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THE IMPACT OF EXTERNAL RESERVES' POSITION ON CAPITAL FLOWS; THE NIGERIAN EXPERIENCE

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1.0 INTRODUCTION

Monetary authorities maintain external assets (or reserves) in order to support a range of activities. These include demonstrating the backing of domestic currency by external assets; supporting and maintaining confidence in monetary and exchange rate policy management; and providing a level of confidence to the international community that the country can meet its current and future external obligations (IMF, 2013). As such, maintaining robust level of external reserves is a signal to market participants that the country is ready and able to maintain price and monetary stability, and instills confidence on foreign financiers that their investments are safe, and could be able to repatriate their capital and returns earned when the need arises.

The Central Bank of Nigeria (CBN) is the sole monetary authority in Nigeria and is charged with maintaining and managing external reserves, as stipulated in the CBN Act (2007). According to the Act, the CBN is to maintain external reserves to safeguard the international value of the legal tender currency. External reserves management is therefore driven by the quest to maintain confidence in the country's monetary and exchange rate policies; provide confidence to the international community on the country's ability to meet its external obligations, including the ability of capital importers to repatriate both their income and capital; provide liquidity to government to meet its external obligations; and maintain foreign exchange liquidity to serve as a buffer during periods of external shocks.

The main objective of this paper is to assess the impact of external reserves position in attracting capital flows. Other objectives include clearly defining what external reserves are, and clearing some misconceptions surrounding external reserves held and managed by the CBN. The paper is divided into four sections. Following this introductory part is section two which briefly defines external reserves and capital flows, as well as the determinants of capital flows. Section three reviews the composition and ownership structure of external reserves in Nigeria. The section also analyzes the role of external reserve holdings on capital flows. Section four concludes the paper and makes recommendations.

2.0 CONCEPTUAL / DEFINITIONAL ISSUES

2.1 External Reserves and Motives for Holding Them

The external reserves of a nation, otherwise called the international reserves are "those external assets that are readily available to, and controlled by the monetary authorities for meeting balance of payments financing needs, for intervention in the foreign exchange market to affect the currency exchange rate, and/or for other purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing)" (IMF, 2009). External reserves assets are therefore different from other foreign currency assets in that they consist of liquid or easily marketable foreign currency assets. They are also held in the form of convertible foreign currency claims of the monetary authorities on nonresidents.

Countries hold external reserve assets for different reasons based on their level of economic development and the structure of the economy. Nonetheless, Bario et al. (2008) identified six major motives for holding external reserves. These are to:

- Intervene in the foreign exchange market to maintain exchange rate stability;
- Pay for goods and services imported from abroad;
- Grant emergency liquidity assistance to the economy, especially the banking sector;
- Provide confidence in the country's ability to meet its external obligations;
- Assist government in meeting its foreign exchange obligations; and
- Support domestic monetary policy to manage liquidity through foreign exchange swaps, etc.

2.2 Capital and Capital Flows

Capital (in this paper, financial capital) refers to financial assets or the financial value of assets. It is used to generate wealth through investments. Capital flows, therefore, means the movement of capital either in (inflow) or out (outflow) of an economy. For instance, capital inflows occur when domestic or foreign agents purchase domestic assets with foreign assets (Rummel, 2010). International capital flow helps in reducing risk through diversification of lending and investment, as well as the spread of best practices in corporate governance, accounting standards and legal practices (Kirabaeva and Razin, 2010). Capital flows can be classified into three broad categories: foreign direct investment (FDI); foreign portfolio investment (FPI) and other investment flows or debt (Rummel, 2010, Kirabaeva and Razin, 2010 and ADB, 2011).

2.2.1 Foreign Direct Investment

FDI occurs when a non-resident acquires at least 10 percent stake in a domestic enterprise (IMF, 2009). It is driven by positive longer-term sentiments about the recipient country that are related to its economic fundamentals, and more difficult to reverse than other flows (Sula and Willet, 2015). It is therefore considered more stable even during financial crisis, and is less associated with output volatility (Rummel, 2010 &Mercado and Park 2011). This therefore makes FDI less destabilizing to the financial system.

2.2.2 Foreign Portfolio Investment

This involves the purchase of securities and equity shareholdings in a foreign country. It is mostly driven by short-term gains and speculative activities. These types of investments are more susceptible to reversals because holders could easily sell their stocks of bonds. They are also more vulnerable to information problems and herding behavior (Sula and Willet, 2015).

2.2.3 Other Capital Inflows

These are debt flows, consisting of bank loans and bond, and other sector loans to finance trade, mortgages, finance leases, etc. These have remained the dominant form of capital flows to developing countries, even though its relative importance has recently declined. According to Kirabaeva and Razin (2010) and ADB (2011), countries with relatively larger short-term debt flows compared to others, have been empirically linked with the likelihood and severity of financial crises. Also, developing countries tend to receive more short-term bank loans during booms, while this kind of financing decreases during economic slowdowns.

2.3 Determinants of Capital Flows

A number of factors could determine whether capital will flow in or out of an economy. While countries, especially emerging and developing economies would want to attract capital into their economies, most developed countries export capital in search of higher yields.

Rummel (2010) and Wesso (2001) identified the following as pull factors to capital flows:

- Strong economic fundamentals;
- High credit worthiness / rating;
- High economic growth potentials;
- Financial reform and level of openness;
- Interest rate level (good in attracting FPI).

While these authors could not directly link external reserve holdings to capital flows, some of the factors are closely related to external reserve position. For instance, maintaining a robust level of external assets is one of the indicators of strong economic fundamentals. In addition, level of external reserves is highly considered in assessing the credit worthiness of a country. This is because it is an indicator of the country's ability to pay its liabilities as and when due. Furthermore, strong external reserve position indicates not only the growth potential of a country, but also current economic performance.

2.4 Benefits of Capital Flows

Rummel (2010) highlights a number of benefits that could be attributed to capital flows. These include:

- Tap foreign savings
- Lower cost of capital for borrowers
- Smoothen consumption
- Help develop financial markets and institutions; and
- Facilitate transfer of technology and management expertise.

3.0 NIGERIAN EXPERIENCE

3.1 Sources of Nigeria's External Reserves

Nigeria's external reserves derive mainly from the proceeds of crude oil production and sales. Nigeria produces crude oil using either joint venture agreements or production sharing contracts with international and indigenous oil companies. Out of this, Nigeria sells a predetermined proportion directly, while the partners sell the rest. The partners pay Petroleum Profit Tax to the Federal Government through the Federal Inland Revenue Service. Other sources include other exports, value added tax, etc. The breakdown of the sources is as follows:

(I) Crude oil production and sales:

- Direct Sales (NNPC)
- Petroleum Profit Tax (Oil Companies)
- Royalties
- Penalty for Gas Flaring
- Rentals

(ii) Other sources:

- Other exports
- Income from Investing foreign reserves
- Inward Money Transfer
- Value Added Tax (VAT)
- Education Tax
- Commission, Etc.

3.2 Ownership Structure and Composition of Nigeria's External Reserves

3.2.1 Ownership Structure

Nigeria's external reserves comprise of three components namely: the Federation; the Federal Government; and the Central Bank of Nigeria portions. The table below illustrates the ownership structure of the reserves:

(i) Federation Reserves

The Federation component consists of sterilized funds (unmonetized) held in the excess crude and PPT/Royalty accounts at the CBN belonging to the three tiers of government. This portion has not yet been monetized for sharing by the federating units. The sovereign wealth fund was created out of the Federation reserves with an initial capital of US$1.0 billion.

(ii) Federal Government Reserves

The Federal Government component consists of funds belonging to some government agencies such as the NNPC; for financing its Joint Venture expenses, PHCN and Ministry of Defense; for Letters of Credit opened on their behalf, etc.

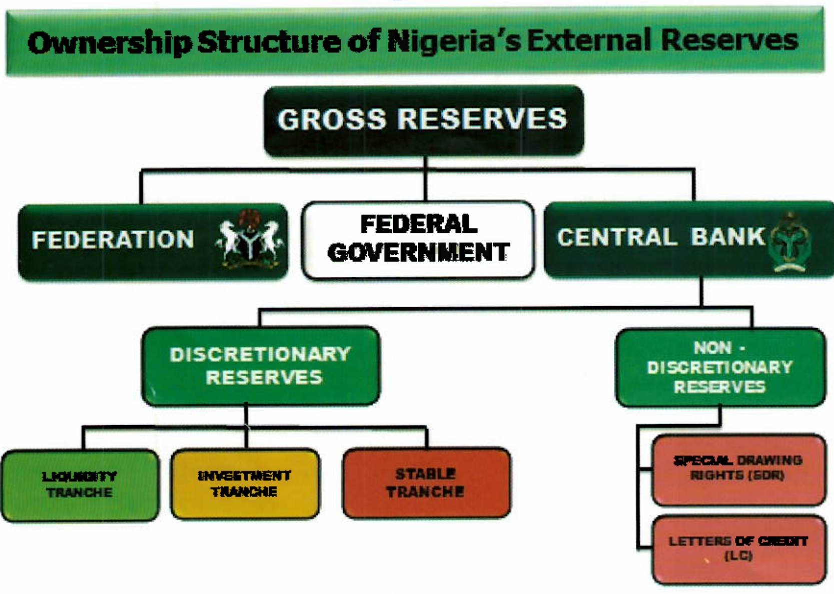
(iii) CBN Reserves

The CBN portion consists of funds that have been monetized and shared. This arises as the Bank receives foreign exchange inflows from crude oil sales and other oil revenues on behalf of the government. Such proceeds are purchased by the Bank and the Naira equivalent credited to the Federation account and shared, each month, in accordance with the constitution and the existing revenue sharing formula. The monetized foreign exchange thus belongs to the CBN. It is from this portion of the reserves that the Bank conducts its monetary policy and defends the value of the Naira. Any utilization of reserves kept by the CBN therefore requires that the naira equivalent be surrendered to the Bank. This is to avoid double spending and largely to maintain stable inflation. It is pertinent at this point to address some misconceptions about external reserve management in Nigeria by answering the following questions:

- Are External Reserves wholly owned by the Federal Government? Nigeria's external reserves are owned by the Federal Government, the Federation, and the CBN, but managed by the CBN. However, the bulk of the country's total external reserves belong to the CBN since the Bank has already monetized the foreign earnings and have released the Naira value to the beneficiaries.

- Why can't External Reserves Be Used for Funding Gaps In The Provision And Rehabilitation of Infrastructure? As stated above, the CBN portion constitutes the bulk of the external reserves having been monetized over time and distributed to the tiers of government. It can only be available to the government and the private sector subject to the provision of Naira cover. Thus, only the federation (un-monetized) and federal government portions of the reserves could be used to meet funding gaps.

- Why can't the US Dollar Receipts from Crude-Oil Exports Be Disbursed Directly into the Domestic Economy? The constitution of the Federal Republic of Nigeria expressly states that the legal tender currency in Nigeria is the Naira. Consequently, the foreign exchange inflows received by



the CBN on behalf of the federation must be converted into Naira before it is credited into the federation account. Indeed, the Naira in circulation is backed by the foreign currency inflows monetized overtime by the CBN.

- Why Can't We Use Naira To Pay For What We Import? The naira is not a convertible currency, so it cannot be used for the payment of international transactions. The Naira has to first be converted into foreign currency and then used to pay.

3.2.2 Composition of External Reserves

In terms of composition, the CBN Act (2007) provides that the Bank shall maintain a reserve of external assets consisting of all or any of the following:

- Monetary Gold coin or bullion;
- Balances at banks outside Nigeria where the currency is freely convertible;
- Treasury bills having a maturity not exceeding one year issued by the government of any country outside Nigeria whose currency is freely convertible;
- Securities of, or guarantees by, a government of any country outside Nigeria whose currency is freely convertible and the maturity of securities not exceeding ten years from the date of the acquisition;
- Securities of, or guarantees by international financial institutions of which Nigeria is a member, if such securities are expressed in currency freely convertible and maturity of the securities not exceeding five years;
- Nigeria's Reserve position in the International Monetary Fund (IMF); and
- Allocation of Special Drawing Rights (SDR) made to Nigeria by the IMF.

Figure 1: External Reserves and Capital Inflows - 2007 - 2014

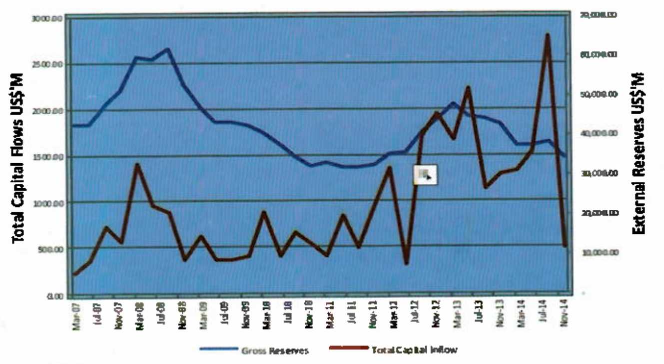
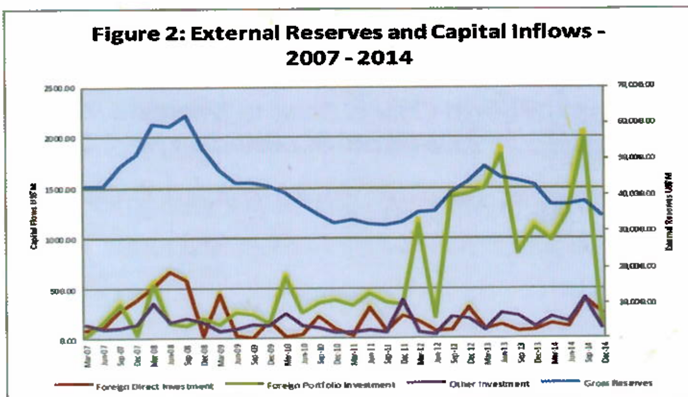


Figure 2: External Reserves and Capital Inflows - 2007 - 2014



As such, the CBN holds external reserves in a combination of the above mentioned assets.

3.3 External Reserves and Capital Flows in Nigeria

From the literature review in section two, we have established that for a country to attract capital flows, it needs to have strong economic fundamentals and a good credit rating, which are related to external reserve holdings. In addition, it has also been established that robust level of external reserves provides confidence to the international community that the country can meet its international obligations.

This gives a positive (indirect) relationship between capital flows and external reserve holdings. It is thus expected that the higher the level of external reserve holdings by a country, the more capital it will attract. Figure 1 below shows the relationship between external reserve holdings and aggregate foreign capital flows.

Before the 2008 global financial crisis, it could be seen that such a positive relation holds, where an increase in the external reserve holding lead to a similar increase in the level of capital flows. However, the relationship broke down in 2010 when we witnessed an increase in the level of capital inflows despite decreasing reserve levels. To unravel the reason for this, we disaggregated the capital flows into three major components: FID, FPI and others, as seen in figure 2 below.

From the above, it can be seen that while FDI and other investments maintained the same trend with external reserve holdings, FPI (stock and bond holdings) rose around November 2011. Though it crashed between May and July 2012, it rose again in September 2012 and reached its

peak in July 2014 before plummeting around November 2014.

A number of factors could provide some possible explanations to the behavior observed in these segments of capital inflows. The low level of FDI and other investments could be attributed to the security challenges and pipeline vandalization in Nigeria; as well as the poor state of infrastructure. However, at the same time, Nigeria had a high interest rate regime in both the bonds and money markets compared to other developed and emerging market economies. This could therefore lead to an increase in FPI, as it seeks for higher returns. More so, FPI is easy to reverse, so investors could easily liquidate their holdings and exit as Nigeria has no capital controls. This may also explain the sharp decline in FPI at the end of 2014 as investors exit due to the tension generated by the March 2015 elections.

4.0 CONCLUSION AND RECOMMENDATIONS

The growth of an economy amidst a sound financial and political environment attracts foreign investments, bringing with it its attendant benefits. Thus, sustained capital inflows above outflows cushion the effect of foreign exchange demand as confidence is established in the financial system and the strength of the economy. However, for a sustained level of inflow, especially FDI which is more productive, an economy must possess strong economic fundamentals. Thus, while Nigeria was able to attract all types of foreign capital before the 2008 global financial crisis due partly to robust level of reserves, only FPI flow was sustained at a higher level after the crisis.

In order to attract more direct investments that are seen as more stable and less speculative, the country must therefore develop the requisite infrastructure for the growth of the real sector. Security of lives and property must also be among the top priorities of government. There is also the need to diversity the sources of foreign exchange earning in Nigeria in order to address the dominance of the oil sector which is subject to the vagaries of international demand and geo-political tension. The National Sovereign Investment Authority (NSIA) should also be strengthened through more funding in order to establish fiscal buffers that will improve Nigeria's credit rating.

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