

The volatility in the terms of trade of African LDCs is an indication of their underlying vulnerability to changes in world prices of a small basket of goods. Looking at African LDC exports, one finds that the lion`s share consists of mineral fuels and oil (66%) followed by various agricultural commodities (see Figure 2). African LDC imports on the other hand, show much greater diversity in product groups (see Figure 3) from mineral fuels, oils, machinery, transport and electrical equipment, articles of iron and steel to cereals. The difference between the import and export composition shows the strong dependence of African LDCs on natural endowments (minerals, oils, agricultural products) for their exports and the limited diversification and manufacturing capacities.

A key policy challenge for both oil and non-oil exporting African LDCs thus remains the limited diversification in export products increasing their vulnerability to negative demand shocks and to fluctuations in commodity prices, which in turn affects their ability to finance imports.

Nonetheless, the current world economic climate offers opportunities in the form of growing demand from emerging markets in Asia. China counts among the largest trading partners for African LDCs already, while other Asian countries such as South Korea or India have been gaining in importance. The growth of these emerging markets has boosted trade with African LDCs and given a boost to world commodity prices. This growth path is predicted to continue in the near future, which in turn should reflect positively in the terms of trade of African LDCs. The challenge will lie in investing the expected terms of trade gains in the strategic diversification of the African LDCs' economies.

Likewise opportunities for export growth and diversification exist with greater regional economic integration within the African region. Diversifying both export products as well as targeted export markets lessens the vulnerability to terms of trade shocks. Increasing regional trade is consequently a positive development in recent years and an opportunity for African LDCs too.

Outlook and Prospects

The composition of exports and imports is a key structural determinant of the African LDCs' terms of trade, while exchange rates and commodity price movements are key determinants of the terms of trade levels reflecting business cycle movements. If the currency of a trading partner appreciates, their import prices are likely to increase faster than African LDCs export prices, causing a decline in the terms of trade. In that case, African LDCs will need to export a greater quantity of goods for the same amount of imports of a given previous period. Developments of the currency value of trading partners as well as the local currency are thus of critical importance.

Particularly as African LDCs also include countries with pegged currencies to the Euro (e.g. Francophone countries) or USD, exchange rate developments of both currencies will play a role in the terms of trade of these countries.

Next to the exchange rate the development of oil as well as non-oil commodity prices will have to be assessed. ITC Trade Map shows that non-oil imports from African LDCs to major markets during the first three quarters of 2010 increased by 13 per cent in volume terms, but by 31 per cent in value terms, compared with same period in 2009 (ITC Trade Map, 2011). For African LDCs, the global trend of increasing commodity prices accelerated towards the end of 2010. The EIU predicts further increases in mineral and oil prices as well as metals and agricultural commodities like coffee and cotton for 2011; this should be expected to provide a boost to African LDC terms of trade in 2011. However, likewise world food prices have been rising increasing the vulnerability of African LDCs net-food importers. After 2011, commodity prices are expected to fall somewhat, though overall remaining fairly strong, mainly due to the expected increased consumption from emerging markets.[3] However, keeping in mind that commodity prices have in the past exhibited falling trends and volatility, the short-term outlook should be treated cautiously. Likewise, oil prices have shot up, most recently due to the political instability in the Middle-Eastern and North African region, but whether or not this will cause a long term price hike remains highly uncertain.

Conclusion

The rise in commodity prices can give some ground for cautious optimism about African LDCs' terms of trade throughout 2011 and 2012. Nonetheless an underlying vulnerability to future strong terms of trade shocks due to the limited diversification of export products for the country group as a whole remains an issue of overriding concern. The major policy implication, with the benefit of hindsight, is that a greater share of the earnings resulting from the favourable external economic environment will need to be re-invested in order to ensure greater diversification of products and markets, both for exports and for imports with the overall aim of sustainable economic growth that creates jobs.

Notes

1. This OSAA Policy Brief has been prepared by Willem van der Geest, Lead Economist, International Trade Centre, Geneva, with the assistance of Hanna Bucher and Kerfalla Conte
2. EIU Global Forecasting Service (http://gfs.eiu.com) from February 17 2011
3. Economist Intelligence Unit, Global Outlook Summary, February 2011 (http://gfs.eiu.com/Default.aspx)