

The Consequences and Management of Capital Inflows. Lessons for Sub-Saharan Africa

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Introduction

The return of foreign private capital to East Asian and Latin American countries in the 1990s has attracted the attention of scholars and policymakers. During most of this period there have been few signs that countries in Sub-Saharan Africa (SSA) were at all affected by the renewed interest that international investors were showing in emerging markets economies.

By 1992, however, there were signs that a few African countries, notably Kenya and Uganda, had begun to attract private capital inflows, and after 1994 South Africa joined the ranks of capital importers. In recent years Nigeria has accounted for about half of the foreign direct investment (SDI) to SSA. With the inflows, many of the less desirable side-effects also became manifest. Nominal and real exchange rate pressures emerged.

As the monetary authorities attempted to stem the appreciation by intervening in the market for foreign exchange, reserve accumulation accelerated and monetary control became more difficult. Attempts to sterilise the foreign exchange transactions often drove domestic interest rates higher, acting as a further stimulus to inflows and increasing debt-servicing costs for the government and the central bank.

Some of the questions that emerge from the African experiences echo those of capital-importing countries in other regions. Other questions are more specific to the African experience: Why has SSA not attracted more flows, despite the improvement in economic performance? What are the prerequisites for attracting portfolio flows? Are the policy instruments limited by

the relatively underdeveloped nature of the financial sector? Is an undeveloped financial sector an asset or a liability when it comes to avoiding Asian-style crises?

The purpose of this study is to answer some of these questions at both the conceptual level as well as in the African context. It presents a framework to analyse the macroeconomic effects of and the policy responses to a surge in capital inflows and places much emphasis on the role played by the financial sector and the stock market. At the empirical level, the study investigates the possible links between the structure and depth of existing capital markets and the volume and composition of the capital flows a country attracts. The issue of contagion is also investigated, including the question as to what extent capital market developments in the "large" countries, such as Kenya, Nigeria and South Africa impact, for better or worse, the whole region.

Conclusions from the conceptual part

The central lesson in the conceptual part of the study is that capital inflows, although definitely more desirable than capital outflows, could be harmful to the recipient country if not adequately managed.

The main risk is to forget that some of the inflow is temporary and could leave in a rush - no region has proven impervious to this risk. The main concern is not so much with the inflow as such but with the potential outflow. The issue is thus similar to that raised by a boom in commodity prices: many countries around the world, notably in Africa and Latin America, have made the mistake of taking the 1970's commodity price rally as permanent and later paid for their unwarranted optimism.

Management of capital inflows is not easy. Sterilisation is costly and capital controls are difficult to implement and may enhance corruption. The main lesson is that fiscal austerity and

enhanced bank supervision and/or higher reserve requirements are the best responses to a capital inflows episode. This can be complemented with higher exchange rate flexibility, but the latter also has drawbacks. The summary at the end highlights some of the lessons and calls attention to some of the "warning signals" a policymaker should heed so as to reduce the potential economic costs of a sudden reversal in capital inflows.

Conclusions from the empirical part

As to empirical analysis, several of the results suggest that capital flows to most of Sub-Saharan Africa are distinct from flows to other regions.

First, the study examines whether there is a systematic link between capital flows to various countries, not only African, and the structure of capital market. This is done by introducing a variety of proxies for the size and depth of the domestic capital market. Not surprisingly, portfolio flows appear to have the closest link to the stock market variables. The conclusion is that the absence of portfolio flows in the region appears to be importantly explained by the lack of developed capital markets in most SSA countries.

Second, unlike the evidence from Asia and Latin America, many of the financial crises that came with financial liberalisation were not the product of a credit boom but rather of the poor state of bank assets at the time of the liberalisation - much of it the outcome of lending to the government.

Third, unlike capital flows to Asia and Latin America, capital flows to SSA do not appear to be as responsive to changes in international interest rates - instead terms of trade shocks appear to be the key external shock in influencing capital flows to the region.

On the other hand, there are also similarities with other regions.

The capital account balance of small countries appears to be affected by developments and trends in the larger countries in the region. According to

the study, rising capital inflows to the larger countries would, other things equal, tend to eventually stimulate increased capital inflows to the smaller countries in the region. This would suggest, for instance, that a successful stabilisation program in one or more of the larger countries, which increase flows to that country, may have positive externalities for some of its neighbouring countries. Conversely, this would imply that wars and civil strife that has plagued numerous African countries had dire consequences for the region as a whole.

Thus capital flows, like financial crises, have a contagious element, which suggests that SSA will require a critical mass of countries attracting foreign capital before the region as a whole starts to see a resurgence in capital inflows.

Lastly, the selected SSA episodes with sterilised intervention mirrored the experiences in Asia, Eastern Europe and Latin America. Namely, that sterilisation resulted in higher domestic interest rates, bigger quasi-fiscal losses, and higher short-term capital inflows. The notable difference with other regions is that the small size of financial sector in SSA countries limits the scope for large-scale long-lived sterilisation efforts.

Summary of the policy lessons

On fiscal policy

- Treat all commodity price booms as if they were temporary and all commodity price declines as permanent.
- Allowing for capital mobility acts as a disciplining device for policymakers, making it more difficult to resort to distortionary taxation. This argues in favour of removing capital controls - at least on capital outflows.

On debt management

- A high volume of short-term debt relative to the stock of international reserves can be a major problem if the

country enters into a balance of payment crisis.

On banks and asset bubbles

- Be aware of marked increases in stock or real estate prices fueled by capital inflows and rapid credit creation, as these could reflect asset price bubbles. Except for South Africa, this is not an important issue for SSA, where portfolio flows are nil.
- Beware of rapid credit growth during the inflow phase of the cycle; when capital flows out, these loans may have to be repaid in short notice, leading to bankruptcies in the private nonfinancial sector and, possibly, bank failures.
- The high incidence of banks taking on greater risks in periods when access to international capital is relatively favourable, highlights the importance of bank supervision during a capital inflows episode.

On monetary policy

- It is a mistake to forget that under a fixed exchange rate regime money is determined by its demand. Thus, if it rises it is because the public wants to hold more money. This is not inflationary, and under these conditions, sterilisation is counter-productive.
- There are "perils in sterilised intervention". Persistent and widening domestic-foreign interest rate differentials, large quasi-fiscal costs, and the temptation for governments to spend some of the accumulated international reserves are among the chief perils.

On the exchange rate regime

- Financial trouble is not absent under flexible exchange rates and it can actually surface at the early stages of a capital inflows cycle. The central bank can increase money supply at the beginning of the cycle in order to

prevent the exchange rate from appreciating. At the end of the cycle it can refrain from contracting the money supply, because otherwise the same financial problems as with fixed exchange rates will surface. Thus, this type of monetary managements is inflation-prone. This can be countered if the assistance to the potentially affected financial institutions comes from the government finances rather than through a monetary expansion by the central bank.

- Currency substitution signifies a major complication for the management of monetary policy under floating exchange rates. This is so because the supply of money is partly a function of the exchange rate. The domestic monetary authority controls the supply of domestic currency but foreign currency could actually be borrowed, significantly weakening the nominal anchor provided by the domestic component of money supply.

On the current account

- Beware of mechanical rules used to compute what is or is it not a "sustainable" current account deficit. Such rules are difficult to apply to countries undergoing transition, which include most developing countries in which structural reforms are taking place.

- Large current account deficits can be problematic if there is a sudden and unexpected slowdown of capital inflows and the government cannot offset it by running down international reserves.

The Expert Group on Development Issues, EGDI, was established by the Swedish Government in 1995 with the objective of contributing to an increased understanding of development issues in a global context and increasing the effectiveness of development cooperation policies.

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A secretariat assists the group and a number of reference groups have direct contact with the work in progress. An annual budget is determined by the Swedish Government.

The full study (EGDI Study 1998:2) can be ordered from
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