# HIGH-LEVEL CONFERENCE ON MANAGING CAPITAL FLOWS: LESSONS FROM EMERGING MARKETS FOR FRONTIER ECONOMIES

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***TRENDS, DYNAMICS, AND CHALLENGES OF CAPITAL FLOWS TO FRONTIER MARKETS***

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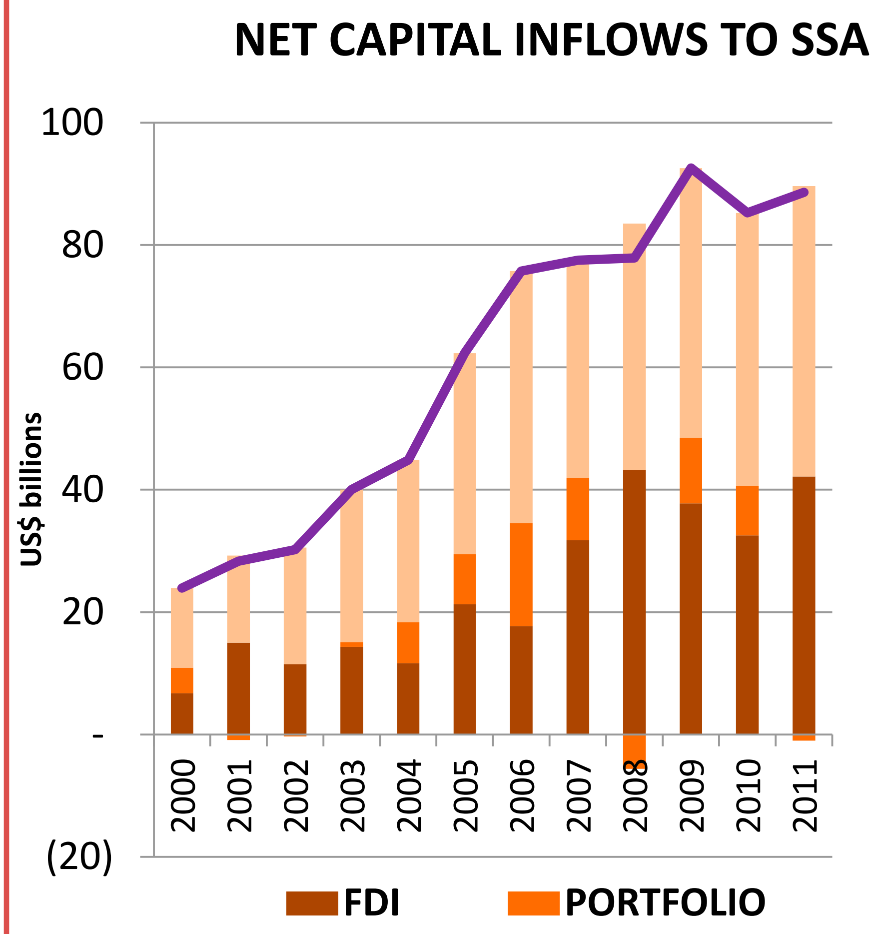
# Capital flows to Frontier Markets

- I will speak on the following (with some reference to EAC and Kenya):
  - Trends and dynamics
  - Characteristics and composition of these flows
  - Challenges
  - Policy measures that can be taken

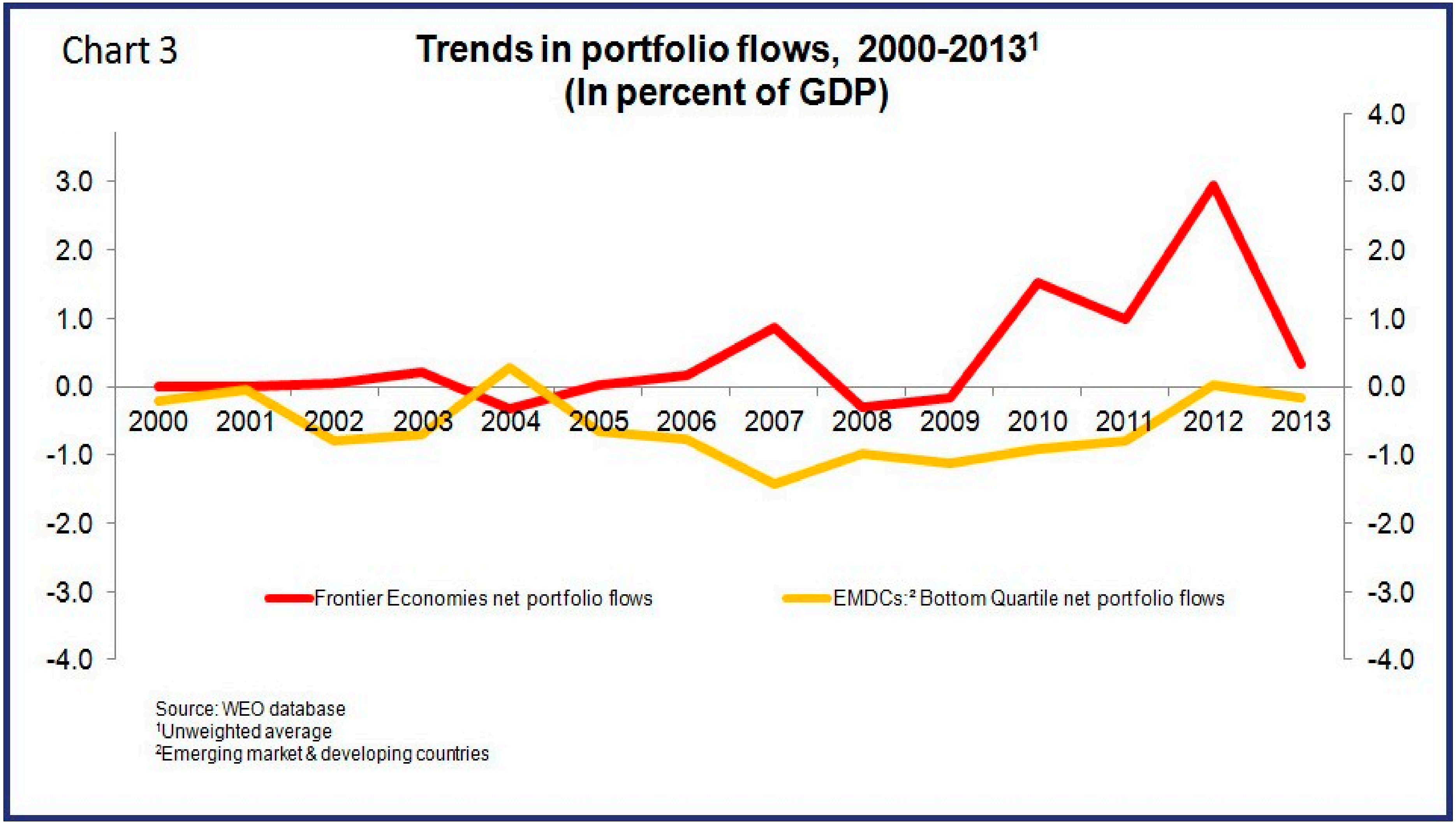
# TRENDS OF CAPITAL FLOWS TO SSA

- Overall, positive picture of increasing capital flows to SSA
  - Both ODA, FDI and Portfolio have increased over time (2000-2011)
  - Outflow in 2008 due to GFC.



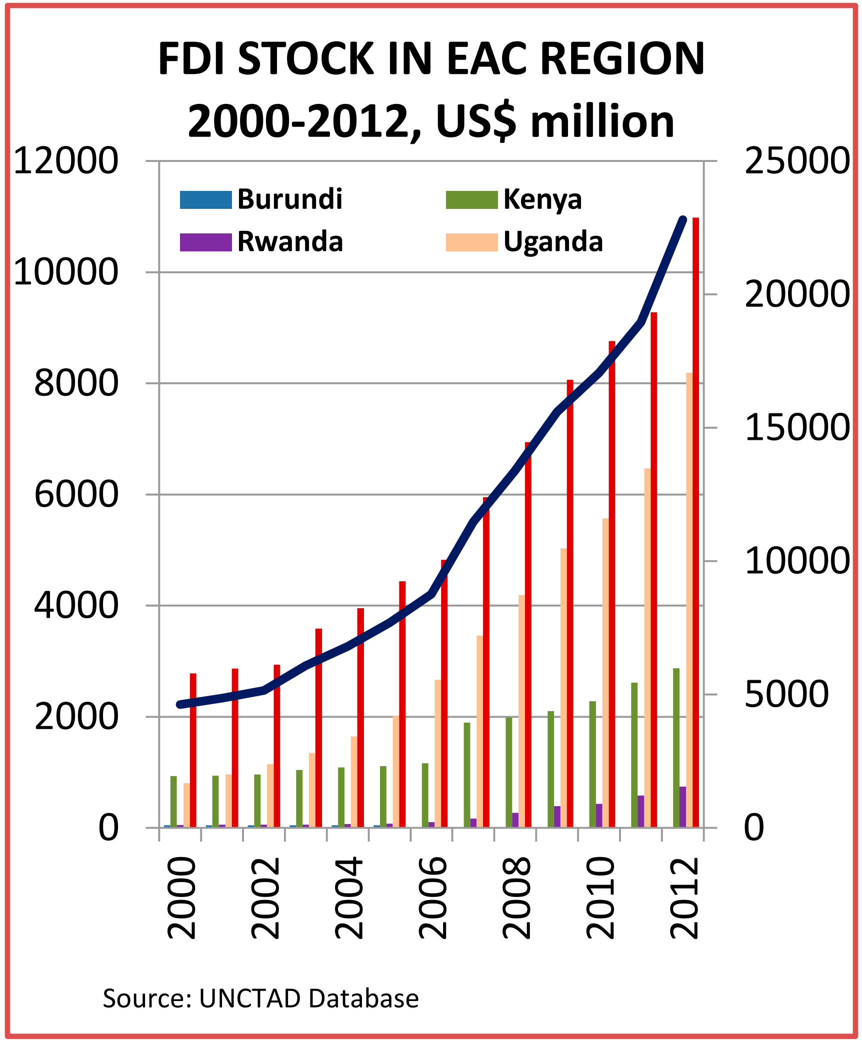

Source: World Bank Database

# Frontier Markets increasingly receiving portfolio flows, but slowed in 2013



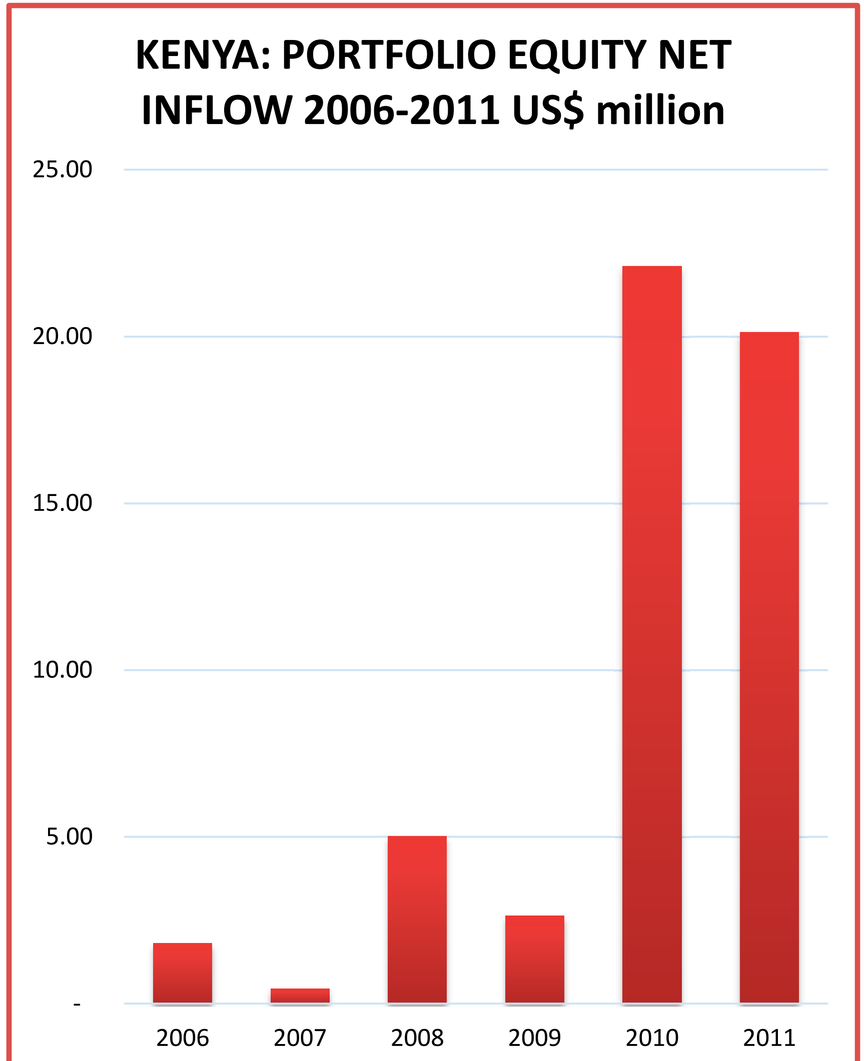
# Capital flows to EAC - FDI

- Stock of FDI has increased over time -- US$ 10 bn in 2007 to US$ 22.8 bn in 2012, largely due to:
    - ➢ Natural resource exploration (oil, gas)
    - ➢ Infrastructure dev't - ports, energy, roads
    - ➢ Cross border banking activities in the region
    - ➢ Expansion of Telecommunication services in Rwanda and Kenya



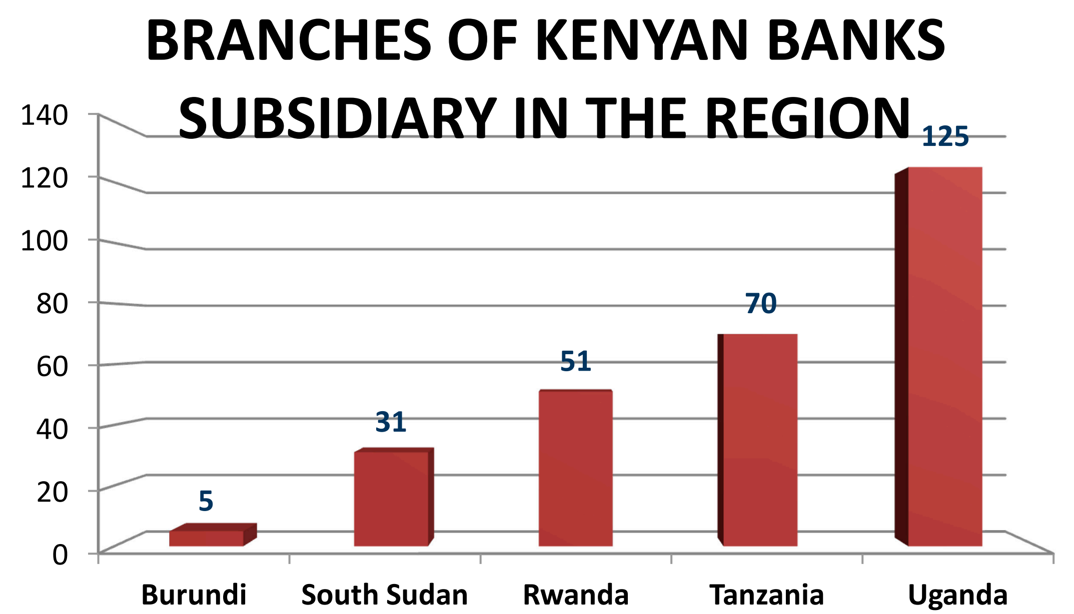
# Capital flows to EAC - Portfolio

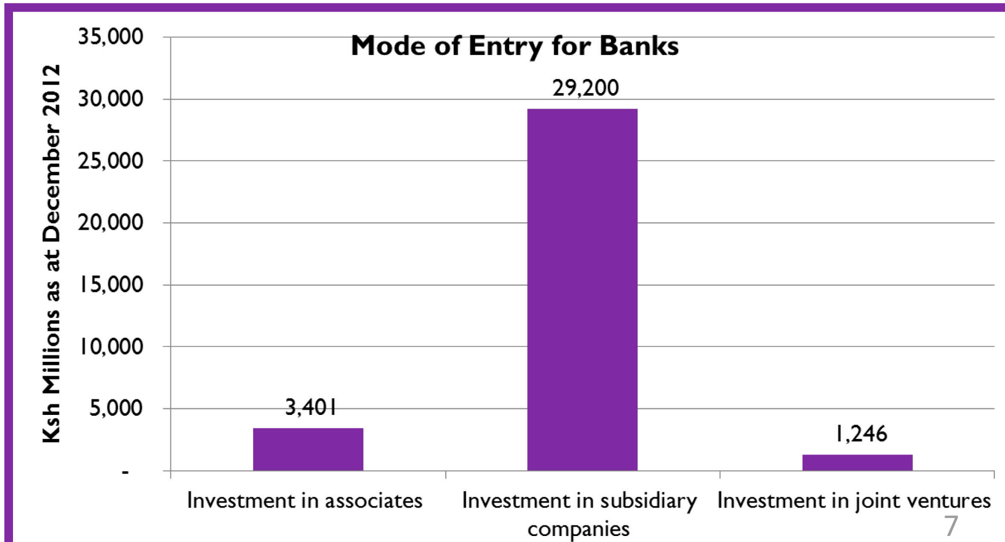
- Portfolio flows in EAC is still low:
  - Presence of capital restrictions in Tanzania, Rwanda, Burundi.
  - Kenya and Uganda do not have restrictions
- In Kenya, net portfolio inflow is gradually rising mainly due
  - Increasing opportunities for investments,
  - increasing returns to investments, and,
  - declining risks attributed to macroeconomic stability.



# Capital flows to EAC – Banking sector

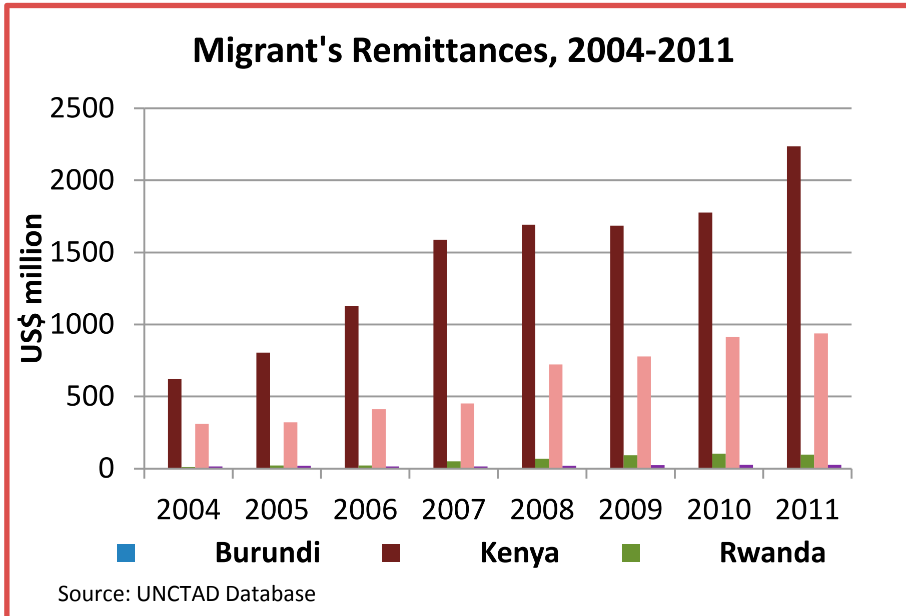
- Cross border capital flows increased steadily in the region due to:
  - Growth in Pan African banking groups in SSA
  - Expansion of Kenyan banks in the EAC member States and S. Sudan (282 subsidiaries as at December 2012)
  - Kenyan banks prefer investing in a subsidiary while expanding to the region

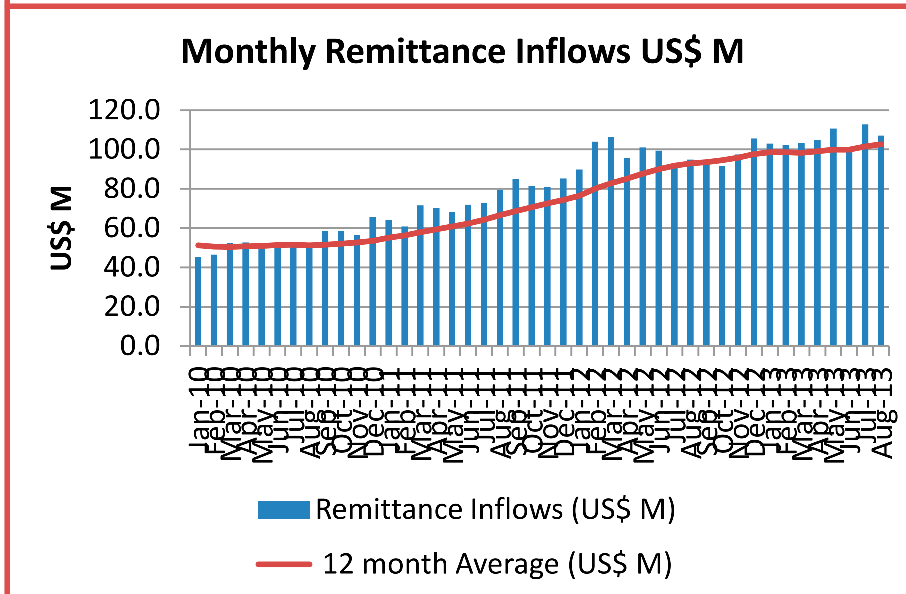


# Remittance flows to EAC

- Increased remittance inflows the EAC region
- For Kenya, remittance inflows have increased significantly
  - averaging about USD 100m per month since January 2013



# In Sum, net capital inflows to FM/EAC/Kenya have increased due to:

- Better economic prospects in FM:
  - Economic reforms (liberalization of the trade, exchange rate and financial sector)
  - Improved macroeconomic management – successful IMF programs, positive ratings (CPIA, S&P, Fitch, etc.), improved creditworthiness
  - Low debt levels
- Investments in infrastructure resulting to stronger growth
- Natural resource exploration
- Cross border investments
- Improved democracy and political stability - risk profiles are changing
- Growing integration in the world capital market - sovereign bonds, portfolio flows and international lending

# Push factors

- Weak economic growth in advanced economies
- Excess liquidity and low bond yields in advanced economies (due to monetary easing) has led to search for better yields

*Risks:*

- Global liquidity are cyclical and can pose balance of payments challenges
  - E.g monetary unwinding in US has put pressure on exchange rates of EM and FM

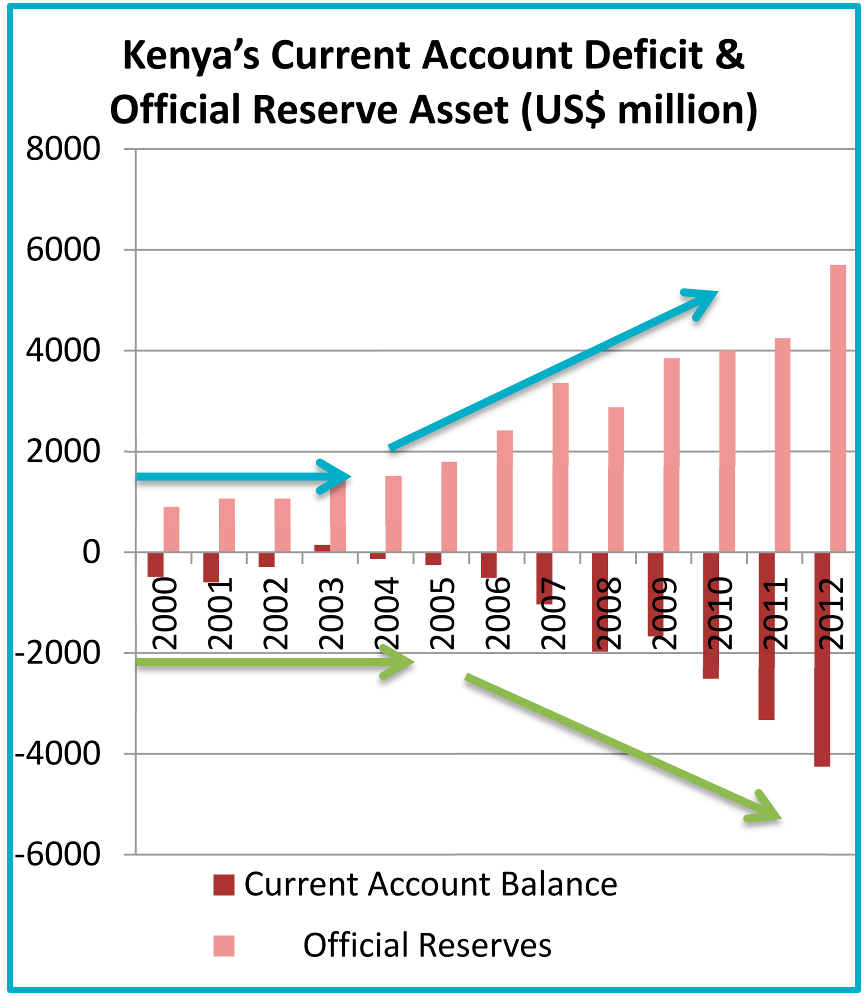
- Investor risk aversion—is highly volatile, and can change abruptly in response to political as well as economic events.

# Challenges of Capital Flows to FM

- Important points to note:
  - **<u>Composition of the flows</u>**: what proportions are ODA, FDI, bank lending, portfolio?
    - Most flows to FM are largely FDI and ODA – good for growth
    - Portfolio flow rising but yet to be significant to pose major risks
      - Links to bank financing that can potentially fuel stock and housing (real) prices are still low
  - **<u>Use of the flows</u>**: are they used for reserve accumulation or financing current account deficits?
    - Some FM have used it to accumulate reserves, others have financed CADs
    - CADs: are they for consumption or productive investments?

# Kenya: Reserve Accumulation Vs CAD

- Capital flows partly used to accumulate foreign exchange reserves
- Also the current account deficit has widened
  - But important to note the dynamics of CADs in FM before making conclusions



# Current Account Deficits in FM/EAC/Kenya

- Are large—around 7-12 percent of GDP
- Driven by rising trade deficits and lower transfers
- ODA and FDI are major sources of financing
  - But more recently, increasing access to external market borrowing—sovereign bond issuance
- Reflects savings-investment gap
  - But public sector fiscal deficits are relatively high

# Current Account Deficits—Issues to note

**FM/EAC/Kenya**

- Large CAD and fiscal deficits largely reflect huge infrastructure investment
  - Consumption spenders need to watch
- Debt levels remain sustainable, even with recent Eurobond issuance
  - *But there is need to be cautious*
- Reserves remain at comfortable levels
  - *But with vulnerabilities precautionary facilities are needed*

**Kenya**

- CAD reflects importation for large infrastructure projects such as Geothermal Plants, SGR, oil and gas exploration equipment
- CAD overstated—transfers (remittance, tourism receipts not fully captured)
- CA deficit reflect fiscal deficit which is financed by concessional ODA
- FDI data understated

# Some policy measures

- Sustained prudent macro management
- Cautious access to external borrowing
- Monitor capital flows and their composition—Improve BOP statistics
- Coordinate cross border surveillance of financial flows
- Strengthen regulatory capital for banks
- Monitor push factors and their potential backlash
- Design new precautionary/Insurance facilities for FM

# CONCLUSIONS

- Capital flows in the FM/EAC region have largely been FDI and ODA, which are long-term in nature, the possibility of capital reversal may be minimal
- The growth in FDI flows has been to the productive sectors of the economy (Infrastructure, IT, Extractive industries and Mining in the last decade), hence boosting investment and growth
- The region has also seen growth in remittance inflows since early 2000 and needs to be properly captured in BOP statistics
- Data challenges underestimate FDI flows and overestimate portfolio flows. This may lead to wrong policy prescription.
- Portfolio flows to the region, if correctly measured, is still low but needs to be monitored closely

# Thank you