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Financial Liberalization and the Structure of Capital Flows in African Countries

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Executive Summary

Since the 1980s, African countries have made efforts in economic reforms, including liberalization of domestic financial markets and the opening of the capital account. The expectation was that financial reforms would result in higher capital inflows. However, the evidence indicates that African countries remain largely on the sidelines of the financial integration phenomenon. The capital account of most African countries remains characterized by heavy dependence on external borrowing and aid, large outflows of funds in the form of debt payment, and low private inflows. In addition, while countries face a heavy burden on debt, they also suffer substantial hemorrhage of resources in the form of capital flight.

While financial liberalization may have succeeded in removing interest rate repression, it has failed to improve competition in the banking sector and efficiency in resource allocation. Interest rate margins remain high, illustrating pervasive monopoly power of banks, which discourages lending. The high interest rate differentials have not attracted much foreign private capital.

Efforts to increase the volume and stability of capital flows must involve strategies to attract more savings from the African diasporas. African governments need also to establish incentives for allocating remittances into domestic investment. Moreover, they need to tackle the problem of financial hemorrhage or capital flight through better rules of accountability and transparency in the management of government funds and in capital account transactions. To curb and reverse capital flight, African countries need to seek better cooperation with the international community to impose more responsible banking practices by Western financial institution.

While African countries need to pursue efforts to attract more private capital flows, they must not be distracted from the need to foster domestic investment. The focus of policy should be on improving the overall investment climate to promote both domestic investment and long-term external capital inflows. Policy makers must especially avoid any bias in investment policy in favor of foreign investors that may put domestic investors at a comparative disadvantage. Accelerating growth will require a healthy rate of domestic investment complemented by sufficient inflows of stable long-term external capital.

I. Introduction

The financial liberalization drive initiated in the 1980s in African countries and other developing regions was expected to achieve a wide range of objectives including: (1) the removal of market distortions in domestic financial markets to allow higher competition and more efficient allocation of capital; (2) alleviation of market segmentation in domestic financial markets; (3) increasing financial intermediation (saving and lending); (4) increasing access to external capital, especially long-term investment capital, thus reaping the benefits of international financial integration; (5) reducing capital flight (Lensink, Hermes, and Murinde 1998); and even (6) reducing corruption through deregulation of the financial system (DeLong 2004).

However, after more than two decades of liberalization, most observers concur that the experiment has been disappointing. Many reasons have been offered for why financial liberalization failed to produce the expected results in African economies. The reasons include: (1) the lack of political anchoring and poor policy choices that undercut financial liberalization efforts (Mkandawire 1999); (2) persistence of government interference in financial markets and partial implementation of liberalization measures (Reinhart and Tokatlidis 2003; Seck and Yasim 1993); (3) and macroeconomic uncertainty and instability, including inflation volatility (Seck and Yasim 1993). Most studies conclude that more needs to be done, especially in terms of accompanying economic and institutional reforms to support financial liberalization. It has become evident that financial liberalization is not a panacea.

One of the expected benefits from financial liberalization is to affect the composition of capital flows in favor of long-term capital in addition to raising the overall volume of capital flows. This study focuses on this particular objective of liberalization and examines whether the structure or composition of capital flows has changed in the era of financial liberalization in African countries. This issue is central to the development agenda. Increasing the share of long-term capital accomplishes important objectives including: (1) improving the ability to finance capital accumulation and stimulate economic growth; (2) ameliorating the sustainability of current account financing, as long-term capital is more reliable than short term capital; and (3) reducing the volatility of capital flows, as long-term capital is more stable than short term capital. The analysis in this paper attempts to establish a linkage between the timing, level, and composition of capital flows on the one hand and measures and episodes of financial liberalization in African countries on the other hand. The analysis sets the stage and gives insights for a discussion of appropriate policies and strategies to increase access to long-term capital and improve the management of capital flows to reduce the risk of instability and maximize the benefits from financial integration.

II. Scope, Benefits and Costs of Financial Liberalization

2.1 Scope of financial liberalization

The literature on financial liberalization has had a tendency to take a segmented approach to financial liberalization, focusing on one sector of the financial system. A comprehensive analysis of liberalization of finance must cover all the three sectors, namely the domestic financial system comprising banks and non-bank financial institutions, the stock/equity market, and the capital account. A comprehensive analysis is motivated by the fact that these sectors interact among each other in such a way that deregulation in one sector affects other sectors. For this reason, the sequencing of liberalization in the three sectors is critical for the success of liberalization. For example, liberalization of the capital account before the establishment of a strong prudential regulatory environment for the domestic financial system raises the risk of banking crises (Caprio and Kliengebiel 1996).

Liberalization of the domestic financial system comprises three key policy actions. The first consists of removal of price restrictions; that is, the removal of ceilings on deposit interest rates and restrictions on lending interest rates. This aspect of financial liberalization has occupied a prominent place in the literature on financial liberalization. Interest rate deregulation is seen as a critical signal for the government's willingness to relinquish control over a key segment of the economy and an important source of financing of budget deficits. Indeed, by imposing ceilings on interest rates, the government is able to keep its borrowing costs low, thus affording higher budget deficits.

The second component of liberalization of domestic financial systems consists of removal of quantity restrictions; that is, the removal of direct credit allocation mechanisms, relaxation of reserve requirements, and removal of restrictions on foreign currency deposits. The removal of quantity restrictions on credit is supposed to induce better allocation of capital across activities and among borrowers. Relaxation of reserve requirements aims at reducing the cost of financial intermediation, which ultimately increases the availability of credit. The removal of restrictions on foreign currency deposits aims, among other things, at reducing the incentives for smuggling of foreign exchange as well as encouraging inflows of foreign capital.

The third policy action consists of removal of entry barriers in the financial system. In countries with a heavy government presence in the financial sector, liberalization involves privatization of public financial institutions and relaxation of restrictions on the creation of private financial institutions. Liberalization also includes opening of the financial system to foreign banks. All these actions aim at promoting higher competition in the financial system, which is supposed to increase access to capital and to reduce the cost of capital through the dismantling of monopolies in the financial system.

The liberalization of the capital account includes the removal of restrictions on inflows and outflows. Deregulation of inflows consists of removal of restrictions on offshore borrowing by domestic financial institutions and non-financial corporations. Deregulation of outflows involves relaxation of controls on capital outflows and multiple exchange rates. The

liberalization of the capital account aims at accelerating financial integration, which is expected to increase access to foreign capital. It is also part of the broader program of removal of market distortions, which aims at improving the efficiency of the whole financial system.

Liberalization of the stock market consists of relaxation of restrictions on acquisition of shares in domestic equity markets by foreigners and removal of restrictions on repatriation of capital, interest income, and dividends by foreign investors. Liberalization of the stock market is expected to increase the depth and liquidity of the market, thus increasing savings mobilization and facilitating access to finance for non-financial corporations.

2.2 The main arguments in support of financial liberalization

The most prominent argument for liberalization of financial markets is that the move away from government control towards market-determined asset pricing and resource allocation improves the efficiency of the financial system in terms of access to finance and allocation of capital.¹ This argument was initially championed in the influential works of McKinnon (1973) and Shaw (1973). Repression in domestic financial systems allows the government to finance deficits with cheap credit, creating a *captive market* for government securities, which ultimately discourages private savings and lending to the private sector. Proponents of financial liberalization see it as a means of promoting financial development by establishing a more market based economy.

By reducing the scope and extent of financial regulation, financial liberalization is also supposed to reduce corruption and improve overall governance (Delong 2004). Financial regulation in the domestic financial markets and in capital account operations creates opportunities for corruption and rent seeking by regulators. Corruption creates perverse incentives and promotes speculative activities to the detriment of long-term investment. Note, however, that removing corruption requires more than just liberalization of finance. Corruption is an institutional phenomenon, which implies that combating corruption requires broad institutional reforms. Moreover, given that institutions do not reform themselves, eradicating and preventing corruption requires the establishment of independent agencies of restraint that enforce the rule of law. For instance, the success of liberalization in the domestic financial system requires a strong and independent central bank that enforces transparency and prudential financial practices. The implication is that financial liberalization can only contribute to broader efforts aimed at alleviating corruption through careful institutional engineering. It cannot be successful in isolation from institutional reform.

Another argument for financial liberalization is that it increases access to finance and therefore reduces financing constraints for private firms (Laeven 2003; Calindo et al 2005). The removal of direct credit regulations facilitates access to finance for activities and firms that were not classified as priority sectors by regulators. In addition, the opening of the domestic market to foreign players is expected to increase access to finance. Liberalization alleviates information imperfections and reduces agency costs of external finance, thus

¹ Recent studies attempt to establish empirical evidence on the effects of financial liberalization on resource allocation. See Galindo et al 2005 for firm-level evidence on these effects.

reducing financing constraints for firms. However, the empirical evidence on this effect is still limited. The evidence suggests that the effects of financial liberalization on access to finance may vary by type of firms. Small firms seem to experience a reduction in financing constraints, while large firms become more financially constrained after liberalization (Laeven 2003). This result may be due to the fact that large firms had privileged access to credit before liberalization. Once these privileges evaporate due to liberalization, large firms may be unprepared to borrow at higher market-determined interest rate. Privileged access to credit may have allowed these firms to generate profits even with inefficient allocation of resources into low-return activities. Liberalization makes some of these activities unprofitable as the unregulated price of credit rises.

The opening of the capital market to foreign institutional investors is expected to be accompanied by higher stability (lower turnover), increased efficiency in the allocation of capital, and improved corporate governance. Individual traders are less informed and more subject to rumors and herd behavior, which increases stock turnover and instability in the capital markets. Institutional traders, in contrast, are better at collecting relevant information on the quality of assets and borrowers, which reduces information asymmetries. They also tend to promote a long-term perspective on securities transactions and management, which should increase availability of long-term capital. Moreover, institutional traders play an important role in monitoring non-financial corporations, which reduces the agency problems, improves governance, and raises the market value of stocks. As a result, the opening of the financial system is expected to raise stock returns, which should induce higher inflows of external capital.

2.3 The main arguments against financial liberalization

Despite these expected gains from financial liberalization, objections have been raised against it, prompted by the important adverse effects of financial integration especially for developing economies. One of the key arguments against financial liberalization is that liberalization increases the risk of financial fragility, which in turn has large negative effects on the economy (Caprio and Klingebiel 1996). One of the key findings from empirical studies is that large financial cycles are triggered by financial deregulation (Demirgüç-Kunt and Detragiache 1998). Financial liberalization is said to exacerbate boom-bust patterns of financial markets, thus increasing overall macroeconomic instability and the risk of banking crisis (Stiglitz 1999; Calvo and Mendoza 2000; Kaminsky and Schmukler 2003). These concerns have prompted strong arguments for capital controls to manage disorderly outflows (Krugman 1998) and interventionist strategies for hedging against the risks arising from the unreliability of the international financial system (Stiglitz 2002).

One empirical question is how exactly financial liberalization increases the risk of banking crises.² One channel is the interest rate risk. As interest rates are liberalized, they may become more variable,³ which may increase interest rate risk and the risk of insolvency in the banking sector. As weaker banks fail, other banks are also affected through contagion effects. The second channel is higher liquidity problems for banks, especially in countries

² See Daumont, Le Gall, and Leroux (2004) for a discussion of the causes of banking crises in African countries.

³ Honohan (2000) finds evidence showing that interest rates become more volatile after financial liberalization.

where the inter-bank market is not well developed (Chari and Jagannathan 1988). The third channel is through a reduction in franchise value of banks due to the removal of ceilings on deposit rates and removal of entry barriers in the banking sector (Demirgüç-Kunt and Detragiache 1998). Finally, financial opening increases the risk of bank crisis because it introduces a new form of risk, the exchange rate risk, over and above the closed-economy banking risks (interest rate risk, credit risk, and liquidity risk). The liberalization of the capital account allows banks to raise funds in international markets and lend to domestic borrowers who may be unhedged against exchange rate risk. The exchange rate risk can generate a currency crisis as lenders and borrowers engage in speculation to minimize losses due to an impending currency collapse. Indeed bank crises (due to exchange rate exposure) tend to be closely related to currency crises (Kaminsky and Reinhart 1999).

Critiques of financial liberalization also argue that capital controls can help to minimize the adverse effects of global capital flows on the economy (Krugman 1998). International capital flows are characterized by a high degree of instability and unpredictability and can be destabilizing for recipient economies. The effects are especially damaging in developing countries whose financial systems are not sufficiently equipped to absorb large and volatile capital inflows. It is argued that it would be ill-advised for developing countries to expose themselves to the vagaries of an international financial system (Stiglitz 2002).

2.4 Issues with the sequencing of liberalization

The implication of the foregoing discussion is that the potential benefits of financial liberalization need to be weighed against the potential adverse effects on the economy, especially in terms of increased financial fragility. Appropriate sequencing and pacing of liberalization can help to minimize adverse effects while maximizing positive effects of liberalization. Indeed premature liberalization can be damaging (Caprio and Summers 1993; Stiglitz 1994).

There is no consensus about the appropriate sequencing of financial liberalization. Historical evidence shows that different countries adopt different strategies as to which sector to liberalize first. However, it appears that in general, countries tend to liberalize the domestic financial system (bank sector and non-bank sector) first and the capital account at a much later stage (Kaminsky and Schmukler 2003). No clear pattern emerges from country experiences with regard to the sequencing of liberalization of stock markets relative to other sectors. Historical experience also indicates that liberalization is a gradual process. Full liberalization occurs several years after the time when the first market is liberalized. In general, the evidence suggests that a prudential and gradual approach is the best way to go with financial liberalization. This allows market players to adjust to new regulations while also allowing policy makers to make the necessary adjustments during the course of liberalization so as to minimize adverse effects.

III. Financial Liberalization in African Countries

In the case of African countries, financial liberalization has mainly involved the relaxation of three types of controls: controls on external capital, domestic controls on wholesale interest rates (Treasury Bill rate and money market rates), and controls on domestic retail bank rates (deposit and lending rates). Liberalization of the stock market is a less prominent issue given the small number and underdeveloped state of stock markets in the continent. It is difficult to determine a precise date for liberalization because the three types of controls are not lifted simultaneously and, most importantly, because the official dispositions do not always match the actual practice. Nonetheless, based on proxies of financial liberalization, we are able to get a sense of the trend and the degree of liberalization in African countries over time and relative to other regions. In this section, we discuss liberalization of the capital account using indexes of capital account restrictions and financial integrations compiled by the IMF. We also examine the extent of liberalization of the domestic financial system based on the evolution of interest rates, and we identify key trends and compare African countries to the rest of the world.

3.1 External financial integration/liberalization in African countries

Liberalization of the capital account in African countries is part of the general movement towards openness of trade and finance in the context of externally mandated (by development assistance institutions) and – to a lesser extent – domestically initiated reforms of the economy and the financial system. The general move towards liberalization originates from the 1980s when African countries were subjected to structural adjustment programs aimed at addressing the debt and balance-of-payments crisis. African countries have progressively relaxed various restrictions on the capital account and foreign exchange transactions. However, relative to other regions, Africa remains comparatively more closed with regard to capital account transactions. Figure 1 shows the proportion of countries in each developing region that have open capital accounts. A country is classified as having an open capital account if it is reported to have no restrictions on capital account transactions. It is classified as having a closed capital account otherwise. The graph shows that up to 1995, the large majority of African countries maintained various kinds of capital account restrictions.

Overall, the African continent is less financially integrated than other developing regions. Figure 2 shows the average index of financial integration by region from 1966 to 1995. While the degree of financial integration in Africa shows a strong upward trend since the early 1990s, it remains lower than in other regions. The index of financial integration reported in Figure 2 is an average of the proxies for capital account controls, foreign exchange restrictions (including surrender of export proceeds) and current account controls. Unfortunately, the IMF series used in this Figure do not extend after 1995. It is likely that financial integration has increased since then due to increasing pressure for openness imposed by the lending institutions on African countries.

Nonetheless, the lower level of financial integration in African countries, perceived or real, contributes to raising the degree of investment risk in the eyes of foreign investors. Prospective investors are wary of having their capital “locked up” in a foreign country due to high restrictions on capital transactions. However, as discussed earlier, the benefits from financial openness in terms of expected higher capital inflows need to be weighed against the costs arising from higher risk of financial instability. The key issue is the pace and sequencing of the removal of the three main types controls discussed above. Historical record shows that there is no universally agreeable sequence of liberalization; each country ought to organize its liberalization on the basis of its particular structure, degree of financial development, and development needs. Most analysts agree that a hasty liberalization may do more damage than strict capital controls.

3.2 Domestic financial liberalization in African countries

Domestic financial liberalization includes various measures regarding the functioning and regulation of the financial system. These include the freeing up of entry restrictions in the banking system, privatization of government owned banks, relaxation of direct credit allocation measures, and removal of interest repression. These reforms are aimed at increasing competition in the banking sector, improving efficiency in the allocation of resources across investment activities, and removing market distortions in the financial system. These reforms often encounter resistance both in government and in the private sector as they result in a transfer of wealth away from the public sector and privileged banks and borrowers. Indeed the removal of interest rate repression implies an increase in the cost of deficit financing for the government and higher costs of borrowing for privileged private and parastatal units. Similarly, the removal of entry barriers in the banking sector implies a loss of monopoly rents for existing banks, and may even lead to financial distress for weak banks. These potential costs of liberalization for governments, banks, and privileged borrowers may explain the slow pace of liberalization of the banking sectors in African countries. They may also explain the discrepancies between the official declarations and the actual practice with regard to deregulation of the banking sector. For instance, it is often observed that while countries officially announce the relaxation of entry barriers in the banking sector, banking sectors remain characterized by large monopoly power of a small number of banks.

The process of domestic financial liberalization initiated since the 1980s in African countries has been accompanied by marked upward trends in interest rates (Figure 3; Table 1). With the removal of interest rate controls, nominal interest rates have risen systematically since the 1980s. For the 22 African countries in Table 1, the average deposit rate increased from 9.5 percent in 1985 to 15 percent in the first half of the 1990s. The lending rate rose from 14.8 percent to 23.3 percent during the same period. As a result the spread rose from 5.3 percent to 8.1 percent. The upward trend persisted despite the slowdown and even decline in inflation rates in many countries, especially among inflation targetters, such as South Africa (see Ndikumana 2005). In the 1990s, the interest rates tapered off. In fact, deposit rates declined in many countries, resulting in a rise in the interest rate spread. The average spread for the 22 countries in Table 1 increased from 8.1 percent in the first half of the 1990s to 11.4 in the subsequent period. Moreover, the interest rates in many African countries have remained high relative to world interest rate, resulting in positive and rising

interest rate differential, especially during the more recent period where world interest rates have declined due to world recession.

The observed trends in interest rates in African countries are consistent with the evidence in other developing countries after liberalization. In general, during the 1990s, developing countries experienced an increase in the level and volatility of nominal interest rates and the spreads relative to developed countries (Honohan 2000). The rise in interest rates reflects several phenomena, including the removal of financial repression, the increase in credit risk, market power in the banking sector, and macroeconomic factors including high budget deficits.

The observed trends of interest rates in African countries are nonetheless puzzling on a number of margins. First, in principle, financial liberalization is expected to be accompanied by an increase in the level of competition in the banking sector, resulting in a higher sensitivity of the interest rates and spreads to changes in market interest rates.⁴ Liberalization should result in a reduction of the monopoly rent enjoyed by banks. Thus, the interest rate spread should decline following liberalization. The evidence on African countries reveals the opposite, indicating rising spreads in the liberalization era (Figures 3 and 4). Despite liberalization efforts, African banking systems remain heavily concentrated whereby a small number of large banks enjoy large substantial market power (see Hawkins (2004) for the case of South Africa). This allows banks to extract high profit rates by keeping deposit rates low while charging high lending rates. The rise in the spread illustrates the rise in bank monopoly rent (Figure 4).

The second puzzle is the fact that interest rates in Africa have remained high and continued to increase while world interest rates declined. Theory suggests that following liberalization, domestic interest rates should adjust to world interest rates. In other words, domestic interest rates should “converge” to world interest rates. It is also expected that the speed of convergence should increase after liberalization. These predictions can be expressed (and tested) formally as follows:

$$\Delta r_t = \alpha_0 + \alpha_1 \Delta r_t^w + \alpha_2 (r_{t-1}^w - r_{t-1}) + \alpha_3 \Delta r_{t-1} + \alpha_4 X_t + \varepsilon_t \quad (1)$$

where r is the domestic interest rate, r^w the world interest rate, X a vector of control factors, and ε the error term. The coefficient α_2 captures the “catch up” effect; that is the tendency of domestic interest rates to converge to world interest rates. In a closed economy, $\alpha_1 = \alpha_2 = 0$. The evidence shows no convergence of interest rates in developing countries to those in developed countries (Honohan 2000).

The high interest rate spreads in African countries may be explained as the outcome of risk management by banks in an oligopolistic market. Lack of competition reduces pressure for portfolio diversification on the part of banks. This explains why banks hold high volumes of government securities which are safe and relatively easy to manage. Government securities

⁴ This prediction can be tested by regressing the spread (or change in the spread) on the market interest rate. The coefficient on the market rate gives a measure of competitiveness in the banking sector; it should be higher after liberalization and it should also be larger in financially developed countries than in financially underdeveloped countries. See Honohan (2000) for some empirical evidence on these predictions.

provide a convenient form of investment for banks while also increasing banks' credibility as they are also used as collateral in inter-bank transactions. The high preference for government securities reduces incentives for lending and thus constitutes a constraint to private investment. Therefore lack of competition in the banking sector causes inefficiencies in the allocation of financial resources in the economy.

The persistence of high interest rates in African countries in the liberalization era poses important policy concerns. The concern with high interest rates is that they discourage borrowing and domestic investment. From a positive side, high domestic interest rates should provide incentives for external capital inflows, thus alleviating resource constraints. The practical question, however, is whether indeed African countries have reaped the benefits from higher interest rate differentials in terms of increased capital inflows. We examine this question in Section 4 below by looking at the level and composition of capital inflows in the financial liberalization era.

3.3 Other challenges in the domestic financial system

Despite substantial progress in the reform of financial systems, a number of critical challenges remain and impede the ability of financial systems to efficiently mobilize and allocate resources. Much of the attention in the financial liberalization agenda has been on interest rate deregulation and curtailment of government's role through privatization. There are other important issues that remain to be addressed; we highlight three of the main problems that still plague financial systems in Africa (see Ndikumana 2003b for further details).

The first important problem is the monopolistic structure of the banking system. This, as discussed above, contributes to perpetuating usurious interest rate margins that discourage borrowing. Because of their substantial monopoly rent, banks are not interested in venturing into lending to new areas beyond their preferred customers, namely the government, parastatals, and large firms. As a result, vital segments of the economy such as small and medium enterprises, agriculture and the rural sector in general suffer from credit rationing. Large banks may indeed not be equipped to manage small loans in these sectors. African governments need to promote the development of a second layer of financial intermediaries that are more specialized to lending to sectors that fall out of the radar screen of large banks.

The second challenge to effective financial intermediation is the weakness of regulatory and supervisory mechanisms. Weak supervision and regulation causes fragility in the financial system, especially due to ineffective enforcement of prudential rules in the banking business. The opening of the banking sector has often been accompanied by a proliferation of poorly capitalized, ill-managed, and high risk taking new intermediaries, resulting in an increase in bank failure rates. Success of financial liberalization requires the strengthening of the supervisory and regulatory capacity of the central banks, which necessitates effective independence of the central bank as well as investment in skills development of the central bank staff.

The third problem that needs to be addressed is the slow progress in the reform and modernization of payment systems in African countries. Modern forms of payments are still scarce, mostly due to technological constraints but also due to rigidity in government regulation despite the official rhetoric that claims full liberalization of finance. Ineffective payment systems discourage domestic and international exchange and resource mobilization.

The foregoing discussion implies that the success of financial liberalization will require broadening the scope of financial reforms beyond interest rate deregulation. The agenda will include investment in technology to accelerate modernization of financial operations and deep institutional reforms to make the banking system more competitive and more accessible to the majority of the population.

IV. Structure of Capital Inflows to Africa in the Liberalization Era

4.1 Africa on the sidelines of financial integration

There are two main dimensions of the structure of capital flows that are most relevant for economic development and financial stability. The first dimension is the distinction between private and official resource inflows. Official resource flows include public debt and official development aid. The second dimension is the term structure of capital flows, long term capital or foreign direct investment vs. short term capital or portfolio equity flows.

Since the early 1990s, non-bank private resource flows, namely foreign direct investment, bond and equity portfolio flows, have accounted for most of the growth in financial flows in developing countries. From 1990 to 1999, private net resource flows to all developing countries increased almost six fold, from \$42 billion to about \$239 billion (*Global Development Finance 2000*). There has been a tendency for private capital flows to replace official flows, debt and aid. This “surge” in private capital flows to developing countries has been interpreted as a byproduct of global financial integration (World Bank 1997). International investors penetrate markets in the developing world in search for higher-returns investment opportunities as well as a way of minimizing risk through portfolio diversification. At the same time, recent economic reforms undertaken by developing countries have contributed to attracting private capital (Singh 1999; Singh and Weiss 1998). Financial integration is supposed to benefit developing countries by allowing them to tap the pool of global capital and achieve higher economic growth through improved resource allocation through financial markets (Fischer 1999).

However, this general picture of a “surge” in private capital flows does not hold for Africa. The continent seems to remain on the sidelines of the financial integration phenomenon. Official resources – aid and debt – continue to make up the largest form of external resources in African countries (Table 2). African countries remain largely outside of the radar screen of foreign investors despite progress in economic reform including deregulation of financial markets and attractive interest rates. Note however that while African countries accumulated external debt, the net gains from borrowing have deteriorated. Indeed net transfers on debt have declined and even turned negative for a number of African countries.

Borrowing by African countries thus has resulted in a net drain of resources towards the Western world. This is compounded by the fact that a large proportion of the borrowed funds has been used to finance private wealth accumulation through capital flight. Evidence shows that African countries as a group constitute a net lender to the rest of the world in the sense that the accumulated capital flight exceeds the foreign liabilities of these countries (Boyce and Ndikumana 2001; Ndikumana and Boyce 2003).

Private capital inflows to African countries have increased in absolute terms in 1990s. However, the volume of private flows remains relatively small and dominated by foreign direct investment. Moreover, private external capital represents a small fraction of gross capital formation (Ndikumana 2003a). Liberalization has not succeeded in inducing enough private resource inflows to fill the resource gap. African countries have made little progress in attracting a more diversified pool of resources, even in countries with “emerging” stock markets such as South Africa (Ahmed et al 2005). South Africa has gone a long way in liberalizing its capital account and deregulating its domestic financial system. It also has implemented sustained reforms in macroeconomic policy, which has improved macroeconomic stability and credibility of macroeconomic policy in the eyes of private operators. Among other achievements, the country has recorded a substantial reduction in inflation and has adopted inflation targeting as the primordial goal of monetary policy since 2000. The primary tool for controlling inflation has been the control of domestic lending and spending through high interest rates. The decline in inflation and the maintenance of high interest rates have resulted in high interest rate differentials with trading partners. However, these positive interest differentials have not attracted higher private resources inflows. In contrast, the high real interest rates carry high costs in terms of reduced domestic investment (Ndikumana 2005). Moreover, high interest rate differentials may induce speculation both by domestic investors, shifting savings into financial assets away from physical capital accumulation, and by foreign investors seeking high-return investments in the stock market rather than long-term productive investment.

In general, the evidence shows that sub-Saharan Africa remains marginalized with regard to global financial flows. While the absolute volume of private resources has increased since the 1990s (from very low levels in the 1980s), the continent’s share in total resources has actually declined (Figures 5 and 6). The volume of foreign direct investment increased from 2.4 billion dollars in 1985 to 5.4 billion dollars in 1995, but Africa’s share in world FDI inflows declined from 4.2 percent to 1.6 percent during the same period. The share has increased since, but it remains below the level achieved in the 1980s.

The evidence suggests that the progress made in deregulating domestic interest rates, which has resulted in higher interest rate differentials, has not been rewarded by higher capital inflows. This evidence raises important questions with regard to Africa’s position in the financially globalizing world. It appears that high direct returns to investment are not sufficient for attracting foreign capital in Africa. Indeed, returns to investment are found to be much higher in Africa than in other developing regions. In 1997, the rate of return on US foreign investment was 25 percent in Africa compared to 16 percent in Asia, 12 percent in Latin America, and an average of 14 percent for all developing countries (UNCTAD 1998). Despite these high rates of return, African markets are still unable to entice private foreign capital. The reason may be that sovereign risk remains high, resulting in lower risk-adjusted returns relative to other regions. Another reason is that the costs of doing business

in Africa remain high due to poor infrastructure and political uncertainty (Asiedu, 2003, 2004; Asiedu and Lien, 2003; Morisset, 2000). Yet another reason may simply be hysteresis: Africa receives less foreign capital because it has received less foreign capital in the past.

The question is when and how the continent will overcome its locational disadvantage vis-à-vis foreign investment. Reducing sovereign risk will require more than just financial liberalization. African countries will need to implement systematic macroeconomic and institutional reforms that allow to reduce overall risk. The improvement in the investment climate that will result from such reforms will not only attract more external capital but will also induce more domestic investment. Indeed, policies that promote domestic capital accumulation are likely to also induce foreign capital inflows.

In general, policy makers in African countries need to keep this perspective of complementarity between domestic investment and foreign capital inflows. Most importantly, it would be counterproductive to give foreign capital special privileges (e.g., through generous tax holidays) that put domestic investors at a comparative disadvantage. Promoting domestic investment should remain a priority, especially given that strong performance in domestic investment serves as an inducement for foreign investors as it indicates high returns to capital and low investment risk. Moreover, domestic investment is more reliable for sustainable growth than foreign capital. Domestic investment has at least as much if not more positive externalities in the economy through employment creation and expenditure multipliers than foreign investment, especially as the proceeds of domestic investment are either reinvested or consumed in the country. Therefore, for the purpose of stable long-run growth, concerns about attracting foreign capital must not undermine efforts to promote domestic investment.

The evidence discussed in this section indicates that raising the rates of return to capital alone is not enough for attracting external capital in African countries. One of the reasons may be that foreign investors attach a higher risk to African economies than warranted by market indicators. This could be due to sheer ignorance on the part of foreign investors or more generally to information asymmetries. One way to overcome these information asymmetries is for African policy makers to establish mechanisms for increasing direct contact between foreign investors and the African environment. If indeed perceptions of high risk are due to ignorance, then more contact between foreign investors and the African reality will reduce the degree of risk aversion on the part of foreign investors and thus promote foreign investment. Empirical evidence does confirm the prediction that closer human contact plays a key role in the level and direction of foreign investment (Goldberg et al 2005). The point is that African countries should not just wait for foreign investors to venture into their markets, they should actively seek to entice these investors through direct contact.

4.2 Remittances, a potential source of diversification of capital inflows

In discussing strategies for increasing and diversifying the pool of foreign capital, worker remittances deserve serious attention for two main reasons. First, recent evidence indicates that worker remittances and other forms of “unrequited transfers” have become an

important source of capital inflows in developing countries. Second, worker remittances may provide some indication of the potential as well as the incentives for repatriation of private assets held abroad by Africans.

While it is difficult to obtain a precise picture of the volume of remittances due to poor quality of the data, recent research provides some indication that these forms of capital flows constitute a promising source of external financing in developing countries (Kapur, 2003; Amuerto-Dorantes and Pozo, 2004; Adams and Page 2003; Lucas 2005; Maimbo and Ratha 2005). Some observers have even suggested that remittances may be a “new way” of financing development. Worker remittances are considered more stable than other forms of private financial flows. The funds are targeted to reach the final recipients and are thus more or less immune from the risks of diversion and corruption that plague official development aid. Moreover, remittances are by nature “unrequited”: they require *no quid pro quo*, and thus are a net financial gain to the recipient country. Furthermore, worker remittances may contribute an important source of finance for starting small and medium enterprises, thereby alleviating financing constraints. Remittances also provide a form of social insurance for the recipient population by mitigating the effects of economic shocks and shortfalls in household incomes. Unfortunately, there is little empirical research on these micro-level effects of remittances. Given the worldwide debate on poverty alleviation, this topic deserves serious attention.

Sub-Saharan countries have lagged behind other developing regions with regard to worker remittances. In 2001, remittances to SSA constituted 10% of net flows, compared to 63% for Asia and 56% for the Middle East and North Africa (Kapur, 2003). North African countries received a substantially higher volume of worker remittances than SSA countries (Table 3).

Given the need to reduce the dependence on aid and debt, African governments need to investigate all possible mechanisms for increasing recorded inflows of capital from Africans abroad. At the moment, the potential for remittances remains largely unexploited. Moreover, a substantial proportion of transfers are done through informal channels due to high direct fees and transactions costs involved with official transfers. Only recently some countries have allowed individuals to hold foreign-currency denominated bank accounts. Facilitating banking and capital account transactions by members of the diasporas will allow African countries to tap the savings of Africans abroad and thus diversify the pool of external resources.

4.3 The case of capital flight

The capital account of African countries presents a stunning paradox. While African countries have accumulated massive amounts of external debt, they also have experienced heavy financial hemorrhage in the form of capital flight, some of which is financed by the borrowed funds. Evidence suggests ironically that sub-Saharan Africa is a “net creditor” to the rest of the world in the sense that the private assets held abroad (partly financed by debt) by private Africans exceed the continent’s liabilities vis-à-vis the rest of the world (Boyce and Ndikumana 2001; Ndikumana and Boyce 2003).

Portfolio theory would suggest that capital flight is driven by lower returns at home compared to returns abroad. However, there is little evidence for this link, which is not surprising given that the bulk of capital flight involves smuggling of funds for the purpose of evading the law rather than pure portfolio diversification. Therefore, even if liberalization succeeded in raising domestic returns to capital, it may not succeed in curbing capital flight. Indeed, empirical studies find little evidence of an effect of liberalization on capital flight (see Lensink, Hermes, and Murinde 1998). Given that capital flight is a symptom of a generalized decay of governmental control and enforcement mechanisms, financial liberalization needs to be accompanied by broader institutional reforms aimed at enforcing accountability and transparency in the management of government funds (including debt). Moreover, domestic reforms need to be complemented by reforms in international banking practices to enforce transparency and responsible lending, especially by preventing complicity by bankers with corrupt leaders in smuggling funds from developing countries.

V. Summary and Policy Implications

Since the 1980s, African countries have made efforts in economic reforms, including liberalization of domestic financial markets and opening of the capital accounts. One important objective of these reforms was to attract more external capital to fill the saving-investment gap and promote faster economic growth. However, the evidence shows that African countries remain largely on the sidelines of the financial integration phenomenon. The continent continues to depend primarily on official resources, namely public borrowing and official aid. These resources have declined since the mid-1990s and have not been replaced by private capital. Although private capital inflows to Africa have increased in the 1990s relative to the previous decade, the volumes remain low compared to other regions. Private external capital still constitutes a small contribution to domestic capital formation. Moreover, sectoral diversification of private external investment has traditionally been weak, with most investments targeting extractive industries, despite the fact that the returns to investment in the secondary and tertiary sectors are often higher.

The evidence discussed in this paper shows that relatively high rates of returns as illustrated by high interest rate differentials have not attracted much foreign capital. A broader set of strategies aimed at reducing country risk are necessary to induce more private capital inflows. These strategies include macroeconomic policy reforms as well as institutional reforms to improve governance and political stability. Moreover, policy makers need to be creative in marketing African investment markets through direct contacts with prospective investors. These contacts will help alleviate information asymmetries and overcoming barriers that are often due to ignorance-based negative stereotypes about African economies.

African countries have not been successful in attracting a diversified pool of private resources, as the flows are dominated by foreign investment. However, the most important concern is the low overall level of capital flows. Attracting short term capital is not (should not be) a priority of financial policy. Short term flows are highly volatile and can cause substantial macroeconomic instability. In fact, the emphasis should be on controlling these types of flows to minimize the adverse effects on the economy. The focus of policy should be on improving the overall investment climate to promote both domestic investment and

long-term external capital inflows. The goal of raising gross capital formation cannot be outsourced in the hands of foreign investors. Policy makers must especially avoid any bias in investment policy in favor of foreign investors that may put domestic investors at a comparative disadvantage. Accelerating growth will require a healthy rate of domestic investment complemented by sufficient inflows of stable long-term external capital.

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Table 1
Interest rates: deposit, lending, spread, and rate differential vis-à-vis the USA

COUNTRY	Deposit rate			Lending rate			Spread			Differential with the USA		
	1980s	1990-95	1996-2003	1980s	1990-95	1996-2003	1980s	1990-95	1996-2003	1980s	1990-95	1996-2003
Algeria	3.6	10.1	8.5	n.a	17.3	11.6	n.a	3.0	3.0	-9.12	-17.13	2.66
Botswana	8.2	10.6	9.9	11.6	12.8	15.0	3.4	2.2	5.2	n.a.	n.a.	n.a.
Cameroon	7.4	7.4	5.1	13.7	17.2	20.8	6.3	9.8	15.8	n.a.	n.a.	n.a.
Central African Rep.	7.2	7.3	5.1	12.1	16.8	20.8	4.8	9.5	15.8	n.a.	n.a.	n.a.
Chad	5.2	6.9	5.1	11.1	16.7	20.8	5.9	9.8	15.8	n.a.	n.a.	n.a.
Congo, Republic of	7.4	7.3	5.1	11.6	16.9	20.8	4.1	9.5	15.8	n.a.	n.a.	n.a.
Egypt	10.7	11.8	9.4	15.5	18.3	13.6	4.8	6.5	4.2	n.a.	n.a.	3.81
Gabon	7.8	7.5	5.1	12.3	16.8	20.8	4.5	9.4	15.8	n.a.	n.a.	n.a.
Ghana	14.3	22.6	27.0	n.a	n.a	n.a	n.a	n.a		-36.32	-2.93	7.32
Kenya	10.7	13.8	10.8	14.2	25.6	24.1	3.5	9.0	13.3	-3.08	-2.00	5.77
Malawi	11.5	20.9	26.3	19.1	28.5	46.7	7.6	7.6	20.4	-9.17	-9.91	9.19
Mauritius	10.2	11.1	9.9	14.0	18.2	20.6	3.8	7.1	10.8	n.a.	n.a.	n.a.
Morocco	7.2	8.4	5.4	7.9	9.4	13.2	0.6	0.7	7.8	n.a.	n.a.	n.a.
Nigeria	9.3	17.1	12.6	11.8	23.7	20.8	2.4	6.6	8.2	n.a.	-37.79	0.00
Seychelles	9.5	9.3	6.3	15.5	15.7	12.8	5.8	6.3	6.5	2.87	12.29	2.27
Sierra Leone	12.7	31.4	9.3	19.7	46.4	24.9	7.0	14.9	15.7	-53.37	-21.88	4.53
South Africa	12.7	14.4	12.3	16.5	18.3	17.3	3.8	4.0	5.0	-5.06	0.82	4.33
Swaziland	9.2	9.1	9.1	14.9	15.3	16.5	5.8	6.2	7.4	-5.94	-1.86	1.13
Tanzania	8.3	21.3	6.9	18.0	36.7	22.2	9.7	15.9	15.3	n.a.	4.98	-2.48
Uganda	17.6	22.0	9.5	25.8	31.3	21.0	7.9	7.4	11.4	-94.33	1.36	4.86
Zambia	10.3	44.0	24.9	16.0	61.9	43.0	5.7	15.4	18.1	-52.83	-43.68	7.23
Zimbabwe	9.7	22.3	28.3	17.6	25.5	50.5	7.9	3.2	22.3	-8.40	-4.06	-10.31
SAMPLE	9.5	15.2	11.5	14.8	23.3	22.9	5.3	8.1	11.4	-24.98	-9.37	2.88

Source: IMF, *International Financial Statistics* 2004. The real interest rate differential is the difference between the country's real TBill rate and the US real TBill rate. The spread is the lending rate minus the deposit rate.

Table 2**Resource inflows in African countries with stock markets, 1980s vs. post-1980s (million \$, average per year)**

Country	Net transfer on debt		Official net resource flows		Foreign investment direct		Portfolio investment		Private net resource flows	
	1980s	1990-2002	1980s	1990-2002	1980s	1990-2002	1980s	1990-2002	1980s	1990-2002
Botswana	15.6	-42.5	94.9	27.2	62.7	21.2	0.0	1.8	66.3	21.6
Cote d'Ivoire	-139.8	-355.6	274.4	487.9	49.2	179.7	0.0	3.1	255.6	80.1
Egypt	910.8	-1229.4	1782.1	1501.3	859.7	757.9	0.0	85.3	1556.7	784.8
Ghana	122.2	203.8	249.1	556.7	8.7	110.8	0.0	0.0	12.7	162.7
Kenya	73.7	-241.1	453.3	376.7	30.4	37.3	0.0	2.3	89.8	-16.0
Mauritius	-5.0	8.9	55.2	18.3	10.2	42.0	0.0	-7.0	20.5	49.0
Morocco	211.4	-1237.7	728.3	229.7	65.2	710.9	0.0	37.6	484.4	796.3
Nigeria	643.4	-1667.3	295.5	-224.9	434.0	1160.4	0.0	0.0	1010.8	794.5
South Africa	na	-576.3	na	152.9	na	1329.3	na	2403.4	na	4017.3
Swaziland	-3.1	-4.2	19.6	17.5	26.6	63.9	0.0	0.4	24.7	67.3
Tunisia	19.1	-108.2	295.4	281.6	157.0	428.2	1.6	18.2	198.7	679.0
Zambia	144.0	-47.5	297.3	502.1	51.6	139.1	0.0	1.1	79.3	130.9
Zimbabwe	30.8	-83.6	226.4	316.3	-4.9	73.7	0.0	4.4	33.7	42.9

Source: World Bank, *Global Development Finance* 2004.

Table 3**Worker remittances and other flows for selected African countries (annual averages by decade) ^(a)**

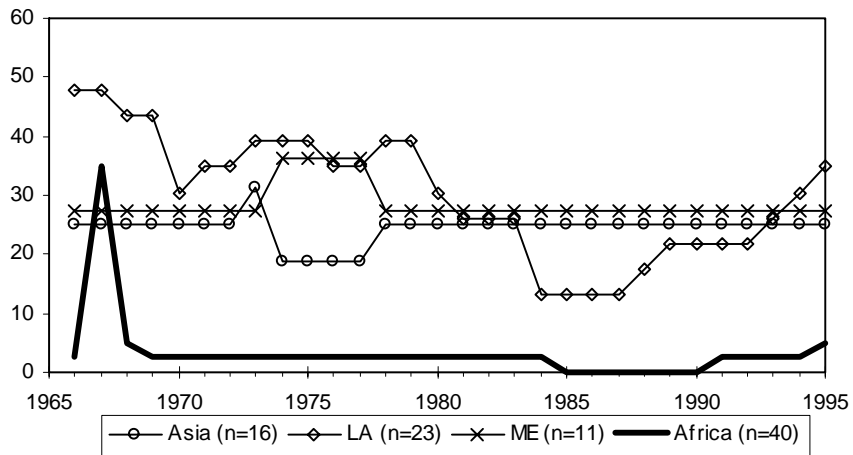
country	Remittances, volume (average, million 1995 \$)			remittances/capita (average 1995 \$)			Remittances/FDI ratio (not %)	Aid/capita (1995 \$)
	1973- 1979	1980- 1989	1990- 2002	1973- 1979	1980- 1989	1990- 2002	1990- 2002	1990- 2002
<i>North Africa</i>								
Algeria	713.5	483.3	822.1	41.3	22.9	29.8	84.5	9.0
Egypt	2720.1	3841.6	3239.4	89.5	83.5	55.5	5.1	45.4
Morocco	1407.0	1491.0	2118.1	82.0	69.0	79.7	4.8	26.8
Tunisia	416.3	487.3	709.8	74.1	67.7	78.1	2.1	28.9
<i>Sub-Saharan Africa</i>								
Benin	90.2	69.3	87.2	33.9	17.3	16.5	13.5	46.3
Burkina Faso	153.3	176.8	84.9	26.7	22.7	8.6	17.7	40.9
Cape Verde	50.3	39.2	80.4	177.7	125.6	208.2	16.5	289.0
Ghana	1.5	3.1	23.0	0.1	0.2	1.3	0.4	36.2
Madagascar	0.5	4.1	10.2	0.1	0.4	0.8	0.3	29.8
Mali	70.4	77.1	97.3	13.2	10.4	10.2	7.8	44.0
Mauritania	2.8	5.4	9.2	2.4	2.9	4.4	3.0	105.0
Niger	7.9	9.9	10.4	1.6	1.5	1.2	2.3	34.2
Nigeria	20.6	9.8	934.6	0.3	0.1	8.2	0.6	2.0
Senegal	93.4	81.8	123.1	19.6	13.0	14.3	20.3	67.7
Togo	15.1	18.6	15.5	6.8	6.1	3.9	4.3	35.9

Note: (a) This table includes countries that have consistently reported data on worker remittances among African countries. (b) FDI = foreign direct investment, inflows.

Nominal values are deflated to real values using the U.S. producer price index, base=1995.

Source: World Bank, *World Development Indicators* 2004; World Bank, *Global Development Finance* 2004.

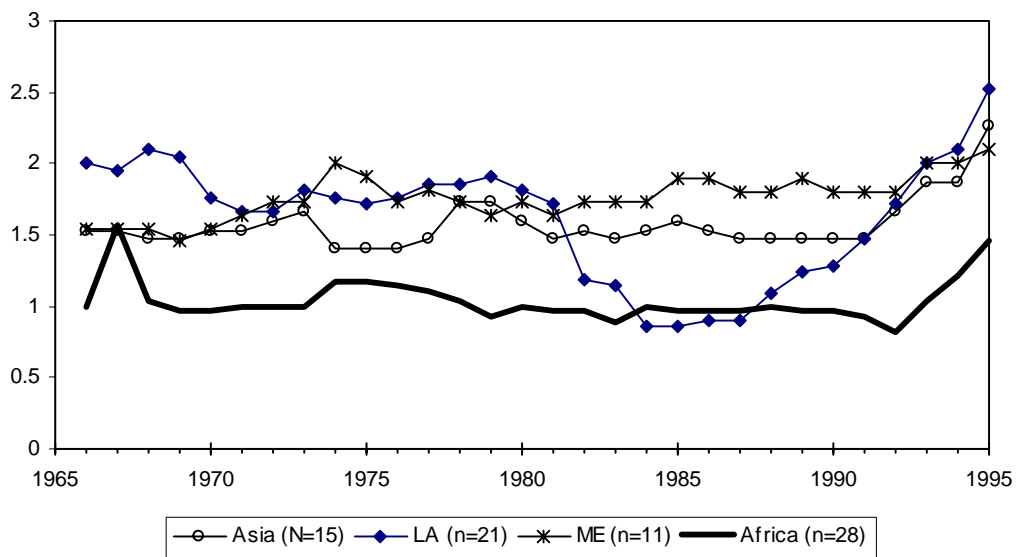
Figure 1: Percentage of countries with open capital accounts per region



Source: IMF

LA = Latin America; ME = Middle East

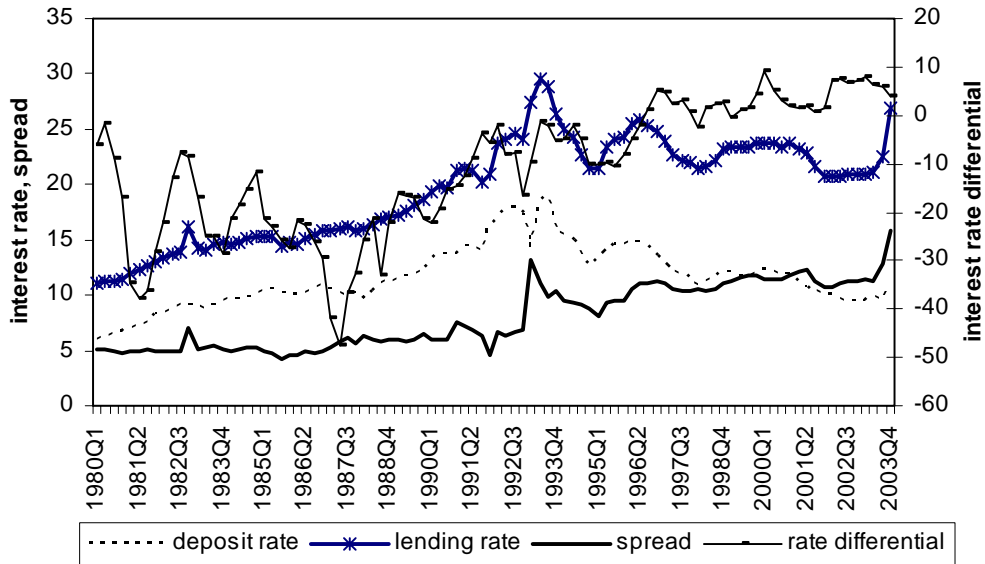
Figure 2: Index of financial integration - average per region



Source: IMF

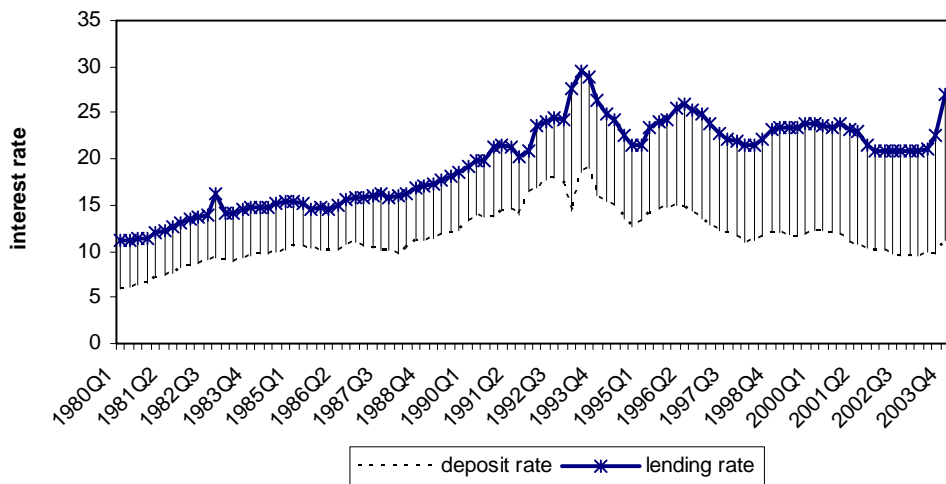
LA = Latin America; ME = Middle East

Figure 3: Interest rates, spread, and interest rate differential (with the USA) for a sample of 22 African countries (quarterly averages, 1980Q1-2003Q4)



Source: IMF, IFS 2004.

Figure 4: Interest rates spread or banks' rent for 22 African countries (quarterly averages, 1980Q1-2003Q4)



Source: IMF, IFS 2004.

