

# Capital Flows and Financial Crises: Policy Issues and Challenges for Nigeria

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## Abstract

Experiences of economies that have suffered from financial crises indicate that emergence of integrated financial markets and high capital mobility made possible by the increasing globalization of world economies predisposes economies, especially developing ones to the volatility of capital flows. Also, the nature and source of capital flows plays critical role in determining the impact of its surge or sudden outflow from an economy, whereas foreign portfolio investment is adjudged the most volatile. Notwithstanding, no matter the nature of capital flows (flows over a medium-to-long-term); they are expected to influence the monetary aggregates, especially the economy's net foreign assets (NFA), inflation, real effective exchange rate, aggregate output (GDP) and possibly the domestic interest rates. Developing countries are attracting great amount of capital flows, Nigeria inclusive. With increasing capital flows, especially the Net Portfolio Investment (NPI) into the Nigerian economy and coupled with its undeveloped nature, the economy may not be insulated from the ravaging impact of capital flows and/or sudden flight, if proactive policy measures were not designed and implemented to forestall them. This paper underscores the relation between capital flows and financial crisis as well as policy issues and challenges for Nigeria. It points out that it is more desirable for the country to adopt and pursue vigorously, appropriate and coherent policies that would respond to the increasing capital flows or sudden capital flight rather than procrastinating, probably to be enmeshed in crisis that often requires very costly measures to solve. Consequently, it proffers policy measures that would forestall the impact of massive capital inflows and/or sudden capital flight from the Nigerian economy.

**Key Words:** Capital flows, Financial Crises

**JEL Classification:** F21, F32

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## I. Introduction

The pursuits of economic growth, low inflation and sustainable balance of payment (BOP) have over time been the force behind most economic policies. The realization of these laudable objectives has no doubt been constrained by the interplay of factors, among, which include low level of domestic savings and investment and foreign exchange shortage. The emergence of integrated financial markets and high capital mobility made possible by the increasing globalization of world economies, has predisposed economies, especially developing ones to the volatility of capital flows - sudden

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and spontaneous, (herd behavior) and loss of market confidence, which often result in severe financial crises.

Capital flows<sup>1</sup> in terms of portfolio investment has been a notable feature of developed economies. This, however, is becoming a very important component of the balance of payments of many emerging economies, such as China, Hong Kong, India, Singapore, Taiwan, Brazil, South Africa etc (Obadan, 2004). The increase in capital flows, especially the foreign portfolio investment (FPI), which have more volatile and destabilizing effects, caused the financial crises suffered notably by Mexico in 1994, East Asian countries in 1997 and Russia in 1998 (Kahler, 1998). Experiences have shown that financial crises in emerging economies are very different today than they were in the past. Between 1940 and the 1970s, financial crises involved large fiscal deficits, repressed domestic financial systems, and balance of payments situations that were associated with sharp worsening of terms of trade. In the late 1990s, however, a 'new variety' of crisis evolved in Asia. Many of the emerging economies that experienced the financial trauma have been considered very successful until the crises explode (Strasek, et al, 2007).

Presently, the world economy is suffering from global financial and economic crises that owe its historical antecedent to the sub-prime mortgage lending crisis that engulfed the world largest economy, the USA in 2007. The magnitude, dimension and extent of the damages it has caused the world economy, is yet to be fully quantified, the crises have resulted in increasing cases of bailout plans for banks and investment companies by governments in the USA, Europe and Asia through partial nationalization and outright buy-over, thereby, putting to doubt the efficacy of capitalist structure in resource allocation.

In Nigeria, the abrogation of certain laws and subsequent entrenchment of investment friendly laws as well as the introduction of structural reforms facilitated the substantial flow of capital. Until 1986, Nigeria did not record any figure on portfolio investment (inflow or outflow) in her BOP accounts. This was attributable to the non-internationalization of the country's money and capital markets as well as the non-disclosure of information on the portfolio investments of Nigerian investors in foreign capital/money markets (CBN 1997:151). For example, the net

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<sup>1</sup>It is a broad term, which includes different kinds of financial transactions: lending by governments and international organizations; bank lending, short-and long-term; investment in public or private bonds; investment in equities; and direct investment in productive capacity (Obadan, 2004). However, in this paper, due to paucity of data, capital flows is taken to imply NDI and NPI, which are reported in the Nigeria's Balance of Payment as oil and non-oil components.



portfolio investment (NPI) and net direct investment (NDI) were ₦151.6 million and ₦735.8 million in 1986, which rose to ₦51,079.13 million and ₦115,952.2 million in 2000, indicating a growth rate of 33,593.36 and 15,658.66 per cent, respectively. In 2005, NPI and NDI went up to ₦116, 035.00 million and ₦654,193.10 million indicating a growth rate of 127.17 and 464.19 per cent, respectively, compared with the 2000 figures. Furthermore, NPI and NDI grew by 202.43 and 22.69 per cent to ₦350, 919.40 million and ₦802, 615.70 million in 2008, respectively, when compared with the 2005 figures.

With increasing capital flows, especially, the NPI into the Nigerian economy and coupled with its undeveloped nature, the economy may not be insulated from the ravaging impact of capital flows and/or sudden flight, if proactive policy measures were not designed and implemented to forestall them. Consequently, there is, the need for urgent safety valves for the economy against the possible impact of the Dutch disease, sudden capital flight and perhaps, financial crisis. It is more desirable for the country to adopt and pursue vigorously, appropriate and coherent policies that would respond to the increasing capital flows or sudden capital flight rather than procrastinating, probably to be enmeshed in crisis that often requires very costly measures to solve. In a nutshell, the paper underscores the relation between capital flows and financial crisis, and the need to design and implement policies that would dampen the impact of massive capital inflows, and forestall sudden capital flight on the domestic economy.

The paper is structured into 5 sections. Following the introduction is section 2, which reviews the theoretical literature. In section 3, capital flows, financial market and a review of the macroeconomic environment are discussed. Section 4, provides some country experiences - on financial/currency crises and their major causes. It also looks at the current global financial and economic crises and their effects on the Nigerian economy as well the lessons to be learnt. Finally, section 5 discusses policy issues and challenges as well as recommendations.

## **II. Theoretical Literature**

Most developing countries are characterized by low level of domestic savings, which has impeded the much-needed investment for economic development. In order to attain a desirable level of investment that would ensure sustainable development, developing country needs some foreign savings to bridge the savings-investment gap. The gap when financed through foreign savings comes in form of capital flows. Capital flows is transmitted through foreign direct investment (FDI), foreign portfolio investment (FPI), draw-down on foreign reserves, foreign loans and credits etc (Obadan, 2004). Theoretical literature has

provided evidences of the benefits of capital flows; ironically, empirical evidence had established that they are not randomly available globally (Aremu, 2003). One of the fundamental issues of capital flows is the high risk of volatility, especially, FPI (short-term flows) that could be reversed at short notice, and probably leading to financial crisis<sup>2</sup>. The dangers of sudden capital flight are that they may create challenges for monetary policy and inflation management as well as foreign exchange rate stability and export competitiveness, especially, in countries with weak financial sectors and inappropriate macroeconomic policies.

Krugman (1979) in his seminal paper argued that financial crisis occurs when the continuous deterioration in the economic fundamental becomes inconsistency with an attempt to fix the exchange rate - typically the persistency of money-financed budget deficit and an attempt to maintain a fixed exchange rate - this has become known as the first-generation models of balance-of-payment crises. Krugman stated that the inconsistency can be temporarily papered over if the central bank has sufficiently large reserves, but when these reserves become inadequate, speculators force the issue with a wave of selling.

In disaggregating short-term capital by purpose and type, Kahler (1998) posited that pension funds and insurance company inflows tend to be relatively stable, while private flows from mutual funds (referred to as "hot money") respond to interest rate differentials among countries and are more quickly withdrawn in a panic. It is the increase in the inflow of hot money that has made emerging countries more vulnerable to financial crises than in the past. Fernandez-Arias and Montiel (1995) in their analytical exposition of surge in capital flows and its sustainability hinted on the possibility of macroeconomic distortions arising from internal imbalances necessitated by distortions in the domestic financial sector, the real economy or from inadequate macroeconomic policy framework. Siegel (1998) maintained that short-term investments that are easily liquidated and speculative capital movements threaten the stability of real economies, especially in the developing world, and force fiscal policy to be on keeping financial markets happy rather than on raising standards of living.

Financial crisis, however, may occur without changes in macroeconomic fundamentals and models built along this line are called second-generation models of balance-of-payment crises. First, there are situations where crises occur as a consequence of pure speculation against the currency. Calvo and Mendoza (1997) developed the model of herding behaviour; the model stresses

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<sup>2</sup>ibid.

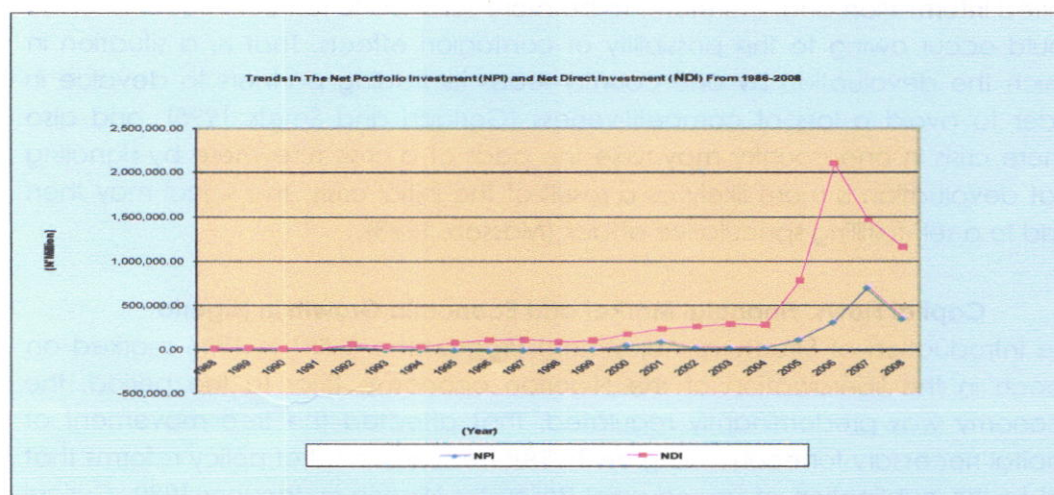


that information costs may lead foreign investors to take decisions based on limited information and, therefore, to be more sensitive to rumours. Second, crises could occur owing to the possibility of contagion effects. That is, a situation in which the devaluation by one country leads its trading partners to devalue in order to avoid a loss of competitiveness (Gerlach and Smets 1995), and also where crisis in one country may raise the odds of a crisis elsewhere by signaling that devaluation is more likely as a result of the initial crisis. The signal may then lead to a self-fulfilling speculative attack (Masson, 1998).

### **III. Capital Flows, Financial Market and Economic Growth in Nigeria**

The introduction of Structural Adjustment Programme (SAP) in 1986 marked an epoch in the liberalization of the Nigerian economy. Prior to the period, the economy was predominantly regulated, that affected the free movement of capital necessary for economic growth. SAP heralded a lot of policy reforms that led to the publication of an Industrial Policy for Nigeria in January 1989. Critical policy reforms leading to the changes in the investment climate in Nigeria for both domestic and foreign investors (provision of enormous opportunity to participate in the economy) were the abrogation of the Nigerian Enterprises Promotion Decree 1989 and the Exchange Control Act of 1962 as well as their subsequent replacements with the Nigerian Investment Promotion Council Decree No 16 of 1995 and Foreign Exchange (Monitoring and Miscellaneous Provisions) Decree 17 of 1995.

As mentioned earlier, the country did not record any NPI on her BOP until 1986. Onosode (1997) posited that between July 1995 and July 1996, about US\$6.0 million foreign portfolio investment (FPI) was made in the Nigerian capital market through the Nigerian Stock Exchange (NSE) for the first time since 1962, while for the whole of 1996, foreign investment through the Nigerian Stock Exchange totaled UD\$32.99 million.

**Figure 1: Trends in Net Portfolio Investment and Net Direct Investment from 1986 – 2008**

In 1986, the NPI in Nigeria was ₦151.6 million. It rose to ₦51,079.13 million in 2000. By 2005, there was a tremendous increase in the NPI figure in Nigeria. It increased from ₦51,079.13 million to ₦116,035.00 million from 2000 to 2005, (a growth rate of 127.17 per cent). It marked the period when the banks were statutorily mandated to shore up their capital base from mere ₦2.0 billion to ₦25.0 billion. It rose to a record level of ₦703,677.60 million in 2007 before declining to ₦350,919.40 million in 2008. Similarly, the NDI was ₦735.8 million in 1986 and rose to ₦115,952.16 million in 2000. It further increased from ₦654,193.10 million in 2005 to ₦1,779,594.80 million in 2006, indicating a growth rate of 172.02 per cent. It, however, dropped to ₦759,350.40 million in 2007 before rising to ₦802,615.70 million in 2008. Comparatively, the NPI and NDI recorded an average annual figures of ₦74,625.76 million and ₦241,075.27 million during 1986 - 2008.

The capital flows into the Nigerian economy has not really been tremendous when compared with flows into some developing economies of South Africa and Brazil. For example, from 2001 to 2007, the average annual capital inflows into Nigeria in terms of FDI and FPI were US\$33,006 million and US\$60,172 million, while South Africa and Brazil were US\$64,237 million and US\$69,998 million, US\$182,441 million and US\$240,451 million, respectively. FPI and FDI into Malaysia were US\$47,256 million and US\$45,693 million, respectively.



**Table 1: Capital Flows into Nigeria in Relation to Some other Countries from 2001-2007 (US\$ Million)**

Year	Nigeria (US\$'M)		South Africa (US\$'M)		Brazil (US\$'M)		Malaysia (US\$'M)	
	FDI	FPI	FDI	FPI	FDI	FPI	FDI	FPI
2001	21,010	65,197	30,569	26,402	121,948	151,741	33,972	15,369
2002	25,222	76,929	30,604	35,677	100,863	137,355	37,542	15,844
2003	45,431	116,450	46,869	46,257	132,818	166,095	41,188	22,822
2004	51,109	132,351	64,451	62,853	161,259	184,758	43,047	50,938
2005	26,345	6,613	78,986	82,837	195,561	232,627	44,460	46,054
2006	29,313	9,028	87,765	102,750	236,184	300,582	53,836	65,764
2007	32,613	14,635	110,415	133,213	328,455	509,999	76,748	103,058

Source: International Financial Statistics (IFS), April, 2009

**Table 2: Net Portfolio Investment (NPI), Net Direct Investment (NDI), Foreign Direct Investment (FDI) Inflow, Outflow and Net Flow into Nigeria**

Year	NPI (N'M)	NPI Growth Rate (%)	NDI (N'M)	NDI Growth Rate (%)	Inflow of FDI (N'M)	Outflow of FDI (N'M)	Net Flow of FDI (N'M)
1986	151.60		735.80	69.50	4,024.00	1,524.40	2,499.60
1987	4,353.10	2,771.44	2,452.80	233.35	5,110.80	4,430.80	680.00
1988	2,611.80	(40.00)	1,718.20	(29.95)	6,236.70	4,891.10	1,345.60
1989	(1,618.80)	(161.98)	13,877.40	707.67	4,692.70	5,132.10	(439.40)
1990	(435.20)	(73.12)	4,686.00	(66.23)	10,450.20	10,914.50	(464.30)
1991	(594.90)	36.70	6,916.10	47.59	5,610.20	3,802.22	1,802.00
1992	36,851.80	(6,294.62)	14,463.10	109.12	11,730.70	3,461.50	8,269.10
1993	(377.00)	(101.02)	29,660.30	105.08	42,624.90	9,630.50	32,994.50
1994	(203.50)	(46.02)	22,229.20	(25.05)	7,825.50	3,918.30	1,455.60
1995	(5,785.00)	2,742.75	75,940.60	241.63	55,999.30	7,322.30	48,677.10
1996	(12,055.20)	108.39	111,297.80	46.56	5,672.90	2,941.90	2,731.00
1997	(4,780.50)	(60.34)	110,456.20	(0.76)	10,004.00	4,273.00	5,731.00
1998	(637.52)	(86.66)	80,750.35	(26.89)	32,434.50	8,355.60	24,079.70
1999	1,015.74	(259.33)	92,792.47	14.91	4,035.50	2,256.40	1,779.10
2000	51,079.13	4,928.76	115,952.16	24.96	16,453.60	13,106.60	3,347.00
2001	92,518.92	81.13	132,433.65	14.21	4,937.00	1,560.00	3,377.00
2002	24,789.19	(73.21)	225,971.96	70.63	8,988.50	781.70	8,206.80
2003	23,555.51	(4.98)	258,388.61	14.35	13,531.20	475.10	13,055.60
2004	23,541.00	(0.06)	248,224.55	(3.93)	20,064.40	155.70	19,908.70
2005	116,035.00	392.91	654,193.10	163.55	26,983.70	202.40	25,881.20
2006	311,780.30	168.70	1,779,594.80	172.03	41,734.00	263.10	41,470.70
2007	703,677.60	125.70	759,380.40	(57.33)	54,254.20	328.80	53,924.80
2008	350,919.40	(50.13)	802,615.70	5.69	37,977.70	4,362.50	33,615.20

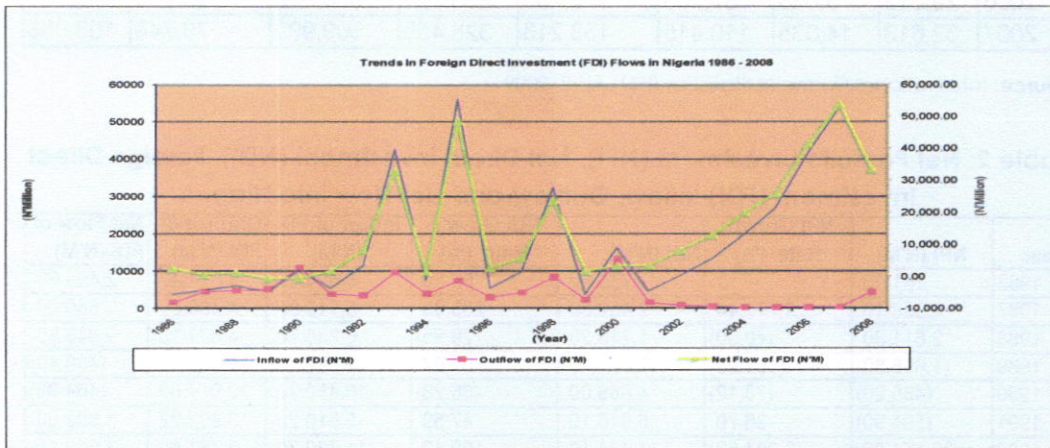
Source: CBN Statistical Bulletin, 50 Years Special Anniversary Edition, 2008 is provisional figure.

Within the period, 1986 – 2008, the inflow of FDI was ₦4,024.00 million in 1986, while the outflow was ₦1,524.40 million, resulting in a net flow of ₦2,499.60 million. In 2000, ₦16,453.60 million was FDI inflow compared with ₦13,106.60 million outflow. In 2007, the FDI inflow and outflow were ₦54,254.20 million and ₦328.80 million,



respectively, while the net flow was ₦53,924.80 million. However, in 2008, the inflow dropped to ₦37,977.70 million, while the outflow increased to ₦4,362.50 million, resulting in a net flow of ₦33,615.20 million. Averagely, the annual FDI inflow and outflow in the economy for the period under review was ₦18,755.49 million and ₦4,090.89 million, respectively, thereby, resulting in a net flow of ₦14,518.59 million. Achieving a positive net foreign investment is important in influencing the overall position of a country's external sector.

**Figure 2: Trends in Foreign Direct Investment (FDI) Flows in Nigeria (1986 - 2008)**



The Nigerian financial market has been witnessing growth since 1970s, although it remains relatively shallow when compared with some advanced and emerging countries. However, within the sub-Saharan African countries, the Nigerian financial market is noted to be among the largest with fairly diversified financial institutions and instrument (Nnanna, et al, 2004). Apart from the law reforms, there was also the economic and financial sector policy reforms designed to reduce barriers and attract investment into the country; easing of import and customs controls, infrastructural investment and financial innovations. The market has recorded tremendous achievements in the banking and insurance sub-sectors. The Nigerian financial markets is dominated mainly by the deposit money banks (DMBs'), while the markets accounted for 93.0 per cent of non-central bank assets in 2000 (World Bank, 2000) and 94.0 and 95.2 per cent of the aggregate financial savings in 2002 and 2003<sup>3</sup>, respectively as well as 60.0 per cent of the stock market capitalization<sup>4</sup>. The banking sub-sector reform was adjudged as the

<sup>3</sup>Op. cit

<sup>4</sup> Paper presented by the Banking Supervision Department, Central Bank of Nigeria at the Monetary Policy Department's retreat in Kaduna, January 30-31, 2009



most successful, with the emergent of 24 strong banks (initially 25) down from 89, larger capital base (from under US\$3.0 billion to over US\$9.0 billion), rating of Nigerian banks by international rating agencies (S & P; Fitch) for the first time, branch network increased from 3,200 in 2004 to 3,866 in April 2007.

**Table 3: Selected Financial Market Deepening Indicators**

Year	GDP at Current Basic Prices (N'Million)	Money Supply (M2) (N'Million)	Credit To Private (CPS) (N'Million)	Market Capitalisation (MC) (N'Million)	MC/GDP (%)	Financial Deepening (M2/GDP) (%)	Financial Deepening (CPS/GDP) (%)
1986	69,147.00	27,389.80	18,299.90	6,800.00	9.8	39.6	26.5
1987	105,222.80	33,667.40	21,892.50	8,300.00	7.9	32.0	20.8
1988	139,085.30	45,446.90	25,472.50	10,000.00	7.2	32.7	18.3
1989	216,797.50	47,055.00	29,643.90	12,800.00	5.9	21.7	13.7
1990	267,550.00	68,662.50	35,436.60	16,400.00	6.1	25.7	13.2
1991	312,139.70	87,499.80	42,079.00	23,100.00	7.4	28.0	13.5
1992	532,613.80	129,085.50	79,958.90	31,300.00	5.9	24.2	15.0
1993	683,869.80	198,479.20	95,529.70	47,400.00	6.9	29.0	14.0
1994	899,863.20	266,944.90	151,000.30	66,400.00	7.4	29.7	16.8
1995	1,933,211.60	318,763.50	211,358.60	180,300.00	9.3	16.5	10.9
1996	2,702,719.10	370,333.50	260,613.50	285,800.00	10.6	13.7	9.6
1997	2,801,972.60	429,731.30	319,512.20	282,000.00	10.1	15.3	11.4
1998	2,708,430.90	525,637.80	372,574.10	262,500.00	9.7	19.4	13.8
1999	3,194,015.00	699,733.70	455,205.20	300,000.00	9.4	21.9	14.3
2000	4,582,127.30	1,036,079.50	596,001.50	472,300.00	10.3	22.6	13.0
2001	4,725,086.00	1,315,869.10	854,999.30	662,600.00	14.0	27.8	18.1
2002	6,912,381.30	1,599,494.60	955,762.10	764,900.00	11.1	23.1	13.8
2003	8,487,031.60	1,985,191.80	1,211,993.40	1,359,300.00	16.0	23.4	14.3
2004	11,411,066.90	2,263,587.90	1,534,447.80	1,925,900.00	16.9	19.8	13.4
2005	14,572,239.10	2,814,646.10	2,007,355.80	2,900,100.00	19.9	19.3	13.8
2006	18,564,594.70	4,027,901.70	2,650,821.50	5,120,900.00	27.6	21.7	14.3
2007	20,657,317.70	5,809,826.50	5,056,720.90	13,294,600.00	64.4	28.1	24.5
2008	24,296,329.30	9,166,835.30	8,059,548.90	9,516,200.00	39.2	37.7	33.2

Source: Computed from the CBN Statistical Bulletin, 50 Years Special Anniversary Edition

In terms of financial market performance, the money supply (M2)/GDP ratio, which measures the financial depth of the economy, was 39.6 per cent in 1986, and by 1996, it declined to 13.7 per cent. However, it rose from 21.7 to 37.7 per cent between 2006 and 2008. Similarly, the credit to private sector (CPS)/GDP ratio, which was 26.5 per cent in 1986, declined to 9.6 per cent in 1996. Between 2006 and 2008, it grew from 14.3 to 33.2 per cent. On the domestic capital market, the market capitalization (MC)/GDP ratio<sup>5</sup> grew from 9.8 to 10.6 per cent between 1986 and 1996. Apart from the decline witnessed from 1997-1999, it grew from 10.3 to 64.4 per cent from 2000 – 2007. However, it declined to 39.2 per

<sup>5</sup> The size of the stock market is assessed by its market capitalization relative to GDP. This measures equity trading as share of national output. It does not indicate how much firms have invested, it does give an indication of the potential to raise funds for investment through the stock market and provides information on prices that guide the allocation of resources (ibid.)

cent in 2008. The decline in the growth rate could be attributed to the impact of the global financial and economic crises.

**Table 4: Selected Macroeconomic Indicators**

Year	Real Gross Domestic Product (RGDP) (%)	Fiscal Balance/GDP (FB/GDP) (%)	Inflation Rate (%)	External Reserve (US\$)	Current Account Balance/GDP (CAB/GDP) (%)
1986	2.45	-11.94	5.40	2.84	11.58
1987	-0.57	-5.60	10.20	7.50	16.29
1988	7.36	-8.74	38.30	5.23	22.71
1989	7.67	-6.98	40.90	3.05	27.27
1990	13.02	-8.27	7.50	4.54	29.83
1991	-0.81	-11.45	13.00	4.15	16.65
1992	2.26	-7.42	44.50	1.55	17.59
1993	1.28	-9.53	57.20	1.43	-5.03
1994	0.22	-7.81	57.00	9.01	-6.03
1995	2.16	0.05	72.80	1.61	-9.73
1996	4.38	-0.45	29.30	3.40	8.89
1997	2.82	-2.75	8.50	7.22	9.60
1998	2.94	-4.92	10.00	7.11	-12.24
1999	0.42	-8.93	6.60	5.42	1.45
2000	5.44	-2.26	6.90	9.39	15.56
2001	8.45	-4.68	18.90	10.27	2.31
2002	21.35	-4.36	12.90	7.68	-1.69
2003	10.23	-2.39	14.00	7.47	8.30
2004	10.48	-1.51	10.00	16.96	18.02
2005	6.51	-1.11	11.60	28.28	27.77
2006	6.03	-0.54	8.50	42.30	18.18
2007	6.52	-0.57	6.60	51.33	13.09
2008	6.71	-0.20	15.10	53.00	17.41

**Source:** Computed from the CBN Statistical Bulletin, 50 Years Special Anniversary Edition

In addition, review of the macroeconomic environment indicated that from the introduction of SAP in 1986 through 1996, the average annual real GDP growth was 3.6 per cent. Between 1986 and 1996, the fiscal balance (FB)/GDP ratio improved from -11.9 to -0.45 per cent, while inflation rate worsened from 5.4 to 29.3 per cent. During the period, the current account balance (CAB)/GDP ratio declined from 11.6 to 8.9 per cent, while the stock of external reserves grew from US\$2.84 billion to US\$4.5 billion by end-December 1996. By 1995, the federal government abandoned the SAP and moved to a partial or guided deregulation of the economy. Comparatively, the average annual real GDP growth improved to 7.4 per cent from 3.6 per cent between 1997–2007 and 1986–1996, respectively, while it was 6.7 per cent in 2008. Meanwhile, the period 1999–2008, witnessed a stable democratic polity and this no doubt, would have influenced some of the macroeconomic aggregates. For example, the real GDP grew from mere 0.42 to 6.7 per cent between 1999 and 2008, while the fiscal balance (FB)/GDP ratio dropped from -8.93 to -0.20 per cent during the same period. Furthermore, the stock of external reserves grew from US\$5.42 billion to US\$53.0 billion by end-December 2008 between 1999 and 2008, while the current account balance (CAB)/GDP ratio increased from 1.5 to 17.4 per cent, respectively. Notwithstanding, the inflation rate soared from 6.6 to 15.1 per cent during the period.



## **4. Emerging Economies and Global Financial Crises**

### **4.1 Emerging Economies Financial Crisis**

The emerging economies have suffered three major financial crises since 1982: the American debt crisis of the 1980s, the Mexican crisis of 1994–1995 and the Asian crisis of 1997. Financial crises seem to have become the norm rather than the exception. In 1992-93, Europe was faced with possible threat of the collapse of the European Exchange Rate Mechanism (ERM). The Italian lira and British pound were withdrawn from the ERM, three other currencies (viz. the Spanish peseta, Irish pound and Danish krona) were devalued, and there was a substantial widening of the bands within which the currencies could fluctuate. In 1994-95, there was the Mexican currency crisis which saw a devaluation of the peso and brought Mexico to the brink of default. There were also spillover effects on Argentina and Brazil. Between July 1997 and mid-1998, the world experienced the effects of the East Asian crisis, which started with a run on the Thai baht, but spread to a number of other regional currencies, most notably the Indonesian rupiah, Malaysian ringgit and Korean won (so-called "Tom-Yam effect"). Also, some other large emerging economies such as Russia and Brazil were rocked by periods of significant market weakness, which required the assistance of the IMF (Ramkishan, 2005).

During 2007–2009, the world experienced financial and economic crises - following a period of unprecedented economic boom, a financial bubble, global in scope and brought about by the collapse of the US sub-prime mortgage market and the reversal of housing boom in other industrialized economies in 2007. The crises were also attributed to financial products engineering - financial products and instruments becoming so complex, leaving the regulators with the daunting task of coping with the complexity of financial innovations.

#### **4.1.1 Mexico Crisis 1994-95**

Before the financial crisis eruption in Mexico, the economy witnessed a tremendous surge in capital inflows in the early 1990's culminating in high growth rate of GDP, considered to be fundamentally sound and seen as a model for other growing economies to emulate. The Mexican government initiated structural changes and macroeconomic stabilization policies in the 1980 that provided an investment friendly climate and macroeconomic stability that were contributory to the capital inflows. Obadan (2004) observed that the economic environment was thus suitable for capital inflows, which were very significant and amounted to over US\$100.0 billion in 1990-93. A substantial part of the financial inflows was however, in the form of equity and debt portfolio investments, that is

highly volatile. Furthermore, a large part of the inflow was used in financing consumption and public borrowing.

The once eulogized financial success started crumbling when the investors suddenly changed their attitudes, leading to interruption of capital flows, which affected the economy. By December 1994, the heightened inconsistency in monetary, fiscal and exchange rate policies caused huge capital reversals. In addition, investor's perception of the likely devaluation of the peso made the economy vulnerable to financial market crisis; speculative attack and massive capital outflow, as its foreign exchange reserves fell to US\$12.9 billion from over US\$30.0 billion. Many factors contributed to the crisis suffered by Mexico, among which are; large and growing current account deficits, rapid growth of capital inflows, which were mostly in the form of short-term investment (Hot Money), declining foreign reserve, increases in the USA rates, weaknesses in the financial system and political unrest.

#### **4.1.2 The East Asian Crises 1997-98**

Before the Southeast Asian crises began in 1997, Asia attracted almost half of the capital inflows to the developing countries. Southeast Asia in particular had high interest rates that attracted foreign investors. This led to a large inflow of money and a run-up in the asset prices. At the same time, the regional economies of Thailand, Malaysia, Indonesia, Singapore and South Korea experienced high GDP growth rates, 8-12 per cent, in the late 1980s and early 1990s. The Southeast Asian economies, however, started witnessing distress with the financial collapse of the Thai Baht, which was caused by the Thai government floating of the Baht, cutting its peg to the US\$ and attempts to protect it in the face of severe financial stress.

During the crisis, Thailand had acquired a burden of foreign debt that made the country effectively bankrupt even before the collapse of its currency. As the crisis spread, most of the Southeast Asian economies experienced a drop in currencies, devalued stock markets and other asset prices, and a precipitous rise in private sector debt. By mid-1990s, Thailand, Indonesia and South Korea had large private current account deficits and the maintenance of fixed exchange rate encouraged external borrowing and led to excessive exposure to foreign exchange risk in both the financial and corporate sectors. Foreign debt-to-GDP ratios rose from 100 to 167 per cent in the four large ASEAN economies in 1993-96, while it shot up beyond 180 per cent during the worst period of the crisis. In Korea, the ratios rose from 13 to 21 per cent and then as high as 40 per cent. Many factors had been adduced as being responsible for the crises that engulfed the Southeast Asian economies. The financial crises may have had its origin traced to



1994, when China, a large economy in Asia effectively devalued its currency by 40.0 per cent and Japan, the second largest world economy, devalued its currency (the yen) by about 25.0 per cent from early 1995 to late 1996. The financial liberalization in Thailand led to rapid and uncontrolled build up of short-term debt by the private sector – a real estate bubble burst in Thailand. The bubble had been created by huge inflows of external capital. Private capital flows into Thailand between 1988 and 1995 totaled 52 per cent of GDP.

#### 4.1.3 Recent Global Financial and Economic Crises

The financial and economic crises currently enveloping the world economies had its origin to the USA sub-prime housing mortgage crisis, which spilled over to many other economies. The roots are in banking rather than in securities market or foreign exchange unlike what happened with the Mexican and Asian crises. Even countries not affected by the financial crisis are now affected by 'second-round effects' as the crisis now becomes 'economic' (Soludo, 2007). It started in June, 2007, when two Bear Stearns hedge funds collapsed. The mortgage brokers were driven by the lure of big commissions, talked buyers with poor credit into accepting housing mortgages with little or no down payment and without credit checks, while banks and financial institutions often repackaged these debts with other high-risk debts and sold them to world-wide investors creating financial instrument, Collateralized Debt Obligations (CDO) (Oluba, 2009).

The crises has led to unprecedented liquidity crunch: banks withholding lending facility; foreclosure of assets, including houses and consumer products; banks and banking products ratings being down-graded; weakened financial system; and loss of confidence in the capital market as well as a collapse or near collapse of some banks and industries. In attempt to restore confidence in the financial system and halt the colossal damages it has continued to inflict on world economies, banks, investment companies and manufacturing industries are being bailed out by governments in the USA, Europe and Asia through all sorts of intervention; partial nationalization, outright buy-over and injection of funds.

The crises have claimed great toll in many economies. Nigeria may not be insulated from the global financial and economic turmoil considering her increasing market size and economic deregulation as well as the impact of globalization. Soludo (2009) and Mordi (2009) aptly captured the impact of the global financial and economic crises on the Nigerian economy as: capital market downturn caused by foreign investors' divestment and panic sales by local investors', resulting in stock market crash as the All-Share Index (ASI) and Market Capitalization (MC) fell by 67.2 and 61.7 per cent, respectively, between

April 2008 and March 2009. Furthermore, they stated that as liquidity squeeze sets in and funds dried up, there was increase in the money market rates as well as increased demand pressure in the foreign exchange market, resulting in the exchange rate depreciation from ₦117 to ₦135 per US dollar as at end-December 2008 as well as high outflows and low inflows of foreign exchange into the economy.

#### **4.2 Lessons**

The lessons to be learnt are double-fold. First, the demonstration that crises; currency, financial and economic can quickly spread from country to country notwithstanding the macroeconomic fundamentals of countries involved. This is underscored by the glowing impact of globalization as natural geographical barriers of nations become broken down. The Mexican crisis of 1994-95 and East Asian Crises 1997-98 provides great lessons for developing countries. It represents a typified textbook example of what could happen to an economy aiming at having a flexible exchange rate, active monetary policy as well as open capital account, all at the same time, in what has come to be known as "impossible or inconsistent triology" model. The lessons include avoiding exchange rate pegs, strengthening financial systems, creating effective ways of restructuring company finances as well as being conscious of the structure and nature of capital flows.

Second, that in pursuit of industrialization through financial market development and capital accounts liberalization, economies is predisposed to all forms of risks and uncertainties. Consequently, economic policies and programmes should be developed and implemented in order to withstand such exigencies. Thus, this calls for institutional strengthening and development that would match the ever-increasing financial innovations; leveraging and swaps, etc; modern information society – that has broken down the natural barriers to the free movement of capital. Intelligent supervision and regulation of the financial system, more accurate information, and disciplined professional, devoid of corruption and cronyism, all these would in principle improve the efficiency and effectiveness of the financial system.

### **5. Policy Issues, Challenges and Recommendations**

#### **5.1 Policy Issues and Challenges**

There are serious policy issues about capital flows because of their potential effects on macroeconomic stability, monetary and exchange rate management, competitiveness of the export sector and external viability. This is because no matter the nature of capital flows (flows over a medium-to-long-term), they are expected to influence the monetary aggregates, especially the economy's net



foreign assets (NFA), inflation, real effective exchange rate, aggregate output (GDP) and possibly the domestic interest rates. The challenge is to understand what drives the capital flows and the impact of its sudden surge or reversal on the economy. No doubt, this may be country specific. However, the causes of capital flows can be generally grouped into three major categories: autonomous increases in the domestic money demand function; increases in the domestic productivity of capital; and external factors, such as falling international interest rates. The first two are usually referred to as "pull" factors, while the third is "push" factors. Interest rates can be useful for determining whether capital inflows are caused by "pull" or by "push" factors. Other things being equal, inflows driven by "pull" factors will be associated with upward pressure on domestic nominal interest rates, while inflows due to "push" factors, such as decline in international interest rates, will tend to put downward pressure on domestic interest rates.

Returns to foreign investors can also provide useful information: real returns, which depend on the expected path of the exchange rate, can be a key determinant. Closely related to this is the issue of trying to have a flexible exchange rate, active monetary policy as well as open capital account of the BOP, all at the same time ("impossible or inconsistent triology"). It may be difficult to achieve the triology in the presence of increasing capital flows or sudden reversals. The major policy challenge is developing optimal policy mix that would ensure the achievement of macroeconomic stability - maintaining both internal and external balances in the economy in the wake of capital surge or reversal.

The emergence of integrated financial markets and high capital mobility, fast-tracked by the globalization of world economies and information technology has predisposed economies, especially developing ones to the volatility of capital flows as well as the challenges of coping with the increasing financial market innovations; securitization of debt instruments into various swaps, derivatives (complex of financial innovations). These have left financial regulatory authorities enmeshed in loose financial system supervision and regulation.

The policy of liberalizing the financial market and capital account in the quest for economic reforms could exert heavy pressure on the macroeconomic variables, where the capital flows are channeled through inefficient and unsophisticated domestic banking systems; the rapid expansion of bank credit, strained credit assessment capabilities (bank supervision) and funds flowing into unprofitable or speculative activities. In addition, the challenge of corporate governance; issue of corruption in the private sector, especially the banking sector has more than ever required the attention of both the regulatory authorities and law

enforcement agencies. The ever-increasing pressure of meeting shareholders expectations; domestic and cross-border expansions, growing cases of non-performing loans, apparently, facilitated by the banks executives and cronies, have invoked the need for adequate prudential supervision and regulation.

## **5.2 Recommendations**

### **(i) Adequate Prudential Supervision and Regulation**

Increase in capital flows could lead to expansion of bank credit as money balances increase. With a poorly supervised and weak banking system, the increase in commercial banks' reserves could encourage excessive risk-taking in lending to unprofitable and speculative activities. Building a strong institution and implementing sound supervision and regulations will help in reducing the risk of financial and currency crises - strengthening banking systems is important to ensuring that any increased capital inflows are allocated to their most efficient uses, instead of being loaned to cronies or directed to inefficient state-sanctioned projects.

### **(ii) Prudent Fiscal Policy.**

In the event of massive flow of capital, prudent fiscal policy is often left as the only tool of stabilization - leading to the imposition of capital controls as a policy option in instances of destabilization caused by massive short-term flows or capital reversals occasioned by change in macroeconomic fundamentals. However, when capital controls are in place for a long time, they tend to become less effective with respect to flows and may hinder the development of the financial system and undermine the efficiency of resource allocation. The choice of prudent fiscal policy should be seen as a temporary measure by the fiscal authority to sterilize the effect of capital flows surge or sudden reversal.

### **(iii) Understanding the Composition of Capital Flows**

As stated earlier, understanding the composition of capital flows and what drives the flows is very important in assessing the macroeconomic impact of capital flows in an economy. To this end, it is therefore, necessary to monitor the composition of the capital flows, including the currency composition and the distribution between NDI and NPI as well as the short-term borrowing of banks and government.

### **(iv) Building a Stable Macroeconomic Environment.**

Large foreign reserves may constitute a temporary solution to an economy in the face of growing financial market turmoil, external shocks and its consequences on growth. Building large external reserves may not be a wrong policy direction



insofar as it is aimed at protecting against interest and exchange rate fluctuations as well as short-term funding disruptions. However, it is not a sufficient solution to financial crisis. Developing comprehensive strategies that would forestall macroeconomic volatility, and strengthen an economy's ability to absorb both internal and external shocks is fundamental in managing financial crisis.

**(v) Sequencing Capital Account Liberalization**

Once a country opens up her economy to capital flows, it has to brace up against capital flows vulnerability. As the economy dismantles some of the impediments to capital flows, it should be cautious in liberalizing her capital account since this will help to insulate the economy in the wake of destabilizing surge of inflows or reversal of capital. Capital account liberalization should be done in an orderly and structured manner taking cognizance of the economy's level of development.

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