



Review

The determinants of private capital flow volatility in Sub-Saharan African countries



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ABSTRACT

The study investigates the underlying factors of patterns of volatility for FDI, portfolio equity and cross-border bank lending inflows for sub-Saharan African countries using a panel framework with data from 1990 to 2011. No other study has focussed exclusively on sub-Saharan Africa when investigating the determinants of private capital flow volatility. This study is further unique in that it employs clearly-delineated cross-border bank lending data from the Bank of International Settlements' (BIS) Locational Banking Statistics that has not been used by similar prior studies. The findings of the study are as follows: (1) global liquidity lowers FDI volatility while private sector credit increases volatility; (2) global liquidity increases portfolio equity volatility with growth and the quality of macroeconomic policies found to be important pull factors in lowering volatility; and (3) the quality of macroeconomic policies and trade openness are important pull factors in lowering cross-border bank lending volatility while financial openness increases volatility.

1. Introduction

Concerns have risen regarding the stability of capital flows to developing economies. It has been argued that global capital flows could have a destabilizing role in developing economies in particular when a financial crisis causes a sudden reversal of such flows (Neumann et al., 2009). The last decade witnessed an increase in capital flow volatility that could have numerous economic consequences (Forbes and Warnock, 2012). These consequences could include economic cycles being amplified by large capital flow increases and decreases, increased financial system vulnerabilities, and exacerbated macroeconomic instability. Capital inflow surges could overwhelm domestic financial markets and hamper the ability of macroeconomic policies' ability to adjust through exchange rate appreciation, asset price bubbles, money market distortions, credit booms and creating unsustainable risk premium drops (IMF, 2012).

Most empirical studies on capital flows focus on the determinants of capital flow levels with few studies on volatility, which is surprising given the link between the stability of capital flows and economic growth (Broto et al., 2011). Demir (2009) states that although the volume of capital flows to developing countries have increased substantially from the 1990s, their volatility has received very meagre attention in the literature. No study has focussed exclusively on sub-Saharan Africa when investigating the determinants of private capital flow volatility. The aim of this study is to investigate the impact of global and domestic factors on the determinants of the volatility of foreign direct investment (FDI), portfolio equity and cross-border bank lending inflows for sub-Saharan African countries.

A novel feature of our study is the use of clearly-delineated cross-border bank lending data from the Bank of International

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Settlements' (BIS) Locational Banking Statistics. Prior empirical studies that analysed disaggregated flows (e.g. Neumann et al., 2009; Broto et al., 2011; Mercado and Park, 2011) have used balance of payments data from the IMF's International Financial Statistics that incorporated a residual category, "other investment," including cross-border bank lending as a subcomponent. Other forms of cross-border finance (e.g. trade finance and cash) are however also included in this category that fundamentally differs from bank loans (World Bank, 2014).

1.1. FDI volatility and economic development

FDI is sought by many sub-Saharan African countries because of the large, positive externalities which are associated with these flows (Adjasi et al., 2012). The related literature has revealed several benefits of FDI, including technology spillovers, global trade integration, better management techniques, forward and backward linkages, and the enhancement of a more competitive business environment (Agbloyor et al., 2013).

Institutional quality in the form of political stability has been found to be a significant FDI determinant in Africa (Naudé and Krugell, 2007). However, FDI is also sensitive to global factors. While confirming that FDI inflows are negatively associated with political risk, Méon and Sekkat (2012) also found that FDI flows are less sensitive to political risk when the global volume of FDI is larger. An implication of this finding is that global risk-taking increases when global FDI activity increases. Therefore, not only FDI volumes but also FDI volatility would be affected by institutional quality (Méon and Sekkat, 2012). Allen and Giovannetti (2011) reported that in the second half of 2008 and the first half of 2009, a number of investment projects in sub-Saharan Africa were put on hold or cancelled. For example, the Democratic Republic of Congo and Zambia had mining projects cancelled while Sudan had a refinery postponed (Allen and Giovannetti, 2011). FDI volatility may thus reflect political and economic uncertainty in a country and these countries may appear less attractive to foreign investors (Lensink and Morrissey, 2006).

While it has almost become a cliché that FDIs positively influence the economic prospects of recipient nations (Bokpin, 2017), its volatility can have negative growth effects (Choong and Liew, 2009). The endogenous growth literature indicates that FDI positively impact growth by decreasing research and development (R & D) costs through stimulating innovation. When FDI flows become uncertain, R & D becomes uncertain, and negatively impacts on incentives to innovate (Lensink and Morrissey, 2006). Empirically, Lensink and Morrissey (2006) found reasonably robust evidence that FDI volatility has a direct negative growth impact while Choong and Liew (2009) found that FDI volatility is associated with lower economic growth in ASEAN-5 countries. In Africa, Ngeni and Mutuku (2014) showed that FDI volatility has a negative impact on growth in Kenya. It therefore becomes important to investigate the determinants of FDI volatility in sub-Saharan Africa.

2. Theoretical and empirical review

Bekaert and Harvey (2003) stated that prior to financial liberalization, emerging market economies start with negligible capital flows while encountering considerable flows post-liberalization that are subject to portfolio rebalancing. It should therefore not be surprising that capital flow volatility increases close to liberalization, but once large capital flows occur should subside.

Aghion et al. (2004) introduced a framework to analyse how financial factors could lead to instability in small open economies. In an economy with a closed capital market, the response to a cash flow shock is limited given the constrained amount of capital available to finance entrepreneurs. The extra funding sources in an open economy could potentially increase the response to a shock and the potential for volatility. Aghion et al. (2004) concluded that unrestricted financial liberalization could be destabilizing without a sufficiently well-developed financial sector.

A major subject in volatility of capital flows is the distinction between push and pull factors (Forbes and Warnock, 2012). Push factors reflect global economic forces that drive capital flows from developed to developing countries and could relate to global interest rates, global growth, and global risk aversion and portfolio diversification (Sarno et al., 2016). Pull factors reflect domestic economic forces that attract capital into a country and capture the appeal of different locations for investment purposes and could relate to domestic interest rates, local growth potential and trade openness (Sarno et al., 2016). Tille and van Wincoop (2014) demonstrate how private information leads to increased capital flow volatility using a two-country Dynamic Stochastic General Equilibrium (DSGE) model through unobserved push and pull factors. Several channels exist through which the unobserved factors impact capital flows. In the portfolio growth channel that is dependent on savings, unobserved pull factors impact capital flows through the relative asset price. An increase in these factors raise the relative home asset price, thereby lowering home saving and raising foreign saving, and through portfolio growth higher capital inflows occur.

Through the average expected excess return channel, unobserved pull factors impact capital flows through the relative asset price. An increase in these factors raises the relative asset price that lowers relative home saving and increases relative home investment, with both causing an excess home asset supply. The expected excess home asset return will then rise to clear asset markets by a portfolio shift to home assets with capital inflows rising (Tille and van Wincoop, 2014). In their model, a trade-off exists between home bias because of the cost of investing abroad and seeking risk reduction through diversification. Through the time-varying risk channel, an increase in the variance of the excess return will raise the portfolio diversification scope and increase capital inflows. The variance of the excess return only depends on push factors in all versions of the model (Tille and van Wincoop, 2014).

In the empirical literature, Bronor and Rigobon (2004) showed that capital flows to developing economies were much more volatile than those to developed economies and that macroeconomic controls offered little explanatory power to explain this. However, country characteristics such as quality of institutions, a high per capita income, and financial development were associated with lower volatility.

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