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DELAYS IN STABILIZATION OR IN REFORMS? THE DEBT CRISIS 






Carlos ALBERTO CINQUETTI¹, Ricardo GONÇALVES SILVA²

Issue 

The Developing Economies
Volume 46, Issue 3, pages
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Empirical analyses attributing the 1980s' debt crisis to inconsistent stabilization policies rest on an inappropriate long-run approach. Revising this long-run approach yields opposite results: terms of trade shocks and foreign indebtedness explain this crisis, regardless of domestic stabilization policies. This prompts us to consider a new hypothesis, of delays in trade-policy reforms, with a model in which terms-of-trade variation (under shocks) is endogenous to export structure and efficiency of resource allocation. Evidence from the structural equations model shows that allocation distortions negatively affect changes in terms of trade, which then explain this crisis. A political economy extension demonstrates that income inequality and regional trade policy determine the distortions, which in turn leads to this crisis.

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DELAYS IN STABILIZATION OR IN REFORMS? THE DEBT CRISIS

CARLOS ALBERTO CINQUETTI¹ AND RICARDO GONÇALVES SILVA²

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First version received November 2006; final version accepted March 2008

Empirical analyses attributing the 1980s' debt crisis to inconsistent stabilization policies rest on an inappropriate long-run approach. Revising this long-run approach yields opposite results: terms of trade shocks and foreign indebtedness explain this crisis, regardless of domestic stabilization policies. This prompts us to consider a new hypothesis, of delays in trade-policy reforms, with a model in which terms-of-trade variation (under shocks) is endogenous to export structure and efficiency of resource allocation. Evidence from the structural equations model shows that allocation distortions negatively affect changes in terms of trade, which then explain this crisis. A political economy extension demonstrates that income inequality and regional trade policy determine the distortions, which in turn leads to this crisis.

Keywords: Debt crisis; Shocks; Stabilization policies; Trade policies; Inequality; Structural equations

JEL classification: F13, F34, O10

I. INTRODUCTION

THE 1980s' debt crisis, a turning point in the development of developing economies, is seen as an outcome of trade policies, as reinforced by the fact that it hit almost all countries that were following import-substitution industrialization and only a few following outward-oriented growth (Little, Cooper, and Corden 1994; Krueger 1995). Nonetheless, Berg and Sachs (1988) demonstrated that both trade openness and variables related to bad stabilization policies help to explain the observed foreign debt defaults, while external economic vicissitudes

We thank M. Cristina Terra and the two anonymous referees for valuable comments and suggestions. For comments on earlier versions, we also thank Lance Taylor, Kenneth Reinert, Persio Arida, and participants at the Encuentro 2005 de la Sociedad de Economía de Chile, VIII ANPEC/SUL in Porto Alegre, as well as Dani Rodrik for providing his database. Financial support from CNPq, FAPESP and Fundunesp are gratefully acknowledged.

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African Development Review, Vol. 22, No. 3, 2010, 366–377

The Global Financial Crisis and Sub-Saharan Africa: The Effects of Slowing Private Capital Inflows on Growth*

José Brambila-Macias and Isabella Massa**

Abstract: This paper uses the bias-corrected least-squares dummy variable (LSDV) estimator to examine the relationship between economic growth and four different types of private capital inflows (cross-border bank lending, foreign direct investment (FDI), bonds flows and portfolio equity flows) on a sample of 15 selected sub-Saharan African countries over the period 1980–2008. Our results show that FDI and cross-border bank lending exert a significant and positive impact on sub-Saharan Africa's growth, whereas portfolio equity flows and bonds flows have no growth impact. Our estimates suggest that a drop by 10 per cent in FDI inflows may lead to a 3 per cent decrease of income per capita growth in sub-Saharan Africa, and a 10 per cent decrease in cross-border bank lending may reduce growth by up to 1.5 per cent. Therefore, the global financial crisis is likely to have an important effect on sub-Saharan Africa's growth through the private capital inflows channel.

1. Introduction

This paper examines the controversial link between capital flows and economic growth (see, for example, Rodrik and Subramanian, 2009). Looking at the sub-Saharan African region (SSA), it seeks to shed light on the growth impact of different types of private capital inflows. It also discusses the effects so far of the current global financial crisis on private capital flows into SSA, and examines the possible consequences for economic growth of a sudden slowdown or reversal of private capital inflows owing to the current global financial crisis.

Over the past decade, SSA has enjoyed robust growth. Private capital inflows took off, driven by a number of domestic and external factors that contributed towards enhancing the region's attractiveness for foreign investors in search of high yields. Net foreign direct investment (FDI) inflows grew steadily, by about 150 per cent from \$13 billion in 2004 to \$33 billion in 2007; portfolio equity flows took off, reaching a value of \$15 billion in 2006; bonds flows rapidly increased by more than 340 per cent between 2006 and 2007; and international banking activity all expanded significantly.

However, the financial turmoil originated in the developed world in August 2007 has since spread to developing countries, and SSA has not been immune to the secondary effects of the global financial crisis. SSA's growth dropped by 1.4 percentage points to 5.5 per cent in 2008 from 6.9 per cent in 2007; in January 2009, the International Monetary Fund (IMF) once more cut its forecast for growth for this year by 1.6 percentage points to 3.5 per cent. In April 2009, the IMF revised again its forecast leading to a new projection for SSA growth in 2009, equal to 1.7 per cent. Private capital inflows to SSA were relatively robust up to the first half of 2008, but dropped sharply from the third quarter of 2008, because of a reduced capability and propensity to invest on the part of foreign investors. Many bond issuance plans were put on hold in countries such as Ghana, Kenya, Tanzania and Uganda. FDI inflows continued to grow, but at a lower rate. Portfolio equity flows slowed down and sometimes reversed, consistent with sharp falls in stock markets in South Africa, Nigeria, Kenya, Mauritius and Côte d'Ivoire. The first signs of contraction of cross-border bank lending began to emerge: banks' total international claims on Ghana, for example, declined by 11 per cent to \$2,592 million in September 2008 from \$2,916 million in March 2008.

*A previous version of this paper was part of a UK Department for International Development (DFID) funded study at the Overseas Development Institute (ODI) on the effects of the global financial crisis on developing countries. The views presented in this paper are those of the authors and do not necessarily represent the views of the ODI or DFID. The authors would like to thank DFID as well as participants to the 2009 African Economic Conference in Addis Ababa, Ethiopia, and the 2010 ESRC Development Economics Conference in Manchester, UK, for helpful comments and suggestions. The authors are also grateful to an anonymous referee for valuable comments on an earlier version of this paper.

**José Brambila-Macias, University of Reading, e-mail: J.BrambilaMacias@reading.ac.uk; Isabella Massa, International Economic Development Group, ODI, corresponding author e-mail: i.massa@odi.org.uk.

These developments in private capital inflows to SSA raise a number of questions, which we will address in this paper. Do private capital inflows foster economic growth in SSA? What types of private capital inflows are specifically useful for growth in SSA? To what extent is the slowdown or reversal in private capital inflows to SSA going to affect the region's economic growth?

The paper is structured as follows. Section 2 describes the trends and composition of private capital inflows to SSA before and after the global financial crisis. Section 3 provides a brief literature review of the growth impact of specific categories of private capital inflows in recipient countries. Section 4 examines which types of private capital inflows foster economic growth in SSA. We pay particular attention to cross-border bank lending, FDI, bonds flows and portfolio equity flows. We also examine the possible effects of the slowdown or reversal of private capital flows due to the global financial crisis on growth in SSA. Section 5 provides our conclusions and Section 6 offers some policy recommendations.

2. Trends and Composition of Private Capital Flows to Sub-Saharan Africa

2.1 The Boom of Private Capital Inflows

Private capital flows into SSA have experienced a remarkable increase since the early 2000s: private equity and debt inflows reached a record high of \$53 billion in 2007 (IMF, 2008a). This surge in private capital inflows owes mainly to the fact that the period 2000–2007 was characterized by abundant global liquidity, and an increasing number of investors in search of high yields were attracted to SSA. The region has enjoyed robust economic growth since the mid-1990s, supported by exports and private consumption, reaching in 2007 one of its highest growth rates (6.9 per cent, see Figure 1). Several factors contributed towards attracting investors to SSA. First, many SSA countries strengthened their macroeconomic performance and reformed their economies, leading to fiscal consolidation, reduced deficits, lower inflation rates and an improved business environment. Second, political instability in SSA became less frequent, and a number of countries embarked on democratic transitions.¹ Third, the vast natural resources endowment of some countries attracted the rapidly growing emerging markets, especially China. In turn, external factors like debt relief and the recent commodities boom added to the attractiveness of SSA.

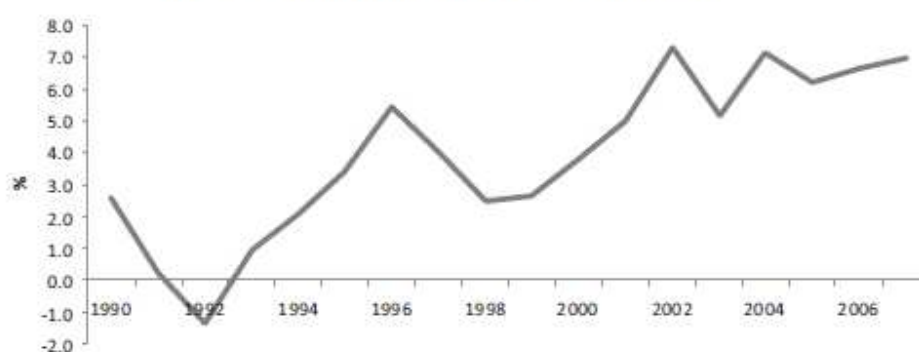
Private capital flows include FDI, portfolio equity flows and debt flows (i.e. portfolio bond flows and bank lending). The rise of private capital inflows to SSA in the period 2000–2007 was due mostly to a rapid surge in private portfolio flows and debt flows, whereas FDI remained rather stable, experiencing a progressive rise over time.

International banking activity in SSA expanded significantly from 2005: total international claims on SSA economies held by banks reporting to the Bank for International Settlements (BIS) increased by 56 per cent from that point, reaching a value of about \$96 billion by the end of 2007 (see Figure 2). Furthermore, bond flows to SSA increased by 340 per cent to about \$9 billion in 2007 from \$2 billion in 2006 (see Figure 3), with Nigeria, Ghana, Gabon and the Seychelles issuing bonds internationally for the first time.²

Portfolio equity flows took off: in 2006 they more than doubled, reaching a value of \$15 billion, as shown in Figure 4. Most of these flows went to South Africa (88 per cent), but other countries with established and relatively more developed stock markets, like Botswana, Côte d'Ivoire, Ghana, Mauritius and Kenya, also experienced increases in portfolio flows.

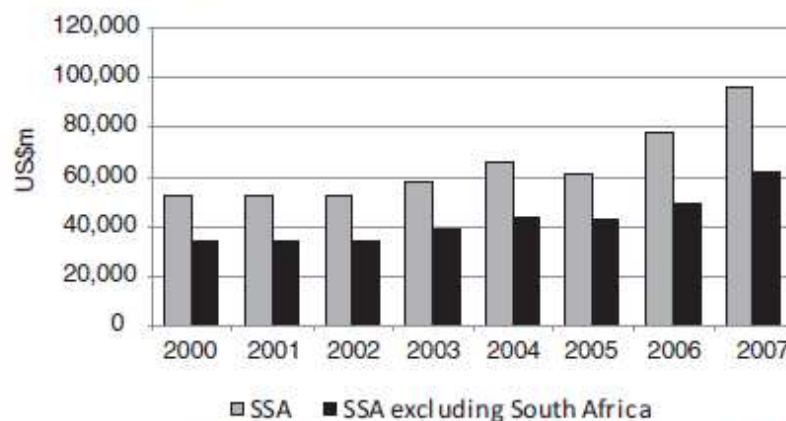
Net FDI inflows to SSA grew steadily, by 150 per cent to \$33 billion in 2007 from \$13 billion in 2004 (see Figure 5). Distribution of the inflows within the region was not homogeneous, since resource-intensive countries attracted most of the flows. Indeed, in

Figure 1: Real GDP growth in SSA, 1990–2007 (%)



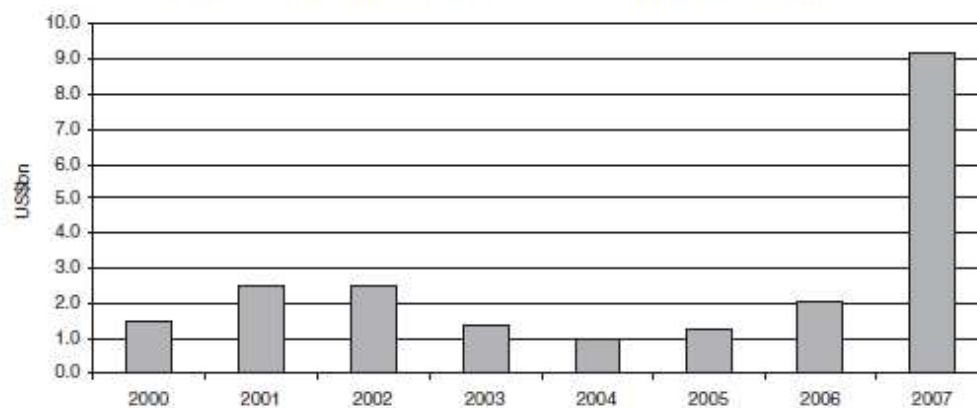
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Figure 2: Cross-border bank lending to SSA, 2000–2007 (US\$ millions)



Note: End of the year values. Cross-border bank lending is measured as banks' total international claims on SSA.
Sources: BIS Consolidated Banking Statistics, March 2009 and authors' calculations.

Figure 3: Bond issuance in SSA, 2000–2007 (US\$ billions)



Sources: World Bank's Global Development Finance, 2008 and authors' calculations.

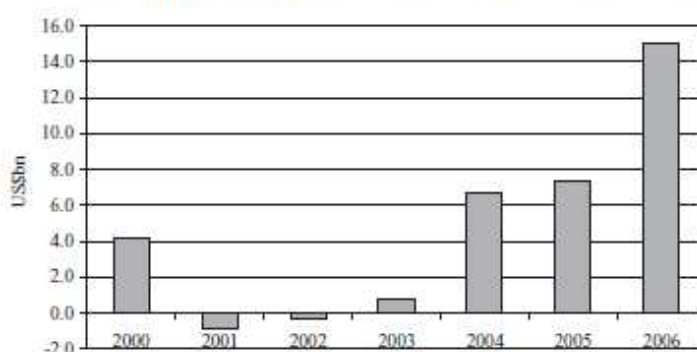
2007 Nigeria and South Africa accounted together for 55 per cent of total FDI inflows to SSA. Nevertheless, other countries, like Equatorial Guinea, Madagascar and Zambia, contributed towards boosting overall FDI to SSA.

Increased private capital flows into SSA may carry important opportunities to the region. For example, they may allow recipient countries to finance more investment than can be supported by domestic saving. They may also increase the efficiency of SSA countries by facilitating the transfer of technology and managerial expertise, improving resource allocation, reducing the cost of raising capital and intensifying domestic competition.

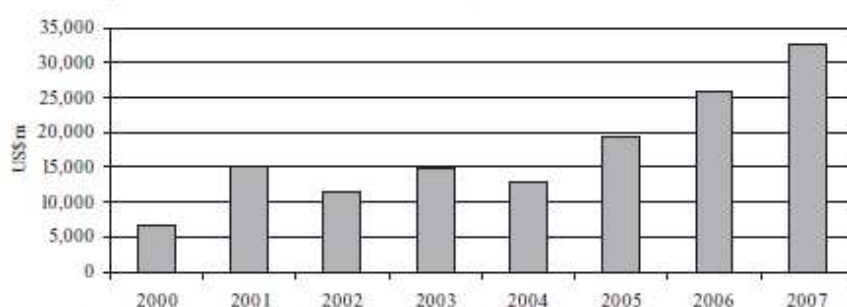
However, the spread of the financial turmoil that originated in the developed world in August 2007 may put at risk the potential beneficial effects of the recent surge in private capital inflows. Indeed, SSA countries are currently exposed to the risk of a slowdown or even a reversal of private capital inflows because of the global financial crisis.

2.2 Private Capital Inflows and the Global Financial Crisis: The Evidence So Far

The direct impact of the financial turmoil on sub-Saharan Africa has so far been less severe than in advanced economies, since SSA countries are less integrated in the global financial system and their financial institutions are relatively inactive in the derivatives market, relying mainly on domestic market resource mobilization rather than on foreign borrowings to finance

Figure 4: Net portfolio equity inflows to SSA, 2000–2006 (US\$ billions)

Sources: World Bank's Global Development Finance, 2008 and authors' calculations.

Figure 5: Net FDI inflows to SSA, 2000–2007 (US\$ millions)

Sources: UN Conference on Trade and Development (2008) and authors' calculations.

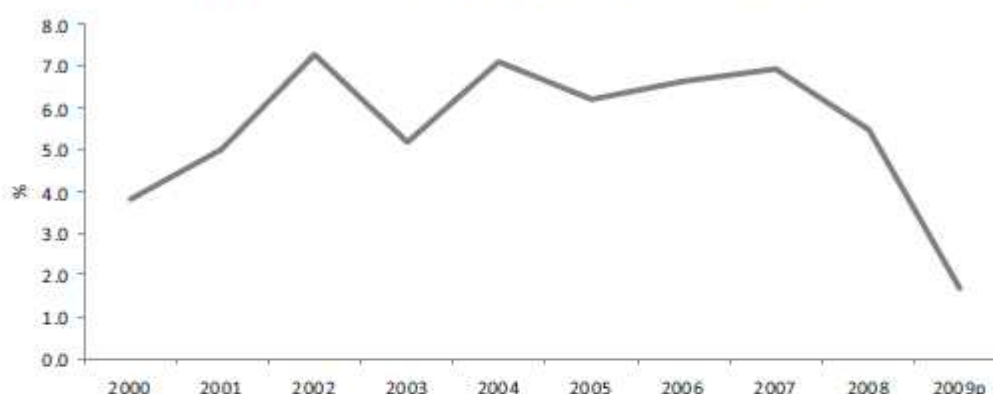
operations. Nevertheless, SSA is not immune to the global financial crisis and it is already feeling the secondary effects, like the drying up of financial inflows (IMF, 2009a).

Private capital inflows to SSA were relatively robust up to the first half of 2008, but dropped sharply from the third quarter of that year. Two main factors were responsible for the fall in direct and portfolio investment: first, a reduced capability to invest; second, a reduced propensity to invest. Credit conditions became tighter, making it more difficult and expensive to invest in foreign operations. At the same time, the gloomy growth prospects worldwide and the increased risk aversion reduced investors' appetite for risk.

The slump of economic growth to 5.5 per cent in 2008 and its forecasted further reduction to 1.7 per cent in 2009 (see Figure 6), as well as the end of the commodities boom, made SSA bond and equity markets less attractive to foreign investors, who preferred to flee into more liquid and safer assets, such as US Treasury bonds. Many bond issuance plans were put on hold. For example, Ghana has cancelled plans for a \$300 million debt issue owing to poor global market conditions. Kenya has delayed a planned debut \$500 million Eurobond. Tanzania has postponed plans to issue a debut Eurobond totalling at least \$500 million until market conditions improve. Uganda will not issue a debut Eurobond to fund infrastructure projects. According to the IMF (2008b), not a single SSA foreign currency denominated bond (Eurobond) came to market in 2008, compared with a value of \$6.5 billion in 2007. More recently, the Trade Association for the Emerging Markets (2009) highlighted that South African bond volumes fell by 32 per cent from \$492 billion in 2007 to \$337 billion in 2008. Looking at the long term, as suggested by the World Bank (2009), the crowding-out effects might also affect developing countries' bond markets negatively. In other words, it is likely that in the coming years developed countries may need to significantly increase the issuance of sovereign bonds — think about the US, which will need to finance a fiscal deficit expected to exceed \$1,000 billion in 2009 — thus potentially crowding out developing countries' private and public debt issuers.

FDI inflows are believed to be remaining more stable than other private capital flows in the face of the global financial crisis. According to the UN Conference on Trade and Development (2009), FDI inflows to Africa are expected to continue to grow in 2008 but at a lower rate (16.8 per cent). Nevertheless, in SSA, the impact of the crisis on FDI is becoming an increasingly

Figure 6: Real GDP growth in SSA, 2000–2009 (%)



Note: p = IMF's projection.

Source: IMF World Economic Outlook Database, April 2009.

significant concern, since a few planned investments have already been postponed or cancelled. For example, the proposed takeover of a South African mining conglomerate by Xstrata was abandoned. In the Democratic Republic of Congo (DRC), most of the foreign mining companies have scaled back, postponed or abandoned their investment plans (African Development Bank, 2009a). The world's number one steel company (ArcelorMittal) has deferred indefinitely an iron-ore project in Liberia. Moreover, Malawi is about to lose a big uranium project. In Ethiopia, the Ethiopian Electric Power Corporation is afraid that its investment plans will be severely affected as a result of the crisis (Institute of Development Studies, 2009). In March 2009, the President of Tanzania reported that a \$3.5 billion investment in aluminium smelting had been postponed and a \$165 million nickel mining and extraction project had been rescheduled.

The slowdown and sometimes the reversal in portfolio equity flows in SSA countries were consistent with the sharp fall of their stock markets.³ As shown in Table 1, South Africa, Nigeria, Kenya, Mauritius and Côte d'Ivoire were among the hardest hit countries over 2008. The situation did not improve much at the beginning of 2009. Indeed, in Kenya the Nairobi Stock Exchange (NSE) All-Share Index fell by 21.36 per cent from 30 January to 27 February and stock market capitalization dropped by 21.35 per cent over the same period. In turn, the Nigeria Stock Exchange All Share Index fell by 30.64 per cent in January and increased by just 7.2 percentage points in February. In Côte d'Ivoire, the BRVM Composite Index has continued to fall to date.

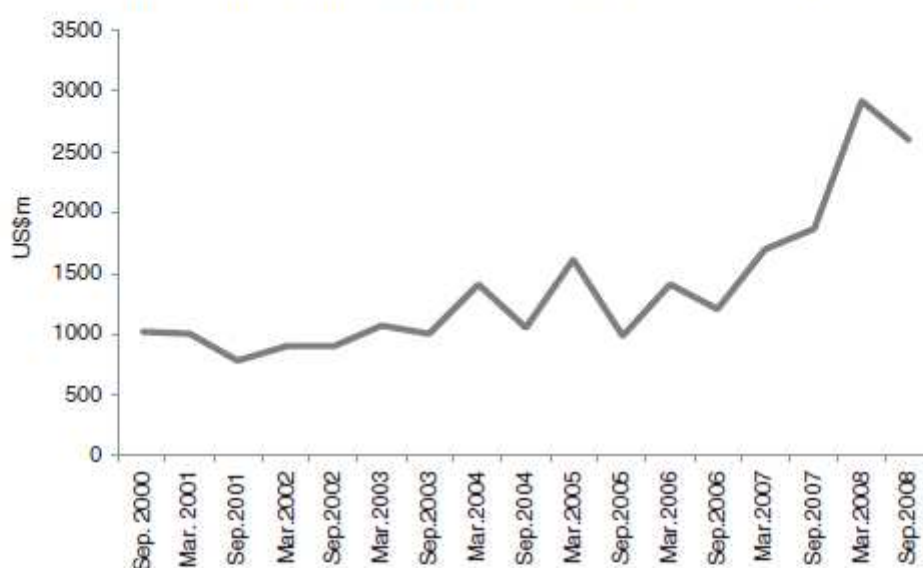
While SSA countries are not highly dependent on credit from foreign banks, some countries have already seen the signs of a drop in foreign claims from the third quarter of 2008 (see Figure 7). The countries most exposed to a fall in international bank lending are likely to be those with a high share of foreign-owned banks (e.g. Ghana, Tanzania, Zambia, Uganda and Swaziland).⁴

The IMF (2009b) reckons that, as the crisis continues, there might be an increasing risk of contagion from distressed foreign parent banks to local subsidiaries in SSA. There are different mechanisms through which this could happen. Parent banks could call in loans or withdraw capital from their SSA subsidiaries. They could stop investing local profits in local subsidiaries or require the closure of their subsidiaries (IMF, 2009c). However, the existence of tight prudential capital controls in many SSA banking systems has so far helped to minimize this contagion effect. In Tanzania, for example, profit repatriation has been regulated and local subsidiaries are not allowed to transfer funds automatically to compensate for losses in parent banks (African Development Bank, 2009b).

Table 1: Stock index change in selected SSA countries, 2008 (%)

Index	% change in 2008
Nigeria All Share Index	-45.90
Mauritius All Share Indices	-36.20
NSE 20-Share Index	-34.10
JSE All Share Index	-25.70
BRVM Composite Index	-10.70

Source: African Development Bank (2009a).

Figure 7: Cross-border bank lending to Ghana, September 2000–September 2008 (US\$ millions)

Note: Cross-border bank lending is measured as banks' total international claims on Ghana.

Source: BIS Consolidated Banking Statistics, March 2009.

The trends described raise two related questions. First, do private capital inflows to SSA promote growth and, in particular, what is the potential growth impact of the various types of capital inflows? Second, is the slowdown or reversal of private capital flows into SSA likely to lead to a further reduction in SSA economic growth? These two questions will be discussed in Section 3 and Section 4.

3. Private Capital Flows and Economic Growth: A Brief Literature Review

The understanding of the growth impact of specific categories of private capital inflows has important policy implications, but so far it has received little — though mounting — attention in the empirical economic literature. With respect to developing countries, this may be owed in part to the relatively new phenomena of some private capital inflows, particularly portfolio equity flows.

Most studies on the growth effect of specific types of private capital flows focus on FDI. Firm-level studies of particular countries provide contradictory evidence on the role played by FDI in economic growth. Willmore (1986), looking at a sample of 282 pairs of firms belonging to 80 industries in Brazil, finds that FDI has a beneficial impact on growth, since foreign firms are more efficient than domestic ones. Moreover, Blomstrom (1986) finds that FDI enhances productivity growth of Mexican sectors. On the other hand, Haddad and Harrison (1993) find no evidence of positive spillovers from FDI in Morocco. Aitken and Harrison (1999) get a similar result with respect to Venezuela in the period 1979–89.

Unlike the microeconomic evidence, macroeconomic studies generally suggest that FDI exerts a positive impact on economic growth in particular contexts. For example, Balasubramanyam *et al.* (1996) find that the effects on growth of FDI are more significant in the presence of trade openness, and Borensztein *et al.* (1998) argue that FDI is an important channel for the transfer of technology and contributes to economic growth when the country has a highly educated workforce. In turn, Alfaro *et al.* (2003) find that FDI is beneficial for economic growth when the country has sufficiently developed financial markets. However, Levine and Carkovic (2002) conducted a Generalized Method of Moments (GMM) panel analysis on pooled data from 72 countries in the period 1960–95 and suggest that FDI flows do not exert a positive impact on economic growth.

Very few studies examine the growth effect of portfolio equity flows. Bekeart and Harvey (1998, 2000) find that portfolio equity inflows increase economic growth in 14 out of 19 lower-income countries under study. Durham (2004) suggests that portfolio equity flows promote economic growth in countries with relatively large equity markets and limited corruption. Levine and Carkovic (2002), instead, find that portfolio inflows have no impact on economic growth.

Curiously, there is very little specific literature on the effects of debt flows on economic growth. This category of capital inflows is more often taken into account in recent studies investigating simultaneously the growth impact of different types of capital flows. For example, Reisen and Soto (2001) measure the independent growth effect of bond flows as well as FDI, portfolio equity flows, official flows and short-term and long-term bank lending on a sample of 44 developing countries around the world over the period 1986–97. Using GMM panel data analysis, they find that FDI and portfolio equity flows exert a significant impact on growth, whereas bonds and official flows do not have any significant effect on growth. Furthermore, short- and long-term bank lending is found to negatively affect economic growth in the recipient country, except when local banks are sufficiently capitalized.

In turn, Durham (2003) examines the impact on growth of bond foreign portfolio investment (BFPI) as well as total foreign portfolio investment (FPI) and other foreign investment (OFI), which includes cross-border bank lending, using a sample of 88 countries from 1977 through 2000. Most of the results suggest that FPI, BFPI and OFI have no effect on economic growth. However, there is some evidence that OFI may have a negative impact on economic growth depending on the level of financial and legal development of the recipient country.

On the other hand, Gheeraert and Malek Mansour (2005) use a structural econometric model and find a significantly positive relationship between growth and various measures of capital flows (i.e. FDI, equity investment, debt investment and flows in financial derivatives). More recently, de Vita and Kyaw (2009), using a dynamic panel model on a large sample of 126 developing countries for the period 1985–2002, examine the impact of FDI and portfolio investment flows on the economic growth of low, lower middle and upper middle income countries. They find that only developing countries that have reached a minimum level of economic development and absorptive capacity are able to capture the growth-enhancing effects of both forms of investment inflows.

While there is evidence of mounting research on the growth impact of specific types of capital inflows to developing countries in general, there are still relatively few studies addressing this issue with respect to specific countries or regions. To our knowledge, a study investigating the relationship between economic growth and cross-border bank lending, FDI, bonds inflows and portfolio equity inflows to SSA is still missing in the literature. In the next section, we attempt to fill this gap.

4. What Types of Private Capital Inflow Foster Growth in Sub-Saharan Africa?

4.1 Methodology and Data

We are interested in studying the relationship between economic growth and four different types of private capital inflows: cross-border bank lending, FDI, bonds flows and portfolio equity flows. In order to do this, we use Bruno's (2005) bias-corrected least-squares dummy variable (LSDV) estimator on pooled data from 15 selected SSA countries over the period 1980–2008. The list of countries used is reported in the appendix.

In order to take into account the unbalanced nature of our panel and the small size of our sample, we first estimate a dynamic panel using the generalized method of moments (GMM) estimator introduced by Arellano and Bond (1991), Arellano and Bover (1995), and Blundell and Bond (1997), and then we use the vector of coefficients obtained to get the bias-corrected LSDV estimates.

The GMM joins in a single system the regression equations in differences and levels, each one with its set of instrumental variables which allow us to deal with the potential endogeneity of our explanatory variables.⁵ The model we estimate is the following:

$$Y_u = Y_{u-1}\gamma + BOND_u\eta + EQUITY_u\mu + FDI_u\phi + BANK_u\varphi + X_u\beta + u_t + \varepsilon_u \quad (1)$$

where the dependent variable (Y_u) is the real per capita income growth rate, and the main explanatory variables of interest are net cross-border bank lending ($BANK$); net bond inflows ($BOND$); foreign direct investment net inflows (FDI); and net portfolio equity inflows ($EQUITY$). We also include a matrix X_u of control variables: trade openness measured as the sum between exports and imports ($TRADE$), and government consumption (GOV). All variables are normalized by GDP. u_t represents the unobserved individual effect, and ε_u is the white-noise disturbance term with constant variance σ_ε^2 .

In order to get rid of the country specific effects we first difference Equation 1 and get:

$$\Delta Y_u = \Delta Y_{u-1}\gamma + \Delta BOND_u\eta + \Delta EQUITY_u\mu + \Delta FDI_u\phi + \Delta BANK_u\varphi + \Delta X_u\beta + \Delta \rho_u \quad (2)$$

where $\Delta \rho_u = \Delta u_t + \Delta \varepsilon_u = (u_t - u) + (\varepsilon_u - \varepsilon_{u-1}) = \varepsilon_u - \varepsilon_{u-1} = \Delta \varepsilon_u$. However, the GMM estimator properties hold only when the number of cross-sections is large, being biased in panels with few cross-sectional units (15 countries in our case). So, in order to overcome this problem, we use Kiviet (1995, 1999), and Kiviet and Bun (2001) bias-corrected least-squares dummy variable

(LSDV) estimator, which was extended by Bruno (2005) to include unbalanced panels. The bias-corrected LSDV estimator can be derived rewriting Equation 1 as follows:

$$y = Du + W\delta + \varepsilon \quad (3)$$

where y and $W = (y_{-1} \dots X)$ are the matrices of observations; D is the matrix of individual dummies; u is the vector of individual effects; $\delta = (\gamma \dots \beta')$ is the vector of coefficients, and ε is the error term. In order to allow for unbalanced panels, Bruno (2005) defines a selection indicator p_{it} such that $p_{it} = 1$ if (y_{it}, x_{it}) is observed and $p_{it} = 0$ otherwise. The dynamic selection rule is defined as $c(p_{it}, p_{it-1})$ by choosing only observations usable for the dynamic panel model, that is, those observations for which current values and one-time lagged values are observable as follows:

$$c_{it} = \begin{cases} 1 & \text{if } (p_{it}, p_{it-1}) = (1, 1) \quad i = 1, \dots, N \quad \text{and} \quad t = 1, \dots, T \\ 0 & \text{otherwise} \end{cases} \quad (4)$$

Therefore, for any individual i , the amount of usable observations is defined by $T_i = \sum_{t=1}^T c_{it}$, where $n = \sum_{i=1}^N T_i$ and $\bar{T} = \frac{n}{N}$ give the average group size. Then, defining for each i the vector $c_i = [c_{i1}, \dots, c_{iT}]'$ and the diagonal matrix C as having the c_i vector on its diagonal, we have a $(NT \times NT)$ block-diagonal matrix $C = \text{diag}(C_i)$, allowing for the possibility of unbalanced dynamic panels:

$$Cy = CDu + CW\delta + C\varepsilon \quad (5)$$

with the LSDV estimator given by $\delta_{LSDV} = (W'M_cW)^{-1} W'M_cy$, where $M_c = C(I - D(D'CD)^{-1}D)C$ corresponds to the symmetric and idempotent $(NT \times NT)$ matrix which takes out individual means and can select usable observations. The final consistent bias-corrected LSDV estimator is then obtained by subtracting the bias approximation estimates from the original LSDV, so that⁶:

$$LSDV_{bias-corrected(i)} = LSDV - \hat{\beta}_i, \quad i = 1, 2, 3 \quad (6)$$

where $\hat{\beta}_i$ corresponds to different levels of accuracy through different bias-approximation terms.⁷

In our study, cross-border bank lending, FDI, bonds flows, and portfolio equity flows data stem from the World Bank's Global Development Finance Database. FDI and cross-border bank lending data are available for a representative number of countries, whereas bond and portfolio equity flows data are less abundant. This constrained our analysis, but left us with enough data to build a small panel. Real per capita GDP data, as well as government consumption and trade openness data, are sourced from the World Bank's World Development Indicators and the IMF's International Financial Statistics database.

4.2 Results

Table 2 summarizes the results of the bias-corrected LSDV coefficients, showing that there exists a relationship between economic growth and cross-border bank lending, FDI and some of the traditional growth determinants.

Table 2: Bias-corrected LSDV estimator results for selected SSA countries, 1980–2008

	Whole sample			Without South Africa and Nigeria		
	(1)	(2)	(3)	(4)	(5)	(6)
Y_{it-1}	0.196***	0.196***	0.196***	0.188***	0.188***	0.190***
FDI_{it}	0.296***	0.296***	0.296***	0.334***	0.333***	0.329***
$BOND_{it}$	0.110			0.066		
$BANK_{it}$	0.150*	0.156**	0.157**	0.256***	0.261***	0.260***
$EQUITY_{it}$	0.072	0.072		-0.338	-0.312	
$TRADE_{it}$	0.030***	0.030***	0.030***	0.032***	0.032***	0.032***
GOV_{it}	-0.137***	-0.137***	-0.137***	-0.127***	-0.127***	-0.127***
N	360	360	360	321	321	321
Countries	15	15	15	13	13	13

Notes: The dependent variable is the real per capita income growth rate. Bias accuracy of the approximation up to $O(1/T)$. Standard errors are calculated through bootstrapping (no. of repetitions = 100).

*, ** and *** denote significance at the 10%, 5% and 1% level respectively.

Source: Authors' calculations.

In the specifications from columns (1) through (3), we test the impact of our variables of interest (FDI, cross-border bank lending, portfolio equity flows and bond flows) on SSA growth for the whole sample including 15 countries (see the appendix).

FDI net inflows (*FDI*) remain significant, positive and stable throughout all specifications, suggesting that FDI inflows exert a positive and significant impact on per capita income growth of SSA recipient economies. This result is consistent with previous findings (see, e.g., Reisen and Soto, 2001, among others), and confirms that, in SSA, FDI inflows may play an important role in the economic performance of a host country. Indeed, FDI provides additional resources that can be used to build additional physical capital and create more employment; it increases the size of capital stock and encourages more efficient use of existing resources, thus enhancing recipient country's output and productivity; and it improves the local skills and promotes technological know-how, thereby enhancing overall economic growth and development. Therefore, the importance is underscored of an adequate set of policies capable of influencing the way in which FDI affects growth, productivity, employment and, above all, poverty reduction within developing countries, and in particular in SSA.⁸

A similarly important growth impact comes from cross-border bank lending, which in the whole sample has a positive effect on economic growth. This result is different from previous findings in the literature (Durham, 2003; Reisen and Soto, 2001), but could be explained as follows. In the literature, the potential benefits of financial integration, such as increased opportunities for risk sharing and diversification, and better allocation of capital among investment opportunities, are widely recognized. Indeed, cross-border activities allow banks to better realize their optimal size, exploit economies of scale and scope, diversify activities and spread risk and revenues. This enables them to improve resource allocation and risk management and increase profitability. As a final effect, the development and integration of the banking sector has a positive impact on economic growth.⁹ On the other hand, cross-border bank lending could also make the banking system more vulnerable to crises by opening up additional transmission channels of systemic risk across borders. In the context of SSA, this risk may have been mitigated over the past years, thanks to a continued effort in reinforcing the regulatory and supervisory framework. As a consequence, the beneficial growth effects of cross-border bank lending may have unfolded.

In contrast with the positive growth impact of FDI and cross-border bank lending, the effects of portfolio equity flows are not significant. In other words, they do not produce any significant positive impact on growth. While it cannot be ruled out that this result is due to the scarcity of portfolio equity flows data in our sample, the non-significance of *EQUITY* may be explained by the fact that the bulk of recently increased portfolio equity inflows has been concentrated in very few SSA countries, mainly in South Africa. This is because among all stock markets in SSA, only nine markets have more than 20 listings.¹⁰ Therefore, the absence of equity markets, the lack of depth and liquidity where there are such markets, and the absence of a coherent policy approach towards capital account liberalization still represent significant constraints on portfolio equity flows at the regional level.¹¹

In line with the existing literature, bonds flows are found to have no significant impact on growth. Moreover, traditional growth variables such as trade openness and government consumption are confirmed to be significant, exerting respectively a positive and negative impact on economic growth.

As a robustness check, from columns (4) through (6), we re-estimate the previous specifications without including in the sample South Africa and Nigeria, which have been the main recipient of FDI and cross-border bank lending in the SSA region. The new estimates are similar to those from columns (1) through (3), and confirm the result that among all different types of private capital inflows only FDI and cross-border bank lending matter for SSA growth. Note that once we take out South Africa and Nigeria, the effect of cross-border bank lending is even higher in magnitude and significance.

Our estimates suggest that a drop by 10 per cent in FDI inflows may lead to a 3 per cent decrease of SSA's income per capita growth, whereas a 10 per cent decrease in cross-border bank lending may have a detrimental effect on growth by up to 1.5 per cent. Therefore, in the context of the current global financial crisis, FDI and cross-border bank lending may represent important channels through which the crisis is likely to negatively affect SSA economic growth.

5. Conclusions

Over the period 2000–2007, SSA enjoyed robust growth and, in a context of abundant global liquidity, attracted an increasing number of investors in search of high yields. As a consequence, private capital inflows, including FDI, portfolio equity flows and debt flows (i.e. portfolio bond flows and bank lending) experienced remarkable increases. Private equity and debt flows reached a record high of \$53 billion in 2007.

The link between capital inflows and economic growth is still controversial, and the existing empirical literature has devoted little attention to the growth impact of different forms of private capital flows. In this paper, by using a bias-corrected least-squares dummy variable (LSDV) estimator, we examined the relationship between economic growth and cross-border bank lending, FDI, bonds flows and portfolio equity flows on a sample of selected SSA countries over the period 1980–2008. Our results show that both FDI and cross-border bank lending exert a positive and significant impact on economic growth in SSA, whereas portfolio equity flows and bonds flows have been found to have no growth impact.

The spread of the global financial crisis, which originated in the developed world in August 2007, has led to a slowdown of private capital inflows to SSA, thus putting at risk the beneficial growth effects of the recent surge in FDI and cross-border bank lending. In several SSA countries, such as DRC, Liberia and Tanzania, among others, investment plans have been scaled back, postponed or abandoned. Moreover, there are already a few signs of a drop in banks' international claims on SSA countries such as Ghana. Our estimates suggest that a drop by 10 per cent in FDI inflows may lead to a 3 per cent decrease in SSA's income per capita growth, whereas a 10 per cent decrease in cross-border bank lending may have a detrimental effect on growth by up to 1.5 per cent.

In light of these results, we argue that the global financial crisis is likely to have an important effect on SSA's growth through the private capital inflows channel, and in particular through FDI and cross-border bank lending.

6. Policy Recommendations

Our results highlight the importance of specific types of private capital flows such as FDI and cross-border bank lending in fostering economic growth in SSA. Therefore, national governments should regularly monitor the inflows of foreign direct investment and international bank lending. This is particularly relevant in the context of the current global financial crisis which has put at risk private capital flows in many SSA economies.

Promoting political and macroeconomic stability, improving the business environment, and creating adequate physical and social infrastructure are imperative for continuing to attract inward FDI. Moreover, a sound supervisory and regulatory framework remains essential to benefit from cross-border bank lending without incurring contagion risks.

Even though our results show that portfolio equity flows appear to be non-significant for SSA growth, this does not mean that they should be neglected. As we explained before, this result may be due to the scarcity of data as well as the fact that many stock markets in SSA are still very small and illiquid. Therefore, if the efficiency of stock markets is enhanced, portfolio equity flows might play a role in fostering economic growth in the SSA region.

Notes

1. The number of democratic countries in Africa had increased from 10 in 1980 to 34 by the end of 2007.
2. Nigeria issued a \$350 million private corporate bond in January 2007 and a \$175 million private corporate bond in March 2007; Ghana issued a \$750 million Eurobond in September 2007; Gabon issued a \$1 billion 10-year Eurobond in December 2007; Seychelles issued a \$200 million sovereign bond in September 2006.
3. Over 2008, investors withdrew \$6.1 billion in South Africa. Evidence of portfolio inflows reversal and capital flight may also be found in Kenya, Tanzania and Nigeria (IMF, 2009c).
4. For a more detailed description of foreign ownership of the banking system in SSA see World Bank (2008) and Massa and te Velde (2008).
5. Usually lags of each variable are used as instruments.
6. More details on the LSDV corrected-bias estimator and its different bias-approximation terms can be found in Bruno (2005) and references therein.
7. $B_1 = a_1(\bar{T}^{-1})$; $B_2 = B_1 + a_2(N^{-1}\bar{T}^{-1})$; $B_3 = B_2 + a_3(N^{-1}\bar{T}^{-2})$. Note that before using the bias-approximation formulas we need to find consistent estimators for σ_v^2 and γ by means of alternative regressions, for example using the Anderson-Hsiao estimator or the GMM estimators (Arellano and Bond, 1991; Blundell and Bond, 1997, etc.), so that depending on our choice the consistent estimator for σ_v^2 will be given by $\hat{\sigma}_v^2 = \frac{e_k' M_k e_k}{(N-k-T)}$, where $e_k = y - W\delta_k$ and h represents the initial estimator that we used, for example Anderson and Hsiao, Arellano and Bond, etc.
8. We refer readers interested in the ways FDI can affect development to te Velde (2006).
9. Numerous studies have provided evidence for the close link between more integrated and efficient financial markets and enhanced economic performance. See, among others, Levine (1997).
10. These nine markets are: Botswana, Côte d'Ivoire, Ghana, Kenya, Mauritius, Namibia, Nigeria, South Africa and Zimbabwe.
11. The degree of capital account liberalization differs significantly. Uganda and Zambia have no capital control. Kenya, Tanzania and Nigeria still have capital restrictions. Angola, Burundi, Ethiopia and Mozambique are not liberalized at all.

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Appendix: Selected Sample of SSA Countries

Botswana	Kenya	Nigeria	Tanzania
Cameroon	Malawi	South Africa	Uganda
Cape Verde	Mauritius	Sudan	Zambia
Ghana	Mozambique	Swaziland	

Note: The selected countries were chosen on the basis of data availability. We include SSA countries with a stock market except countries served by the *Bourse Régionales des Valeurs Mobilières* (i.e. Benin, Burkina Faso, Guinea Bissau, Côte d'Ivoire, Mali, Niger, Senegal, and Togo), and Namibia, Rwanda and Zimbabwe, for which bonds flows and portfolio equity flows data are very scarce or not available.