

**FOREIGN DIRECT INVESTMENT IN AFRICA: THE ROLE OF THE
FINANCIAL SYSTEM.**

W. Smit
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Supervisor: Prof. A. Saayman
Assistant Supervisor: Dr. W.F. Krugell

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ABSTRACT

Africa remains the poorest continent despite being one of the most richly endowed regions of the world. With a per capita income of only US\$ 300, four out of every 10 Africans live in extreme poverty on less than US \$1 per day. In terms of capital inflow, Africa receives very low levels FDI inflows and its share of total FDI flows has risen by less than one percentage point during the last decade. The positive impacts of FDI have been studied and empirically proven over the last few years. Economic growth and the expansion of productive capacities are positive results associated with FDI, yet the effective attraction and absorption of FDI is a necessary prerequisite. It is in this context that the financial systems of African countries are evaluated.

The first objective of this study was to create a theoretical understanding vis-à-vis FDI by studying the different determinants, advantages, disadvantages and prerequisites for successful FDI absorption. From the literature it was found that FDI can bring two broad kinds of substantial economic benefits namely economic growth and the expansion of productive capacities.

The second objective was to determine, the functioning, composition and elements of the financial system as the financial system plays an important role in the abortion of FDI and converting it into the identified two economic benefits. Two primary types of financial systems were identified namely: a bank- and a market based financial system.

The third objective was to analyze current global and African FDI, economic growth and financial system trends. It was found that Africa is receiving very low levels of FDI relative to the rest of the world and that Africa's economic growth are not in tandem with the increasing levels of FDI flows to the African continent. This raised the question of effective FDI absorption in Africa which led to the identification of different financial system variables which spurred the empirical investigation.

The last objective and main aim of the study was to answer the following three research questions: (i) what are the elements (if any) of Africa's financial system that deter FDI inflows to the continent, (ii) how effective is the abortion of FDI in Africa and which elements of the financial system are able to absorb FDI effectively and (iii) do FDI inflows and the financial system absorption capacity significantly affect economic growth on the continent?

Data of 26 African countries from 1980 to 2002 were used to attain an African perspective on the relationship between FDI, the financial system and GDP growth. The results indicate that various financial system variables do indeed have a positive influence on the attraction of FDI towards African countries. There was also some evidence of a balance between bank and market related variables which imply that developing a balanced financial system can contribute to FDI inflows in Africa. With only 12 active equity markets on the continent, the implication of this crisis an area for development.

The results also indicated that a more market-based financial system does better in absorbing FDI in the economy, maximizing the economic benefit. It can thus be concluded that even though FDI is an important source of potential growth, Africa's absorptive capacity is not developed thoroughly enough to convert FDI flows into economic growth. While Africa's financial system is not a deterrent to attracting FDI towards the continent, it is unable to utilize this optimally towards the advantage of its people. This inability to absorb FDI is a very important question as it holds a potential solution for Africa's high levels of poverty and underdevelopment.

OPSOMMING

Afrika, met sy swak ekonomiese toestande, is die armste kontinent in die wêreld. Ten spyte van ryk natuurlike hulpbronne is die per capita inkomste slegs VS\$300 terwyl vier uit tien Afrikane in uiterste armoede met minder as US\$1 per dag moet oorleef. Die positiewe invloed van direkte buitelandse investering (DBI) het die laaste paar jaar aansienlik aandag geniet en die positiewe invloed is ook empiries deur verskeie ekonome en navorsers bewys.

Ekonomiese groei en verhoogde produktiewe kapasiteit is die belangrikste positiewe uitkomst wat met DBI verband hou. DBI kan dus as 'n moontlike oplossing gesien word vir 'n sukkelende Afrika. Afrika het egter die laaste paar jaar baie lae vlakke van DBI inkomstes ontvang. Gedurende die afgelope tien jaar het Afrika se aandeel met minder as 1% -punt toegeneem.

Die eerste doelwit van hierdie studie is om omvattende insig van DBI te verkry. Die verskillende determinante, voordele, nadele en voorvereistes vir suksesvolle DBI absorpsie word volledig bespreek. Uit die literatuur is gevind dat DBI potensieel twee belangrike ekonomiese voordele tot gevolg kan hê. Eerstens bevorder dit ekonomiese groei en so ook verhoog dit 'n land se produktiewe kapasiteit.

Die tweede doelwit is om die funksionering, samestelling en komponente van finansiële stelsels te bepaal. Die finansiële stelsels speel 'n beduidende rol in die absorbering van DBI en ook in die omskakeling van DBI na die bogenoemde twee ekonomiese voordele.

Hierdie studie het ook die twee primêre tipes finansiële stelsels geïdentifiseer naamlik: 'n bank-gebaseerde en 'n mark-gebaseerde finansiële stelsel.

Die derde doelwit was om die effek van DBI op ekonomiese groei te bestudeer. Daar is gevind dat Afrika, in verhouding tot die res van die wêreld, baie lae vlakke van DBI-inkomste ontvang. Die verhouding waarmee DBI inkomste toeneem in vergelyking met die ekonomiese groei is ook nie reg nie. Die vraag het ontstaan ten opsigte van die mate van effektiewe DBI absorpsie in Afrika; dit het verder gelei tot die identifisering van verskeie finansiële stelsel-veranderlikes wat weer op hul beurt die empiriese ondersoek daargestel het. Die laaste en hoofdoelstelling van die studie was om die volgende drie vrae effektief te beantwoord:

- (i) Wat is die komponente (indien enige) van Afrika se finansiële stelsels wat DBI-Invloei tot die kontinent stimuleer?,
- (ii) Hoe effektief is die absorpsie van DBI in Afrika en watter komponente van die finansiële stelsels is bevoeg om DBI effektief te absorbeer?,

- (iii) Beïnvloed DBI en finansiële stelsels die absorpsievermoëns wat groei bepaal die ekonomiese groei van die kontinent?

Data van 26 Afrika-lande vanaf 1980 tot 2002 is gebruik om 'n Afrika-perspektief te verkry ten opsigte van die verhouding tussen DBI, die finansiële stelsel en die BBP-groei. Die bevinding dui daarop dat die verskillende finansiële stelsel-veranderlikes inderdaad 'n positiewe invloed op die attraksie van DBI ten opsigte van Afrika-lande het. Daar was ook bewyse van 'n balans tussen bank- en markverwante veranderlikes wat beteken dat die ontwikkeling van 'n gebalanseerde finansiële stelsel kan bydra tot groter DBI-invloei na Afrika.

Aandelemarkte is steeds klein en onontwikkeld. Daar is egter gevind dat 'n meer mark-gebaseerde finansiële stelsel DBI-invloei in die ekonomie beter absorbeer en sodoende die ekonomiese voordeel optimaliseer. As finansiële veranderlikes gebruik word om die effek van BBP-groei te bepaal, is daar 'n ooreenkoms tussen bank- en markverwante veranderlikes omdat beide 'n beduidende, maar negatiewe verhouding met BBP groei getoon het.

Die studie dui verder aan dat Afrika se absorberings kapasiteit en vermoëns nie voldoende ontwikkel is om DBI-invloei in ekonomiese groei om te skakel nie.

Afrika en sy stelsels is instaat om DBI te werf, maar het nie die vermoë om dit optimaal te benut tot voordeel van die miljoene arm Afrikane nie.

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LIST OF ABBREVIATIONS

\$ - US Dollar

ABRI – African Business research institute

ATM - Automatic Teller Machine

BDS - Bank deposits

BIS - Bank of International Settlements

BMI-T - BMI-TechKnowledge

BRVM - Regional Stock Exchange - Bourse Regionale des Valeurs Mobilieres

CBA - Central bank assets to GDP

CIS - Commonwealth of Independent States (formerly the USSR)

CMCG - Capital Markets Consultative Group

CO₂ -Carbon dioxide

DMB - Deposit money bank vs. central bank assets

EME - Emerging market economy

F2G – Percentage of FDI to GDP (FDI/GDP x 100)

FDI – Foreign direct investment

FSD - Financial system deposits

GDP - Gross Domestic Product

IFS - International Financial Statistics

IMF – International Monetary Fund

Inc - Incorporated (US Company)

IPA - Investment Promotion Agency

JSE – Johannesburg Stock Exchange

LDC - Least Developed Country

LLY - Liquid liabilities to GDP

Ltd - Private Limited Company

M&A - Mergers & Acquisitions

MDG - Millennium Development Goals

MNE -Multinational Enterprise (referred to as TNC in this study)

NEPAD - New Partnership for Africa's Development

NYSE – New York Stock Exchange

ODA - Official Development Assistance

OECD - Organisation for Economic Co-operation and Development

OPEC - Organization of Petroleum Exporting Countries

PCD - Private credit by deposit money banks to GDP

PCO - Private credit by deposit money banks and other financial institutions to GDP

Plc - Public Limited Company (UK)

R&D- Research and Development

SMC - Stock market capitalisation to GDP

SMT - Stock market turnover ratio

SMV - Stock market total value traded to GDP

TNC - Trans-National Corporation

UEMOA – Union Economique et Monétaire Ouest Africaine (West African Economic and Monetary Union)

UK - United Kingdom

UN - United Nations

UNCTAD - United Nations Conference on Trade and Development

US - United States of America

WTO - World Trade Organization

CHAPTER 1

INTRODUCTION AND PROBLEM STATEMENT

1.1 Introduction

Foreign direct investment (FDI) has assumed increasing importance over time, becoming a prime concern for policy makers (Chakrabarti, 2001). FDI can be defined as the net flow of money in the form of an investment from one economy to another. The nature of the investment is to acquire a long lasting interest (at least ten percent or more of the voting stock) in the foreign country's enterprise. FDI implies that the investor acquire a significant degree of influence in the invested enterprise while still a resident in the other economy (UNCTAD, 2004). FDI differs from foreign aid since foreign aid expects no returns on investments. FDI however is made with an expectation of growth on the initial investment. The more efficient and rewarding the output of the FDI receiving country, the more FDI it will attract.

Africa, in comparison with the rest of the world, received very low levels FDI inflows during the last decade. During the past ten years Africa's share has risen by less than one percentage point (UNCTAD, 2005). Even when comparing Africa with other emerging market economies, which as a group experienced high levels of FDI increases during the previous ten years, Africa's performance can be summarised as lagging behind.

Africa remains the poorest continent despite being one of the most richly endowed regions of the world (NEPAD, 2005). Most African nations suffer from corruption, military dictatorships, civil unrest and deep poverty. With a per capita income of only US\$ 300, four out of every 10 Africans live in extreme poverty on less than US \$1 per day (Amoako, 2002). Numerous development strategies have failed to yield the expected result and the majority of the countries classified by the UN as least developed are in Africa. Although some believe that the continent is doomed to perpetual poverty and economic slavery, others believe Africa to have immense potential (Global Policy Forum, 2005).

At the start of the new millennium, the UN Developing countries developed the UN Millennium Declaration (UN, 2005). The eight Millennium Development Goals (MDGs) – which range from halving extreme poverty to halting the spread of HIV/AIDS and providing universal primary education, should all be reached by the

target date of 2015 (UN Millennium goals, 2005) . However, the UN warns that progress has been hardest to come by in the poorest nations especially in Africa. In many cases, there is lack of significant progress or even reversals (UN, 2005). “Unless we can speed things up dramatically, we shall find when we get to 2015 that the words of the Declaration ring hollow” (Annan, 2002).

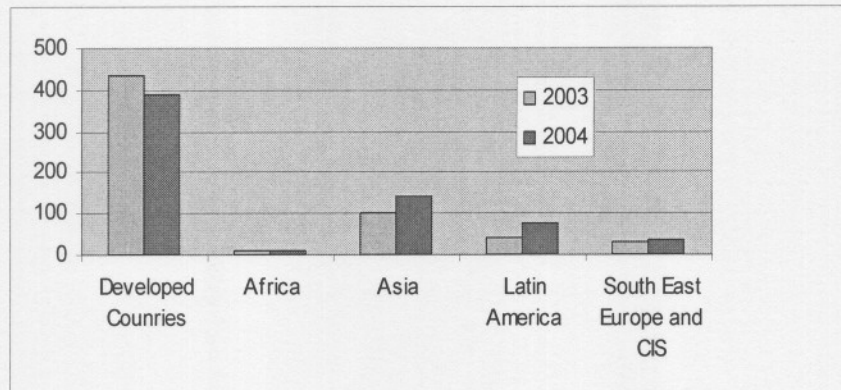
The three most important and needed building blocks for reaching the above-mentioned millennium goals are higher income, employment and education (UN, 2005). It is in this regard that FDI can make a positive contribution to African economies. The positive impacts of FDI have been studied and empirically proven over the last few years by researchers that include Fry (1993), Akinlo (2004), Braunstein & Epstein (2002), Caves (1995), and Moran & Theodore (1998). According to Gallagher & Zarsky (2003) economic growth and the expansion of productive capacities are positive results associated with FDI inflows.

FDI, the primary capital flow towards Africa (World Bank 2002), might just be a solution to Africa’s economic predicament. As already mentioned, the levels of Africa’s FDI inflows are small in comparison with the rest of the world. Yet, it is encouraging to notice that the FDI flows to Africa have increased over the last few years (UNCTAD, 2005).

1.2 Problem statement

Although Africa with its multiple resources attempt to attract FDI, the level of FDI flows to the continent remained almost unchanged in 2004, at \$18 billion. This amount of Africa’s share of world FDI flows was only 3% in 2004 (UNCTAD, 2005). When comparing the statistics of FDI flows to emerging market economies (EMEs) and least developed countries (LDCs) it must be said that Africa is receiving much less than other countries in the World. Even a statistical comparison of FDI flows to the world’s EMEs shows that Africa is far behind the rest of the world. This is illustrated in Figure 1.1.

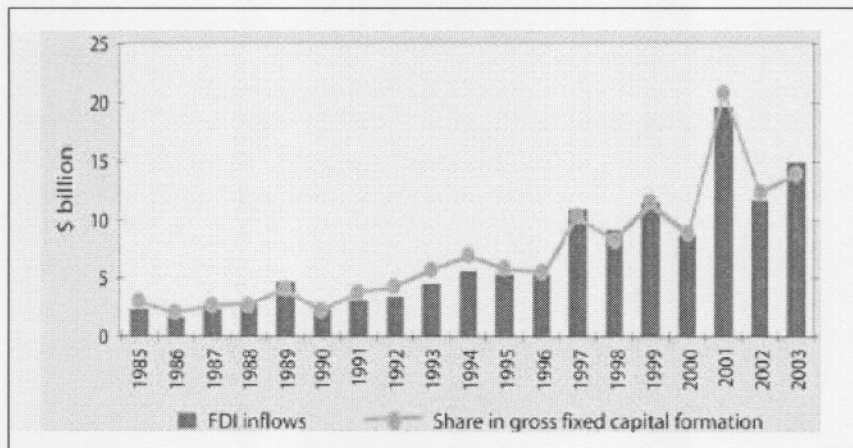
Figure 1.1: FDI flows by region for 2003 & 2004



(Source: UNCTAD, 2005).

However, in the African context, FDI inflows were relatively high compared to previous years since a 39% increase in FDI were experienced in 2003 and were sustained in 2004 (UNCTAD 2004, 2005). These significant increases of FDI experienced in Africa over the last few years are illustrated in Figure 1.2, and the World Bank (2003) indicate that FDI has now become by far the single largest component of Africa's net capital inflows (World Bank, 2003).

Figure 1.2: Africa: FDI inflows from 1985 - 2003



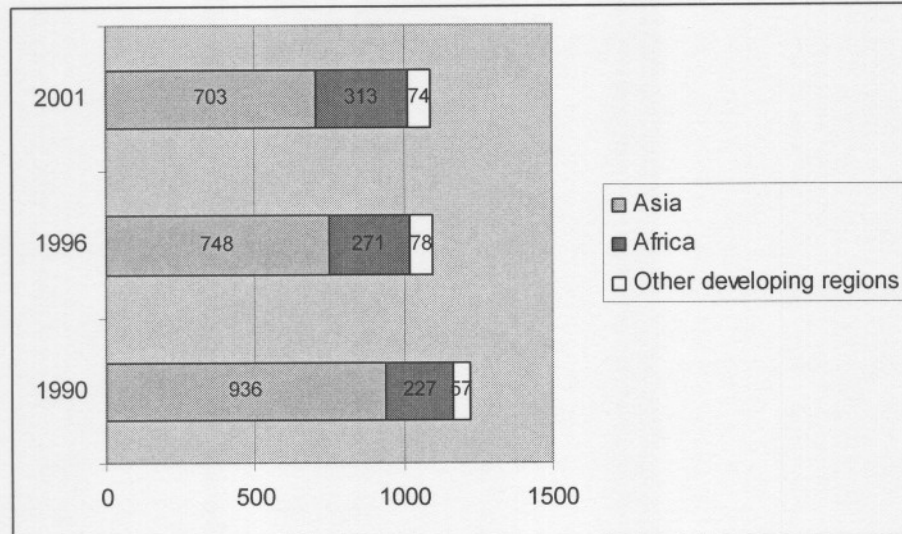
(Source: UNCTAD, 2005).

Yet, despite this, Africa's overall performance remains less than desirable, as can be seen from the following:

- The overall performance of the countries of the region during the period from 1990 to 2000, with respect to achieving the Millennium Development Goals has been disappointing (UN, 2005).

- A total of 300 million people live in extreme poverty today, compared to 200 million 14 years ago (Amoako, 2002). This is also seen in Figure 1.3 where the number of people living on less than \$1 per day increased over the last few years.

Figure 1.3: Number of people living on less than US\$1 a day (Millions)



(Source: Millennium Development Goals Report, 2005).

- Performance on halving poverty and increasing the primary education completion rate was particularly weak (UN 2005).
- Employment growth has also remained flat. This implies that FDI growth in Africa has not been sufficiently employment-intensive (UN, 2005).

Theoretically, FDI is often thought of as a stimulus for growth and development (Gallagher & Zarsky, 2003) and the question whether the lack of FDI flows to Africa might be a contributing factor in Africa's battle for growth and development becomes important. Figures 1.1 and 2.1 indicated that there are FDI flowing to Africa, but does it contribute towards growth on the continent?

To translate capital into optimal output, there must just be an optimal absorption of the inflowing resources into a country (Alesina & Dollar, 2000). The more effective this absorption, the more growth can be expected (Magarinos, 2002). One aspect that influences the absorption of FDI is the efficiency of the receiving country's financial system (Faure, 2003). Scholtens (2000) defined the financial system as the three factors namely financial markets, financial institutions and financial

regulations that regulate and manage money flows in a country. It is important to know that the financial system includes both financial markets and banks.

In most African countries the financial system is not developed to the extent that it is in the rest of the world. This leads to the question whether the financial system of the continent is a constraint for the attraction and absorption of FDI?

1.3 Objectives of research

According to Annan (2005) success cannot surface overnight. Success will require sustained action across the entire decade between now and the deadline (referring to the Millennium Goals). It takes time to train the teachers, nurses and engineers; to build the roads, schools and hospitals; to grow the small and large businesses able to create the jobs and income needed. Therefore the study focuses not only on recent trends in FDI flows, but a longer view is taken into consideration. In using 22 years' data from 26 African countries, this study aims is to investigate and analyze the relationship between FDI, the financial system and eventually growth on the continent.

The focus of this study is on the role of the financial system in attracting and absorbing FDI to enhance economic growth. In order to achieve this, the following objectives were set:

- To give a theoretical overview and understanding regarding the definition, determinants and effects of FDI.
- To determine, from a theoretical point of view, the functioning, composition and elements of the financial system.
- To analyze current global and African trends in FDI, economic growth and the financial system.
- To determine:
 - What elements of Africa's financial system deter FDI inflows to the continent?
 - How effective is the absorption of FDI in Africa and which elements of Africa's financial system are able to absorb FDI effectively.
 - Whether FDI inflows and the financial system absorption capacity significantly affect economic growth on the continent.

1.4 Methodology

The methodology followed in the research are threefold, namely a literature study, a report of current trends and finally an empirical analysis. Most of the research relies on certain relevant research reports by various institutions which include:

- United Nations Conference on Trade and Development (UNCTAD).
- Bank for International Settlements (BIS).
- World Bank.
- International Monetary Fund (IMF).
- Several central banks from different countries.
- African Financial Markets.

1.4.1 Literature study

Firstly, the method of research for the theoretical chapters is a literature study. Different components of the two concepts, FDI and the financial system are investigated theoretically.

1.4.2 Report of current situation

This is followed by extensive literature on International and African financial system and FDI flows. This part of the study is not a clinical theoretical study but manifest itself as a report on the status quo and current trends.

1.4.3 Empirical analysis

Finally an empirical analysis is completed to analyse firstly, the elements of Africa's financial system that have a significant effect on attracting FDI and finally if Africa's FDI and absorption contribute to the expansion of economic growth on the continent.

In the empirical analysis the previous literature and information is used and incorporated with actual data to determine if the theoretical work is in fact in line with the reality. The study uses substantial data from the World Bank Financial Structure Database. The study uses data of all the different financial system variables from 1980 to 2002 as it was the period of most comprehensive, available data. Over these 22 years, 26 different African countries are identified on the basis of available

data. These identified countries also represent all the different sub-regions of Africa (see chapter 5 for a more complete discussion).

The movement of different financial system variables, GDP output and FDI flows are analyzed and interpreted by using panel data techniques. Different regression models are used and the movement between FDI and GDP are used to determine if there is a correlation between FDI and growth. Furthermore the relationship between different financial market variables and FDI were monitored to determine the relationship between FDI and these financial system variables. The financial system variables were identified by King & Levine and Levine and Zervos (as quoted in Alfaro et al. (2004)) who studied the financial system from two different perspectives namely market- and bank variables. These variables are expanded with other financial system variables which were identified in the World Bank Financial Structure Database is were analyzed empirically by using the country specific data as mentioned above. (Refer to chapter 5 for a more thorough discussion of the methodology).

1.5 Chapter exposition

Chapter one introduces and discusses the problem to be addressed in this study. What becomes evident is that there is a definite question about the relationships between FDI, the financial system and economic growth in Africa when looking at other regions in the world. The aim of chapter two is to give insight on FDI to thoroughly understand the rest of the study. This is done by looking at the following factors of FDI: misconceptions, the definition, measurement problems, the development, determinants, advantages and disadvantages and finally the prerequisites for FDI absorption. Therefore, the second chapter is about FDI.

Chapter 3 focuses on the role of the financial system in the process of attracting and more importantly, the absorption of FDI. Therefore, it is necessary to understand the financial system. This aim of this chapter is to explain the different aspects, functioning and elements of the financial system. The definition, basic functions, importance, different types, advantages and disadvantage of the financial system is discussed in this chapter.

In chapter four an overview of the status quo of FDI, economic growth, markets, banking and future prospects is done. This chapter is about what is currently going

on globally and furthermore and most importantly, what is the African position in a global context. It is important to understand this as it will assist in identifying the problems and opportunities to the continent.

The aim of the fifth chapter is to incorporate the literature in the earlier chapters with real data to determine, empirically, which variables can be used to explain and influence FDI and growth. The question asked in this empirical study is if financial system variables have an influence on the level of FDI flowing to a country and secondly if there is any evidence of FDI absorption that leads to economic growth in FDI receiving countries.

The final and sixth chapter concludes the study. It comprises a summary of the study, as well as the conclusions and proposals regarding FDI and the financial system in Africa

1.6 Important definitions

The following terms or concepts will be referred to regularly during the study and are therefore defined.

1.6.1 Foreign Direct investment (FDI)

FDI is an international investment made by a resident entity in one economy (direct investor) with the objective of establishing a lasting interest in an enterprise resident in an economy other than that of the investor (direct investment enterprise) (OECD, 1996). This "lasting interest" implies a long-term relationship between direct investor and enterprise and distinguishes FDI from portfolio investment. A lasting interest means that there should be a noticeable influence on the management of the direct investment enterprise. Absolute control is not required; the IMF and OECD (1996) assume that a share of 10% of the nominal capital owned by a foreign investor will ensure this noticeable influence.

1.6.2 United Nations Conference on Trade and Development (UNCTAD)

The organisation is the focal point within the United Nations for the integrated treatment of trade and development and related issues in the areas of investment, finance, technology, enterprise development and sustainable development (UNCTAD, 2005).

1.6.3 Transnational corporation (TNC)

A transnational corporation (TNC) (also known as a multinational corporation (MNC) or multinational enterprise (MNE)) is a corporation or company that spans multiple nations. Such institutions are often very large and have offices, factories or branch plants in different countries. They usually have a centralised head office where they coordinate global management (Wikipedia, 2005).

1.6.4 Gross Domestic Product (GDP)

The total value of final goods and services produced within a country. GDP is the single most commonly used measure of a country's overall economic activity (IMF, 2005).

1.6.5 Emerging Markets

Developing countries' financial markets that are less than fully developed, but are nonetheless broadly accessible to foreign investors (IMF, 2005).

1.6.6 Mergers & Acquisitions (M&As)

Mergers and acquisitions are the result of two businesses joining together, either by merging or by one company taking over the other (The Economist, 2005).

1.6.7 Stock Market

The set of institutions that facilitate the exchange of stocks between buyers and sellers. A stock market can be an actual place, but with the growth of electronic transactions a large portion of stock market transactions are no longer centrally located in a particular location (Popular Economics, 2005).

1.6.8 Financial system

The companies and institutions that together make it possible for money to make the world go round. This includes financial markets, stock markets, banks, different funds, insurers, national regulators, central banks, governments and multinational institutions (The Economist, 2005).

1.6.9 Greenfield investment

A form of investment where an investor creates a new asset or facility in the destination country (for example: builds a factory with or without joint venture (JV) partners) (Trade Law Centre for Southern Africa (TRALAC), 2004).

1.6.10 Tier 1 capital

Shareholders' equity plus irredeemable and non-cumulative preference shares and excluding hybrid forms of capital such as goodwill (Anon, 2005).

1.6.11 World development Indicators (WDI)

The World Bank's premier annual compilation of data about development. The 2005 WDI, which were used for this study, includes more than 800 indicators in 83 tables organised in 6 sections: World View, People, Environment, Economy, States and Markets, and Global Links (World Bank, 2005c).

1.6.12 Economic growth

Expresses the quantitative change or expansion in a country's economy. Economic growth is conventionally measured as the percentage increase in gross domestic product (GDP) or gross national product (GNP) during one year (World Bank, 2005c).

1.6.13 World Bank

An international lending institution that aims to reduce poverty and improve people's lives by strengthening economies and promoting sustainable development. Owned by the governments of its 181 member countries, the Bank lends about \$20 billion a year to development projects, provides technical assistance and policy advice, and acts as a catalyst for investment and lending from other sources (World Bank, 2005c).

CHAPTER 2

THEORETICAL OVERVIEW OF FOREIGN DIRECT INVESTMENT (FDI)

2.1 Introduction

Before this study continues, it is important to provide the necessary insight into exactly what is meant by FDI. The aim of this chapter is to provide these insights. In order to achieve this, the following elements of FDI are investigated: firstly it must be noted that there are many misconceptions about FDI and the definition is not a familiar and well-known concept. The chapter develops further by looking the different misconceptions and measurement problems of FDI. An overview of the development of FDI over the last few years is also provided in this chapter, followed by the identification of the different determinants of FDI. This chapter concludes by looking at the advantages and disadvantages of FDI and, finally, the prerequisites for successful FDI absorption.

2.2 Definition of FDI

The understanding of the concept of FDI has undergone changes over the years and the available definitions are not yet uniform. FDI was historically seen as an investor planning to exert a controlling influence in an enterprise by acquiring equity abroad (OECD, 1996).

To understand the meaning of FDI, a more specified definition is required. FDI can be defined in different ways such as:

FDI occurs when investors in one country establish or acquire a significant portion of the assets in an enterprise in another country. In principle, "significant" means enough to gain an active voice in the management of the enterprise. In practice, the IMF defines "significant" as more than 10%. Thus, FDI involves cross-border ownership and some degree of control (Head & Ries, 2005).

The most descriptive and comprehensive definition that will be used in this study as the accepted definition of FDI originated in September 2003 when a report was compiled that reflected the views of private sector participants. The participants in this report examined the determinants, trends and prospects of FDI in emerging market countries. This working group comprised staff and management of the HSBC

Banking group, members of the Capital Markets Consultative Group (CMCG), the International Monetary Fund (IMF), and the World Bank. This "Working Group of the CMCG" defined FDI as a cross-border investment in which a lasting interest in an enterprise in one economy (the direct investment enterprise) is acquired by a resident in another economy (the direct investor). The direct investor usually gets an effective voice in the management of the direct investment enterprise due to the long-term relationship between the direct investor and the direct investment enterprise. A direct investment is only established if the direct investor acquires 10% or more of the voting power or ordinary shares of an enterprise in another economy (OECD, 2003).

According to United Nations Conference on Trade and Development (UNCTAD), three components of FDI can be identified, namely (i) equity capital, (ii) reinvested earnings from profits achieved and (iii) intra-company loans (UNCTAD, 2004).

Firstly, equity capital is the initial purchase of foreign enterprise shares. The investment in these shares usually takes the form of the establishment of manufacturing plants, warehouses, bank premises and other permanent or long-term facilities in the investment enterprise. The initial investment is not necessarily tangible but may also involve transactions such as the creation of the new establishment or investment. Other examples of initial investments include joint ventures and cross-border mergers and acquisitions. The investment can be incorporated or unincorporated and includes ownership of land and buildings by individuals (CMCG, 2003).

The second component of FDI is the reinvested earnings from profits achieved in the foreign country. Increases in FDI can take place by expanding the initial equity capital once FDI is established. This is usually done by reinvesting earnings not distributed as dividends. Extension of suppliers' credits or loans in the form of inter-company claims and undistributed branch profits all represent FDI capital. Enterprises can also expand their operations by borrowing in local markets and in international capital markets (CMCG, 2003).

The final component of FDI is intra-company loans. This refers to the short-term- or long-term borrowing and lending of funds. It includes all subsequent transactions between the direct investor and the direct investment enterprise and among affiliated enterprises. Thus, "direct investment relationship extends beyond the

original direct investor and includes foreign subsidiaries and affiliates of the direct investor that are part of the parent group“(CMCG, 2003).

FDI is thus not only money flowing from one country to another. It is a specified and focused flow of funds where an investor wishes to acquire specific assets in a foreign country with an income motive.

Dunning (1988) points out that FDI involves issues of direct control as resources are transferred internally within firms rather than externally between independent firms. Clearly there is more to the definition of FDI than one tends to think and it is therefore necessary to clearly state what FDI is not.

2.3 Misconceptions about FDI

There are a few popular misconceptions about the definition of FDI. These may be the result of the several changes the definition has undergone over the years. Misconceptions about the definition of FDI include (CMCG, 2003):

- FDI is not only money flowing from one country to another. It is a specified and focused flow of funds where an investor wishes to acquire specific assets in a foreign country with an income motive.
- Only a 10% ownership is required to establish a direct investment relationship. FDI does not imply total control of the enterprise.
- One investor or a “related group” of investors must acquire 10% or greater ownership in an enterprise abroad. FDI does not comprise a 10% or greater ownership by a group of unrelated investors living in the same foreign country.
- In establishing an FDI transaction, geographical prerequisites must apply. FDI is based on the residency of the investor and not on nationality or citizenship.
- Another misleading perception about FDI is borrowings. Borrowings from unrelated parties abroad that are guaranteed by direct investors are also not FDI.
- Concerning FDI positions, FDI covers only that portion financed by the direct investor or foreign subsidiaries and affiliates of the direct investor that are part of the parent group.

- FDI covers only the portion of assets financed by the direct investor or affiliates of the direct investor that are part of the parent group and not all of the assets of the direct investment enterprise.

2.4 FDI measurement problems

When looking at the definitions of FDI according to the OECD and UNCTAD, there are many technical difficulties in practice when investigating individual countries. In spite of ongoing efforts to harmonise the collected and reported information, the measurement of FDI is often problematic.

According to the International Relations department Report of Deutsche Bundesbank (2003), one of the problems is the valuation of contributed machinery or intangible assets that are often part of a direct investment. Another problem experienced with the measurement of FDI arises from different transnational Company (TNC) transactions. The problem arises because FDI data should, in principle, include information on international lending and interest payments between individual TNCs as well as reinvested earnings. Nevertheless, transactions between TNCs often result in data problems for they are often not included in recorded data. Omissions in the FDI data reported for TNCs are particularly widespread (Lehmann, 2002).

Another misleading and problematic factor is national statistics. Although an investment may be channelled through a subsidiary holding company, national statistics will attribute FDI to the country of the holding company and not to its final destination. These statistics therefore do not reflect an accurate flow of investments. In some countries, investors from the host country may withdraw their capital to gain exceptional treatment often received by foreign investors (Lehmann, 2002). Therefore, no reliable information on the process of international integration is given by FDI data.

2.5 Overview of the development of FDI

The flow of cross-border capital is not a new concept. Evidence of such flows in Europe can be traced back as far as the Middle Ages. Therefore, transactions such as portfolio investments, bank lending and direct investments by international enterprises are not a recent trend (IMF, 1997).

In February 2003, a report by Deutsche Bundesbank's International Relations department on the role of FDI in emerging market economies compared to other forms of financing looked at past developments and implications for financial stability.

The report explains the path that capital flows have travelled to become FDI as we know it today. The change in the economical climate over the years and capital flows' behaviour towards that change also gives insight as to how FDI can react in different economical situations. The overview of the development of FDI in this study will be achieved by discussing different periods in the development process of FDI as suggested by the above-mentioned report. It will be discussed under the following headings. Firstly, the period of 50 years preceding World War I is discussed. This is followed by the effects of the World Wars and the breakdown of the Gold standard, the Post World War II era, the period since the 1940s, the years of the debt crisis, capital flows since the beginning of the 1990s and concludes with the financial sector development since the Asian crisis.

2.5.1. The 50 years preceding World War I

TNCs, as we know them today, are a trend that developed during the second half of the nineteenth century as a result the Industrial Revolution. During this time the world economy was already well developed and integrated. In the fifty years preceding World War I, capital flowed to Australia, Canada, Russia and the US (the emerging economies of that time) (IMF, 1997).

Capital flowed from the developed countries of Europe, which were the main source of knowledge and money. The main exporter of capital was Britain, where outflows reached nearly 10% of GDP. Other European countries such as Germany, France, and the Netherlands were also major contributors towards capital flow during that time (IMF, 1997). These capital flows were primarily aimed at the development of foreign infrastructure such as railroads and other projects. Funds were mobilised in the form of portfolio investments through attaining long-term government debt and the purchase of corporate bonds.

According to Lipsey (1999), the acquisition of controlling interests in manufacturing enterprises abroad was exceptional. Transactions where investors acquired direct control in management or ownership in a foreign country's enterprises accounted for less than one-tenth of all cross-border capital flows.

This cannot be compared with FDI flows as they are known today. Certain transactions such as equity investments in exchange-traded companies that are included in FDI statistics today were not recorded in those days. Furthermore, no clear distinction was made between controlling and non-controlling investments.

Finally, the developing world of that time developed differentiated methods and fields of export. For example, Europe favoured financial investments while the U.S.A.'s outward capital flows consisted mainly of FDI (Lipsey, 1999).

2.5.2. The effects of the World Wars and the breakdown of the Gold standard

One of the most important impacts of World War I and the breakdown of the gold standard on international capital flows was the imposition of more conservative trade patterns. Countries imposed numerous restrictions on trade and capital flows. During the post World War I years up until the late 1920s substantial capital movements were realised. The outflows during the inter-war years were the results of the U.S.A buying from former lending countries that faced large financing needs due to the war (Deutsche Bundesbank, 2003).

During these years, FDI flows did not always experience favourable conditions as this period was characterised by increasing levels of debt. The higher levels of debt resulted in lower levels of FDI flows. The drastic interest rate increase in 1928 caused the US's lending to come to a stop. Nevertheless, many countries became unable to service their accumulated debt burdens due to the economic crisis. All of these factors contributed to the continued decline in international capital flows (Deutsche Bundesbank, 2003).

2.5.3. The Post World War II era

Private capital flows were extremely concentrated among the most industrialised countries for quite some time after World War II. Another occurrence of the post World War II era was that global reduction of expenditure was gradually upturned. Europe and Japan experienced massive capital needs due to the destruction caused by the war. During this period, bank lending and portfolio investments were very passive. Hope in these regions initially came through official flows followed by a raise in FDI. The US became very important as the main investor (Deutsche Bundesbank, 2003).

2.5.4. Since the 1940s

From the late 1930s, a definite improvement in the flows of FDI was experienced. The stimulation in FDI was caused by improved communication technology that made it easier to exercise control over a geographically distant enterprise. The late sixties brought a perspective change concerning FDI. The relative importance of FDI started to decline in countries' policy planning and strategies. Due to this different economic approach, capital flows started to draw back temporarily. To maintain economic growth and development, another form of financing was needed. Bank lending became progressively more important for emerging market economies (EMEs). This form of financing became a prominent source of capital for the next decade. Then the oil crisis erupted in 1973, which brought a drastic change in the use of borrowed funds. Bank lending helped to finance capital flight and maintain levels of imports instead of sustaining investment and growth. The early years of the 1980s brought about the end of this period (Deutsche Bundesbank, 2003).

2.5.5. The debt crisis

Another global economic event that resulted in drastic worldwide economic disturbances was the debt crisis. The debt crisis began in the mid-1970s when many of the Organization of Petroleum Exporting Countries (OPEC; e.g., Saudi Arabia, Kuwait) amassed great wealth. They put this accumulated money into Western banks. These banks loaned money to Third World countries for large development projects. Nevertheless, several factors such as the rise in world interest rates, a global recession, and low commodity prices caused the size of these debts to start growing very fast. Several countries began to fall behind in their payments. Because of the irresponsibility of creditor and debtor governments, these countries did not use the money for productive investment; rather, they spent these new dollars on immediate consumption. Consequently, these governments amassed debt and refused to repay their loans.

The result of this was that the amount of money owed by developing countries has increased dramatically since the early 1980s. These countries now owe money to commercial banks and to organisations like the World Bank, the International Monetary Fund, and to First World governments (Deutsche Bundesbank, 2003).

The debt crisis was a long, drawn out occurrence that continued up until 1989. During this time, official capital flows became a vital source of foreign finance to

EMEs, while bank lending remained passive. FDI recovered substantially from 1982-1989, flowing mainly to Western Hemisphere and Asian countries.

2.5.6 Capital flows since the beginning of the 1990s

From a collective view, capital flows to EMEs increased considerably since the beginning of the 1990s. The increase came mainly through FDI and portfolio investments, while bank lending and trade credit were rather unstable during this period. The average level of inflows, however, had an upward shift since the beginning of the 1990s. The contributing factors for this movement are a combination of economic reform in recipient countries and a decrease in the number of centrally planned regimes. The global trend in EMEs to adopt market-oriented and stability-oriented policies associated with the concept of the "Washington consensus" is also a contributing factor (see Table 2.1).

Table 2.1 Net Private capital flows to emerging market economies 1999 – 2003

(US\$ Billion)					
Countries	Annual average		1996	2000	2003
	1990-1996	1997-2002			
All countries	142.0	61.0	228.8	29.4	64.9
<i>FDI</i>	62.0	156.8	114.4	158.0	160.9
<i>Portfolio flows</i>	59.0	5.2	90.2	-4.3	-4.0
<i>Others</i>	21.0	-101.0	24.1	-124.3	-91.9
Africa	7.1	9.7	11.9	6.1	8.9
<i>FDI</i>	2.5	10.9	3.6	7.7	10.1
<i>Portfolio flows</i>	1.8	1.1	2.8	-2.2	-1.3
<i>Others</i>	2.9	-2.4	5.5	0.6	0.1
Asia	60.4	0.6	122.1	-12.9	7.9
<i>FDI</i>	31.7	56.3	53.4	54.2	59.0
<i>Portfolio flows</i>	16.5	-0.8	32.8	4.3	-9.7
<i>Others</i>	12.2	-54.9	35.9	-71.4	-41.3
Middle East & Turkey	22.5	-11.0	7.2	-22.4	-9.4
<i>FDI</i>	3.5	7.5	4.8	7.9	11.5
<i>Portfolio flows</i>	6.3	-10.5	1.8	-13.7	-6.6
<i>Others</i>	12.7	-8.1	0.6	-16.7	-14.4
Western Hemisphere	40.0	45.6	64.9	48.6	26.5
<i>FDI</i>	18.2	58.7	40.3	64.7	45.6
<i>Portfolio flows</i>	26.8	10.0	39.5	4.7	7.6
<i>Others</i>	5.0	-23.8	-14.9	-20.8	-26.7
Countries in transition	11.8	16.2	22.6	10.0	31.1
<i>FDI</i>	6.1	23.4	12.3	23.4	34.7
<i>Portfolio flows</i>	7.5	4.7	13.3	2.6	6.0
<i>Others</i>	-1.8	-11.9	-3.0	-16.0	-9.6

(Source: World Bank, 2005a)

In 1997, a drastic change began in the world economy as the Asian crisis erupted. A sharp downward correction in total capital inflows to EMEs followed before recovery came in 2002. The crisis was globally characterised by significant retrenchments in bank lending, portfolio investments and trade credits. The movement of FDI during this period is somewhat surprising as it increased until 2001 and has decreased

slightly since then. In the process of regaining momentum in the global economy, FDI played a significant role. Strengthening FDI activities together with a decrease in the net outflows of EMEs' capital accounts occurred over the last few years.

According to the World Bank (2002), improved macroeconomic policies with the lowering of international barriers to trade and investments heightened the magnetism of EMEs as capital importers either in the form of FDI or as portfolio investments.

In fear of a repeat of the debt crisis experienced in the 1980s, economists urged a resolution. The implementation of the Brady Plan followed. This stimulated bond issues by emerging market borrowers as a new vehicle of capital inflows. The Brady Plan implied a securitisation of the banks' restructured claims. The stabilised and improving global economic situation caused expansion in the financial sectors of EMEs. Stock markets also became more attractive with the outlook of economic growth by enhancing financial (Deutsche Bundesbank, 2003).

The historical background of FDI is important in providing greater insight into what FDI actually looks like today. Deriving from this historical overview it is clear that FDI became an important element of countries' economies. To attract FDI, however, there are certain determinants that are needed by countries in order to convince investors to invest there.

2.6 Determinants of FDI

"Free trade alone is not sufficient to ensure FDI inflows" (Naudé & Krugell, 2003).

For a country to attract FDI, a thorough and well-researched approach must be followed, focused on the determinants taken of foreign investors. According to Naudé & Krugell (2003), Wang and Swain classify host country characteristics into micro-determinants, macro-determinants, and strategic determinants of FDI. These three determinants will be discussed in this part of the chapter.

Before this study explores the different determinants of FDI, three important definitions need to be understood. These three concepts contribute the largest and primary part of FDI flowing from one country to another. Firstly, the definition of TNCs needs to be expanded.

TNCs (or Multi National Enterprises (MNEs)) are defined as a firm that performs value added operations in at least two countries (Rugman & Verbeke, 2000).

It is now widely accepted that TNCs play a crucial role in facilitating international transfers of resources, technology, management know-how, products and services from a home country to a host country. They also make a positive contribution to the economic growth of a host economy by supplying capital, technology and management resources that would otherwise not be available in that country (Jeon & Ahn, 2004).

The second important concept that must be understood is that of Mergers & Acquisitions (M&As). M&As are, according to UNCTAD (2000), a change of assets from domestic to foreign subjects and, at least initially, they do not add to the productive capacity of host countries. Since the late 1980s, cross-border M&As have been the key driver of global FDI. The value of M&As decreased from \$370 billion in 2002 to \$297 billion in 2003, a decline of 20% (UNCTAD, 2005).

Investment through cross-border M&As is made either through foreign firms merging with domestic firms (the results of which are new entities) or foreign firms taking over existing domestic firms (which become new foreign affiliates). Cross-border M&As can involve private firms only, or can take the specific forms of privatisation with the participation of foreign buyers (UNCTAD, 2000).

The final definition that needs to be explored in the determinants of FDI is privatisation. Privatised enterprises are those in which any of the firm's shares shift to private individuals. A privatised enterprise is defined as a firm in which the ownership has shifted more than 50% of the shares to private individuals. The most restrictive definition, complete privatisation, implies that a privatised firm is one in which all the shares have been shifted to private individuals (Li, 2003).

In June 2004, Ndi Okereke-Onyiuke, head of the African stock exchange association and director general of the Nigerian stock exchange, urged for privatisation. According to Okereke-Onyiuke, privatised enterprises such as the telecommunication and energy suppliers are attractive propositions that give investors opportunities to invest. Therefore, increased privatisation will lead to higher levels of FDI inflows, which will be followed by the expansion of this developing economy. Globally, an important factor in the decline of FDI has been a slowdown or end to privatisation (Anon, 2004b).

The remainder of this chapter now turns towards the determinants of FDI, described under the headings of micro-determinants and macro-determinants of FDI and concluding with the strategic factors that attract FDI.

2.6.1 Micro-determinants of FDI

The micro-determinants of FDI are mainly concerned with those location-specific factors that have an impact on the profitability of FDI at firm or industry level (Naudé & Krugell, 2003). Host country characteristics that influence productivity and cost at this micro-level include market size and growth, labour factors, host government policies, profitability and other firm and product specific micro-determinants.

2.6.1.1 Market size and growth

According to Nunnenkamp (2002), who investigated traditional FDI determinants, market-related factors clearly stand out. In a frequently quoted survey of the earlier literature on FDI determinants, Nunnenkamp (2002) states that Agarwal found the size of host country markets to be the most popular explanation of a country's propensity to attract FDI. These findings were corroborated in subsequent empirical studies by Shamsuddin (2004).

According Naudé & Krugell (2003), FDI is likely to be attracted to host countries with large local markets and higher levels of economic development. A large, growing domestic economy ensures MNEs of a market for their products and provides for economies of scale. Furthermore, transaction costs are likely to be lower according to Nunnenkamp (2002), Shamsuddin (2004) and Naudé & Krugell (2003). These views are supported and strengthened by Petrochilos (1989) who states that the size of a country's domestic market, as measured by the country's GDP, plays an important role in attracting FDI.

As soon as the market size of the country grows to a level where advantages of economies of scale can be utilised by foreign investors producing in the host country, that country becomes the target for FDI (Petrochilos, 1989). If the country can be successful in achieving these above-mentioned high levels of GDP per capita, it can be seen as an indicator of a healthy economy. This positive perception of those countries will eventually increase FDI inflows further, increasing host countries' potential profitability. A positive

correlation can therefore be assumed between market size and FDI inflows towards a larger domestic market in host countries (Schneider & Frey, 1985). This hypothesis is supported by Lizondo (1990). Countries with large markets are usually characterised by a high level of consumer expenditure and large populations (Amihramadi & Wu, 1994). Furthermore, higher levels of sales in a country contribute to a positive perception of this country and will eventually lead to higher levels of FDI inflows. An increase in sales can therefore be viewed as an indicator of potential growth and future profitable opportunities in a host country (Garner, 1993).

Schneider & Frey (1985) summarise the above-mentioned ideas and views by stating that: High levels of GDP growth can be seen as an indicator of positive future development potential in a country. This has the positive influence on FDI inflows towards the host country.

2.6.1.2 Labour factors

Labour is one of the most important factors in the production process, and therefore labour related factors are investigated very intensely by investors planning to invest in a foreign country. Different labour related issues can be identified and this study takes a closer look at labour cost, the levels of skills and education and finally the stability in a country's labour force.

2.6.1.2.1 Labour cost

Countries with high labour costs can expect lower levels of FDI flows than countries with lower levels of labour costs (Petrochilos, 1989). Lower levels of labour costs make it more profitable to be involved in a country and therefore levels of investment will rise. A negative relationship between FDI and labour costs therefore exists (Schneider et al, 1985). As wages rise, FDI aimed at low cost, efficient production, tends to be discouraged (Naudé & Krugell, 2003). Krugell & Naude (2003) further state that according to Lucas, as wages rise relative to the cost of capital, there may be a tendency to substitute foreign capital in the place of labour.

These results suggest that countries such as Portugal, which has higher levels of labour costs than other EU members may have more problems in attracting foreign investments (Galego et al., 2004).

2.6.1.2.2 Level of skills and education

Firms may not only be interested in the lowest wages. Petrochilos (1989) states that levels of productivity play an equally important role. TNCs may seek skilled labourers and professionals. Instead of just low wages, it is important that wages reflect productivity. TNCs aim to maximise profits through efficiency gains and/or cost minimisation (Naudé & Krugell, 2003).

In a country like South Africa, labour is very expensive and productivity levels are very low, influencing FDI negatively (Keller, 1994).

A well-trained and skilled labour force is another prerequisite for a foreign investor investing in a country's production or business sector (Schneider & Frey, 1985). Moreover, the level of skills and education is becoming of increasing importance in the decision making process of foreign investment. The industrial potential can be viewed as one of the most important strategic factors in the decision making process of foreign investment. Productivity and the level of skills of the available labourers in a host country largely determine the country's industrial potential (Amirahmadi & Wu, 1994).

2.6.1.2.3 Labour force stability

In a country where labour strikes often occur, the risk of losing production and increased opportunity cost threatens potential investors, making these countries less attractive for FDI (Keller, 1994). Striking is usually the result of unresolved labour disputes. A given host country is less attractive the greater the occurrence or harshness of industrial disputes (Yang et al., 2000).

2.6.1.3 Host government policies

Government needs to provide an appropriate environment to attract FDI. Such measures as relaxation or elimination of restrictions on profits and capital remittances, opening of sectors to investors and provision of adequate security, among others, should be put in place (Akinlo, 2004).

These policies are location-specific factors that may influence profitability and foreign enterprises' decision to undertake FDI, in a number of ways.

According to Naudé & Krugell (2003), host governments often offer incentives such as tax breaks and trade incentives. The latter include duty-free imports of inputs to increase the attractiveness of their location. The incentives aim to encourage FDI inflows by reducing costs and making investment more profitable. Such incentive schemes are crucial in order to remain competitive in attracting FDI.

Naudé & Krugell (2003) further state that, performance requirements are related to incentives. FDI can be acquired by enforcing performance requirements on investors to try to ensure that the benefits of FDI accrue to the country. The result of such requirements usually occurs in the form of hiring and training of local personnel, local content, technology transfer and exporting of output. These incentive schemes may attract FDI more efficiently than government intervention as a negative perception of governmental intervention is often found in tax increases etc.

In addition to the above-mentioned incentives and schemes, governments need to be more innovative and must aim policy decisions at investment-attracting ventures such as privatisation. Therefore governments need to provide a legal and administrative framework for effective privatisation (Akinlo, 2004). Furthermore, host governments should make major efforts to correct unwanted occurrences such as corruption when determining policies. Corruption affects the composition of capital inflows in a way that is not favourable to the country as a corrupt country receives substantially less FDI (Wei, 1999).

Another important policy decision that needs to be taken into account by host governments in policy making is the issue of tariff barriers. Openness in trade as a FDI determinant will be discussed under micro determinants later

in this chapter. The matter of trade barriers is also a policy-related issue as host governments determine the rules and regulations. According to Naudé & Krugell (2003), the so-called “tariff hopping” hypothesis states that high protective trade barriers make exports by foreign investors to a potential host country uncompetitive. Potential marketing cost savings, from avoiding protectionist barriers, as well as transport cost reductions, encourage investors to enter foreign markets through FDI (Wang & Swain, 1997).

The policy challenge may become fairly complex; host country governments would have “to provide and publicise a unique set of immobile assets, pertinent to the types of economic activity they wish to attract and retain, in comparison with those offered by other countries” according to Dunning (1999).

2.6.1.4 Profitability

According to Petrochilos (1989), the single and most important motive for investment is to make profit and FDI is no exception. Because profitability is such an important issue, thorough project evaluation will be done by potential investors. Investors will consider different risks but eventually the county with the highest expected income potential over the lifetime of the planned investment project will be chosen (Petrochilos, 1989).

Capital will therefore flow from countries with a low expected profit potential to countries with high expected profit potential. The difference in revenue at different locations can therefore be seen as a determinant of FDI (Garner, 1993). Garner (1993) adds that by adding that firms will invest in foreign markets rather than domestic markets if the marginal revenue is higher and the marginal cost of capital is the same for both types of investments.

2.6.1.5 Firm specific determinants

When firms take decisions on investing in foreign markets by expanding their business overseas, these decisions are influenced by factors such as the size of the firm and marketing and technological related determinants. These determinants are now discussed.

2.6.1.5.1 Size of the firm

The size of a firm is determined by the total sales and turnover. The size of a firm has a direct influence on the tendency to invest in foreign markets. Petrochilos (1989), states from his studies that there is a direct, positive relationship between the size of a firm and FDI.

2.6.1.5.2 Marketing & technology

Firms become TNCs to exploit their technological inventions on a broader scale than the domestic market (Petrochilos, 1989). Such TNCs are seen as important vehicles for technological diffusion in the global production process. Petrochilos (1998) states that there is also a direct relationship between international marketing and FDI. According to him, the technological infrastructure, comprising supportive systems, training facilities and R&D capacity, plays an enormous role in attracting FDI from different firms. When the above-mentioned infrastructures are in place, it will make large expenditure on marketing and technology more economical and will therefore attract FDI more efficiently (Amirahmadi & Wu, 1994).

2.6.1.6 Product specific determinants

In the process of decision making when considering foreign investing, the opportunities and viability of products also need to be investigated and researched thoroughly (Steyn, 1997). This is usually done by market research in the targeted market. Product-specific determinants include product differentiation and product cycles. These determinants are subsequently discussed.

2.6.1.6.1 Product differentiation

Investment tends to be drawn to industries characterised by certain market structures. TNCs are usually found in industries characterised by high levels of product differentiation. Petrochilos (1989) also identifies differentiated oligopolies with positive FDI flows.

2.6.1.6.2 Product cycles

Every product is subjected to a product cycle (Steyn, 1997). Firms need to determine the potential product cycle of a newly introduced product. If a single product is introduced to a foreign market, the financial viability over time needs to be determined before investment in production or marketing facilities will take place. Therefore, products with a longer product cycle can be associated with FDI. Naudé & Krugell (2003) add that the stage of the product's life cycle, as between a new, mature or standardised commodity may also be of significance. Locations with lower input costs are important when the product is standardised.

2.6.2. *Macro-determinants of FDI*

The micro-determinants of FDI discussed above are market size and growth, labour factors, host government policies, profitability and other firm and product-specific micro-determinants. The macro-determinants of FDI are the factors that influence profitability and the choice to invest at economy-wide level. These are the size and growth of the host market and factor prices. Factor prices are in turn influenced by tariffs and taxes. Thus there is an overlap with the microenvironment that is reflected in a number of additional determinants of FDI. These include openness and export orientation, exchange rates, the inflation rate, budget deficit, and domestic investment as well as political risk (Naudé & Krugell, 2003).

2.6.2.1 Openness and exports

Moosa & Cardak (2003) applied extreme bounds analysis to a sample of cross-sectional data covering 140 countries. Their empirical results suggested that countries that are more successful in attracting FDI are countries with a high degree of openness.

After studying FDI trends over the last few years, Asiedu (2002) notes that in the 1980s, openness to foreign investment was the "exception rather than the norm". Several countries had restrictions on FDI and trade. In several countries, investments in some industries were entirely closed to foreign investors. With the modern trend of globalisation, the marginal impact of increased openness is high in those countries. Therefore, a minor

improvement in such a country's FDI framework will make them very attractive to foreign investors. The situation is different when openness is the "norm rather than the exception" as experienced in the 1990s. When this situation is experienced, openness is not longer the only sufficient condition for FDI. An increase in openness may make a country eligible for FDI, but does not necessarily guarantee FDI. In order to attract more FDI, the country needs to have more competitive advantages than other competing countries. This may require "drastic improvements in openness, especially for countries that had very restrictive regimes prior to implementing reform" (Asiedu, 2002).

Naudé & Krugell (2003) state that there are a number of arguments linking openness, exports, and FDI flows. According to them, the tariff-hopping hypothesis claims that there is a negative relationship between openness and FDI. Apparently closed economies receive FDI that substitutes trade. The opposing view by Jun and Singh (1996) can be given where they tested the tariff-hopping hypothesis and found that the relationship between openness and FDI is indeed positive. Therefore, outward-orientated economies are more successful at attracting FDI. An outward-orientated economy is not handicapped by the size of its domestic economy when attracting FDI as it offers efficiency and access to world markets.

Empirical studies, determining whether import-oriented countries actually attract FDI support openness. As quoted in Naudé & Krugell (2003), Lucas found that, in Southeast Asian countries FDI is more elastic with respect to the demand for exports than with respect to aggregate domestic demand. Furthermore, a strong relationship was found between exports in general, manufacturing exports in particular and FDI.

Akinlo (2004) accepts Lucas' arguments and states very clearly that, when taking these factors into account, governments need to provide an appropriate environment to attract manufacturing FDI. Such measures as decreases in restrictions on profits and capital remittances, opening of all sectors to investors and provision of adequate security, among others, should be put in place.

Akinlo (2004) also states that, by applying these measures, privatisation will be increased that will engender competition and greater efficiency.

Furthermore, privatisation will lead to much needed transparency in these domestic and foreign market sectors. Akinlo (2004) concludes by saying that policies that assist greater openness will definitely lead to higher levels of FDI inflows and will increase exports that will, in the long run, lead to higher economic growth in receiving countries.

Nunnenkamp (2002) adds to Akinlo's (2004) views by saying that export orientation is the strongest variable for explaining why a country attracts FDI. Janicki & Wunnava (2004) support these views by reiterating Deichman's earlier research where he explained that trade and investments complement each other. Similarly, Bevan & Estrin argue that countries that are more liberal in their trade approach tend to export more, and this situation represents an attractive opportunity for foreign investors, especially those that are considered export-driven (Janicki & Wunnava, 2004).

2.6.2.2. Exchange rates

Exchange rate, related to openness, is a similar important determinant of FDI flows to host economies. According to Barrell & Pain (1996), exchange rate uncertainty influences the financing of foreign investment and may affect FDI inflows to host countries.

Cushman (1985) among others used the absolute measure of the exchange rate as a way to measure the determinants of the level of FDI abroad. Li & Moshirian (2004) hypothesise that exchange rate movements can have either a positive or a negative influence on FDI. They explain this hypothesis by saying that increased uncertainty about exchange rates will lead to a lower level of FDI, if the FDI decision making is based on "initial costs of establishing foreign branches." Nevertheless it will increase FDI if foreign investment decision making is based on "long-term anticipated gains from income generating branches" (Li & Moshirian, 2004).

Naudé & Krugell (2003) identified two broad lines of thought related to the importance of exchange rates as a determinant of FDI; (i) Considerations of exchange rate risk and (ii) the currency area hypothesis.

Exchange rate risk comprises the risk that foreign firms are exposed to when FDI is made. The degree of this risk will influence the decision to locate in a

specific country. High risk countries are usually not very attractive to foreign investors.

According to Naudé & Krugell (2003), the exchange rate determines the value of repatriated profits. In developing countries a deteriorating exchange rate may threaten restrictions on remittances, irrespective of that exchange rate as a determinant of FDI. Studies of the effect of exchange rate devaluation of FDI show that it depends on whether foreign firms in a country are dependent on the foreign market more for the import of their inputs, or for the export of their outputs (Wang & Swain, 1997).

The nature of the risk also depends on the foreign firms' nature of activities in the host country. If foreign firms are in the exporting business, depreciation of the exchange rate will be beneficial. The devaluation will make output more competitive from a price point of view. Furthermore, large exchange rate fluctuations discourage FDI flows, as they increase instability in the economy of the host country (Wang & Swain, 1997). The second line of thought is concerned with the currency area hypothesis that argues that firms from harder currency areas are able to borrow at lower costs and capitalise the earnings on their FDI in softer currency areas at higher rates than the local firms. The higher the share of capital value added and the size of the premium on the local currency, the greater the comparative advantage that foreign investors enjoy over local firms. Such advantages attract FDI (Naudé & Krugell, 2003).

2.6.2.3 Inflation rates

High levels of inflation can be seen as an indication of bad economic policy and management by the host countries' authorities (Garner, 1993). High levels of inflation might be the result of the fiscal authorities being unable to balance the national budget, the monetary authorities failing to control the money supply of the country or a combination of bad management from both these authorities (Schneider & Frey, 1985). This increases uncertainty regarding the business climate in host countries. Furthermore, an inflationary raise in the prices of domestic goods and services will make production in the host country less competitive. The higher production costs and signs of economical tension caused by inflation will discourage FDI flows towards host countries (Garner, 1993).

2.6.2.4 Budget deficits

According to Naudé & Krugell (2003) a high or increasing budget deficit is not a host country characteristic that encourages FDI flows. They continue by stating that Chaudhuri and Srivastava's empirical findings support a negative and significant relationship between budget deficits and FDI flows.

2.6.2.5 Investment and infrastructure

As quoted in Naudé & Krugell (2003), Chaudhuri and Srivastava stated that FDI supplements domestic capital, but it may be argued that the cause also runs the other way: domestic investment crowds-in FDI. It does so by increasing productive capacity. Nevertheless, domestic investment must be encouraged in an open economy, as foreign investments tend to follow domestic investment. Referring to a country like South Africa, Irwin supports the above-mentioned view by saying that: "I don't see South African companies raising money to finance bold new ventures, foreigners are going to look at that and say, 'If locals aren't investing, why should we?'" (Anon, 2004b)

In the same way, infrastructure creates an enabling environment for foreign investors (Naudé & Krugell, 2003). A good infrastructure increases the productivity of investments and therefore stimulates FDI flows (Wheeler & Mody, 1992). According to the empirical studies of Asiedu (2002), infrastructure development generated more FDI in Sub-Saharan Africa in both the 1980s and 1990s.

2.6.2.6 Political Instability

The level of political instability has a direct impact on the ability of countries to attract motivated and skilled human resources (Garner, 1993).

The negative correlation between FDI and political instability can be found in the studies of Petrochilos (1989). He indicates that political instability will affect FDI negatively. This outflow of FDI due to political instability might be driven by the fact that political instability can be associated with potential revenue losses. These revenue losses may occur as a result of disruptions

in production, uncertainty of available resources and unpredictable policy changes (Amirahmadi & Frey, 1994). Therefore, an increase in domestic political stability will result in higher levels of FDI flows towards that country and an improvement in political diplomacy between countries will have the same positive effect on countries. According to Naudé & Krugell (2003), political instability embodies a variety of concerns from confiscation or damage to property to threats to personnel, to a change in macroeconomic management or the regulatory environment.

Schneider & Frey (1989) conclude that: political instability disrupts the economic process and especially affects FDI. Increasing political instability will convince marginal decision makers to decrease FDI flows to countries experiencing political instability. Therefore, a negative correlation exists between FDI and political instability.

2.6.3 *Strategic factors*

The following strategic factors that influence FDI were identified and are subsequently discussed; firstly, indirect long-term factors followed by portfolio differentiation and finally industrial organisation.

2.6.3.1 Indirect long-term factors

The need to invest in foreign markets may be the result of investors' desire to protect foreign markets and foreign investment against competitors. FDI may therefore take the form of a need to maintain or acquire a grip on a protected market. This may result in a source of supply that may be useful to the foreign investor in the long run. Another long-term factor can be identified where the investor has a desire to bind itself to a specific type of technology to complement existing investment projects. All these factors have a direct, long-term influence on FDI and have a direct relationship with the profitability of the firm (Petrochilos, 1989).

2.6.3.2 Portfolio differentiation

In the process of finding suitable projects, foreign investors are guided by the expected revenues as well as the level of risk exposure in different countries. The total risk exposure of foreign investors can be minimised by investing in different projects in different countries. FDI can therefore be seen as international portfolio differentiation on the corporate level (Petrochilos, 1989).

2.6.3.3 Industrial organisation

When the firm begins operating in a foreign country, it is confronted by several disadvantages, for instance cultural differences, language differences, different legal systems etc. In order to stay competitive with domestic firms, a foreign firm needs firm-specific comparative advantages. These competitive advantages include international brands, patented technology, lower financing rates, improved marketing and management skills. Foreign firms with these competitive advantages will get involved in FDI (Petrochilos, 1989).

All the above-mentioned determinants are important for countries when planning strategies to attract FDI. From a strategic economic point of view, the determinants of FDI must be taken into account by governments (Naudé & Krugell, 2003).

2.7 The effects of FDI

The effects of FDI on an economy can be separated into positive and negative effects. The positive effects are discussed under the advantages of FDI while the negative effects are the disadvantages of FDI.

2.7.1 Advantages of FDI

FDI has a direct or indirect positive effect on the economy of host countries. Borensztein et al. (1998) investigated the effects of FDI in Less Developed Countries (LDCs). Their studies indicated that FDI contributed to economic growth, technology transfer and higher levels of investment for these countries. The Chinese government ranks high among the world's boosters for foreign investment. FDI has played an enormously important role in the development of China, one of the

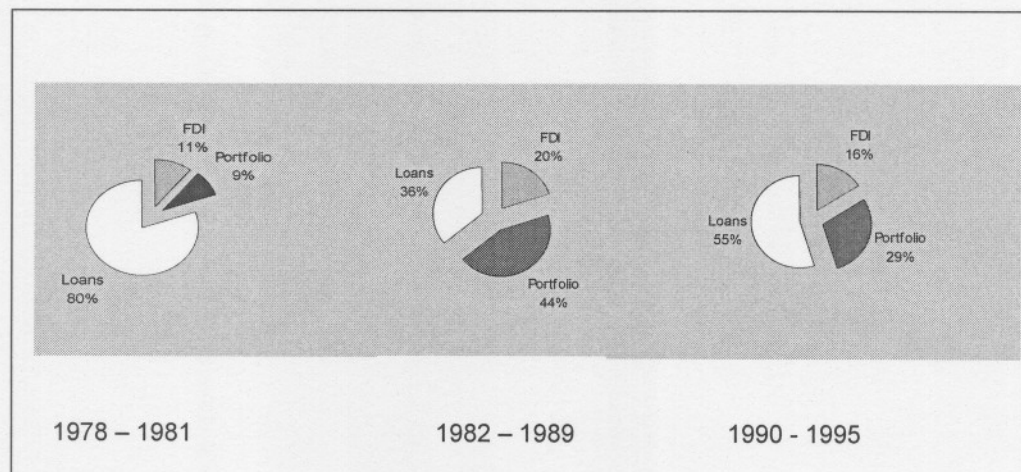
strongest and fastest growing economies in the world today. When FDI started to decline in late 1990s, the Chinese government accelerated its efforts to join the World Trade Organization (WTO) as a strategic attempt to attract more FDI. This action was primarily driven by the Chinese government's belief in FDI as a stimulus for Chinese economic development (Braunstein & Epstein, 2002).

To explain how FDI is able to contribute to receiving countries in an advantageous form, the following factors of FDI are discussed: firstly it is important to determine whether FDI is indeed the preferred capital flow in the global economic environment. If so, FDI is indeed advantageous, but what are the reasons for this? Secondly, FDI can potentially bring two direct categories of economic benefits: Economic growth and the expansion of productive capacities (Gallagher & Zarsky, 2003). These two economic benefits are discussed separately. Finally, there is a discussion of a category of indirect benefits to FDI receiving countries.

2.7.1.1 FDI: The preferred capital flow

The United Nations Conference on Trade and Development (UNCTAD) expects FDI to provide a stronger stimulus to income growth in host countries than other types of capital inflows. FDI is therefore considered an important component for achieving sustainable growth and development (Nunnenkamp, 2002). The historical composition of different capital flows are illustrated in figure 2.1

Figure 2.1: How the composition of capital inflows has shifted from bank loans towards FDI flows and portfolio investments



(Source: Loungani & Razin, 2001).

Nunnenkamp's findings about FDI as preferred capital flows are further supported by the following arguments: firstly, FDI is the most stable form of capital flow. Secondly, FDI performs better during financial crises if compared to other forms of capital flow and, finally, FDI crowds-in domestic investments. These arguments will be discussed subsequently as a comparison between FDI and other forms of capital flow.

2.7.1.1.1 Stable flow

FDI is pictured as being immobile and a relatively more permanent investment making it much more stable than other types of capital flow. Nunnenkamp (2002) finds evidence that supports the view that FDI is more stable than other types of capital inflow. This is supported by the fact that the volatility of FDI remained exceptionally low in the 1990s, when several emerging economies were hit by financial crises.

2.7.1.1.2 Performance during financial crisis.

"Foreign direct investment (FDI) has proved to be resilient during financial crises" (Loungani & Razin, 2001)."

According to Braunstein & Epstein (2002) the following crises can be used as examples to illustrate the value of FDI during such difficult times, making it "one of the most sought-after commodities in the global economy.

- The global financial crises of 1997-98 in East Asian countries.
- The Mexican crisis of 1994-95.
- The Latin American debt crisis of the 1980s.

During these times, FDI proved to be stable and flexible; other flows such as debt, private capital, portfolio, equity, and particularly short-term flows were subject to large reversals during the same periods (Dadush et al. 2000)."

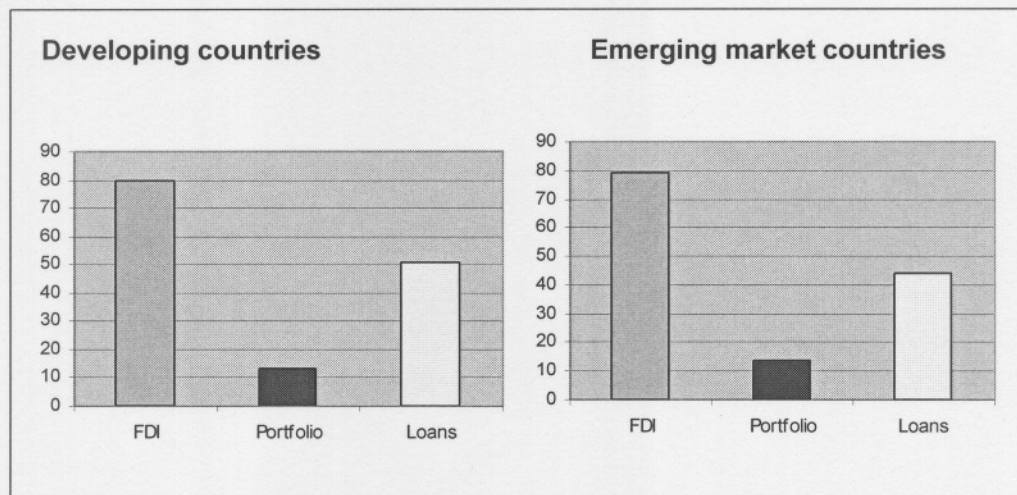
Therefore Loungani & Razin (2001) correctly suggest that when hedging a country against potential financial crises, FDI should be

treated as the capital flow of choice because other flows proved to be unreliable.

2.7.1.1.3. Crowding-in of domestic investments

Loungani & Razin (2001) state that FDI brings about a one-for-one increase in domestic investment (see figure below).

Figure 2.2: FDI's stronger impact on domestic investment than portfolio flows and loans



(Source: Loungani & Razin, 2001).

2.7.1.2 Economic Growth

“Beginning with growth, applications of the most standard type with some combination of capital and labour explaining GDP growth, find that FDI makes significant contributions to growth” (Lipsey, 1999).

When investigating the different advantages linked to FDI from an economic growth perspective, the following advantages can be identified and are discussed separately: Firstly, FDI results in an increase in capital flows and, secondly, it increases income. Thirdly, FDI may contribute positively towards the balance of payments of a country and, finally, it may increase local employment in FDI receiving countries.

2.7.1.2.1 Increase in Capital flows

FDI brings financial investment resources to countries in which capital is scarce. One of the identified channels through which FDI can contribute towards economic growth is via increased capital accumulation in the recipient economy. The main driving force behind a higher growth potential is seen in an expanding capital base (Moosa, 2002). The inflow of foreign funds enables countries to grow faster without sacrificing current consumption (Lipsey, 1999).

Feldstein & Horioka (1980) noted that economists favour the capital flow across national borders. This allows capital to seek out the highest rate of return. Other advantages include a reduction of risk due to the diversified lending and investment portfolio options. Furthermore, the global integration of capital markets can contribute towards a uniform global structure of best practices in corporate governance, accounting rules, and legal traditions that will expand international trade. Finally, the increased international capital flows restrict the ability of governments to follow bad policies.

If countries fail to attract funding in the form of capital flows they will be forced to finance economic expansion projects with external debt burdens (Barrios et al, 2004). It is thus in the best interest of the country to attract foreign capital for growth expansion. In using this as a form of financing, the growth potential could be raised without incurring the vulnerabilities associated with external debt burdens. FDI inflows are easier to service and much more stable than commercial debt or portfolio investment.

2.7.1.2.2 Increase in income

In the previous paragraph, it has become clear that FDI increases the amount of money available to a country for investments and expansion. Increases are based not only on the capital inflows but also in the form of wage increases that increase the income of individuals. As Resnick (2001) puts it: "FDI puts more money in the pockets of employees than domestic firms do thus, FDI is good for wages."

Aitken et al. (1996) found that there are significant advantages in working for foreign firms in countries such as Venezuela, Mexico, and the United States. A relationship between FDI and higher wages was also found a year later by Feenstra & Hanson (1997) who focused on Mexico.

Barry & Bradley (1997) conducted a study about Irish wages and employment. Focusing specifically on industrial workers, the average wage in the foreign-dominated sectors (for 1993) was around £14,000 compared to an average for the rest of manufacturing of around £12,000. From Asia, empirical evidence from China proved that FDI has raised wages in China over the last decade and a half (Braunstein & Epstein, 2002).

Resnick (2001) concludes that, the poorer a country receiving FDI, the greater advantage a foreign firm will have working in that country.

2.7.1.2.3 Balance of payments

When a foreign enterprise invests in a country, the immediate effect on balance of payments is a one-time inflow of capital. As the enterprise starts operating at a profitable level, a continuing outflow of funds may be experienced. The direct beneficial implications for balance of payments include factors such as: the inflow of initial capital from TNC exports, export revenues, interest as well as after-tax profits accrued outside the host country, and loans from the home country. Indirect benefits include the savings realised due to changes in flows due to substitution of local resources for previously imported goods and services (Deutsche Bundesbank, 2003).

Horizontal FDI, i.e. investment in a company that essentially produces the same goods, may have the advantage of jumping trade barriers or reducing transaction costs due to economies of scale. Exports will increase through the advantages of lower production costs.

Balance of payments advantages are clearly visible in countries such as Vietnam where foreign companies contribute to 27% of the

country's (non-oil) exports (Freeman, 2002). The most remarkable balance of payments improvement flows from the fact that expertise, knowledge, methods and additional capital brought to host countries by TNCs can lead to the expansion of export markets, which could increase exports.

2.7.1.2.4 Increase in local employment

Lall (2000), states that FDI is a useful source of increases in employment. Lall furthermore suggests that a well-managed government structure is an essential prerequisite for increases in employment. A classic example of this is demonstrated in East Asia's newly industrialised countries where FDI led to the relief of unemployment. According to Braunstein & Epstein (2002), one of the key reasons that local officials are so interested in attracting FDI to China is employment creation. There will be tremendous pressure on China's authorities to manage and control the potential unemployment problem, particularly in urban areas. This potential unemployment problem is the result of a fast growing population, economic reforms and the rising incidence of layoffs in the state sector (Jiang 2002).

Otsubo (1998) predicts that the employment situation in the Asian economies should improve because these economies still possess dualistic labour market structures as well as sectoral structures, and FDI inflow creates new job opportunities.

2.7.1.3 Productive capacities

On the macro impacts of FDI, results from macro econometric analyses by Fry (1993) show that, unlike Latin American cases, FDIs in Asia led to a direct expansion of productive stock, and rates of domestic savings and investment tend to increase together with an inflow of FDI (Gallagher and Zarsky, 2003).

The expansion of the productive capacities in FDI receiving countries is explained in this part of the chapter by looking at the transfer of technology, human capital development, skills and management, increases in TNCs,

local stock market expansion, different forms of linkages in other domestic markets, spin-off benefits as results of FDI, stimulation of domestic investment, increases in productivity of domestic firms, increased integration in global markets and, finally, tax revenue advantages.

2.7.1.3.1 Transfer of technology

One of the strongest and most prominent channels through which FDI can result in positive outcomes is through the transfer of technology to host countries, making them more efficient. The implication of this positive flow is that it results in a saving of domestic resources. The technological inflows carried forward by foreign enterprises would have cost host countries a lot if it were to be obtained via other sources. Local enterprises would have to undertake their own R&D initiatives or would have to import technology at high cost.

According to Gallagher and Zarsky (2003), an IMF study found evidence of positive effects, including productivity increases through technology transfer, to be “overwhelming”.

Developing countries are often under-resourced in terms of technology used. Technology is usually outdated in many domestic industries. The fact that efficiency levels of technology are also relatively low is a greater matter of concern. With highly competitive new market demands today, developing economies often lack the productive capacity to take part in global trade. Lall (2000) states that even if part of their productivity gap is compensated by lower wages, technical inefficiency and obsolescence affect the quality of their products, making them uncompetitive. Lall (2000) also claims that foreign investors can initiate a spillover process by supplying new state-of-the-art technology to domestic enterprises. In doing this, local enterprises will gradually adapt advanced technology that will lead to an increase in domestic productivity, resulting in economic growth in the region.

TNCs can also help domestic enterprises to operate at optimal levels of efficiency by offering technical assistance. Due to their levels of experience and expertise, TNCs are able to adapt technologies to local

conditions. According to Lall (2000), this may, in some cases, lead to the set up of local R&D facilities.

Technology is constantly changing globally. For the state to be competitive and effective with the technology used in production requires large amounts of research and capital. TNCs can make a useful contribution towards domestic enterprises by assisting them in strategic planning as technologies and innovations emerge and consumption patterns change. In the long term, the financial sector of FDI receiving countries can enjoy the advantages of FDI through the enhanced stability of the domestic financial system (Deutsche Bundesbank, 2003).

2.7.1.3.2 Human capital development, skills and management

The transfer of improvements in management techniques shows that the direct effects of FDI are positive (Evenet & Voicu, 2002). By training the local employees, the foreign investor can contribute to the host country as the transferred skills and techniques will gradually become part of the domestic society, leading to improved production and ultimately stimulating economic growth in the region.

Local enterprises are often not familiar with the recent trends in skills development and management practices. TNCs and foreign investors can assist domestic enterprises in these important matters, which are not always valued in host countries. By bringing in experts and setting up training facilities, TNCs can transfer advanced skills to host countries. The same can be done for the transfer of management techniques that will enable host countries to operate more competitively (Evenet & Voicu, 2002).

This is not done to enforce foreign methods on the domestic market. As Barry & Bradley (1997) state, skill levels in foreign industry are simply higher than in local industry. Host countries of FDI must therefore not see the flow of skill and management as problematic to the domestic culture of production. This process must be seen as a contribution to the development of human capital in the host country.

2.7.1.3.3 Increase in TNCs

The importance of TNCs in FDI receiving countries lies in the fact that TNCs usually enjoy better access to international financial markets and are subject to larger economies of scale than enterprises based only in the host economy. The effects of a successful TNC investment can lead to even more expansion in the host country as one TNC can induce other TNCs to invest in the same country (Resnick, 2001).

2.7.1.3.4 Local Stock market expansion

The local stock market is the most accessible channel through which foreign enterprises can obtain ownership in local enterprises. According to the International Relations department Report of Deutsche Bundesbank (2003), the liquidity of stock markets is increased if foreign investors choose to purchase existing equities of the local firm as part of the investment. The effect of FDI on the local stock market depends on the ability of foreign enterprises to recover part of the investment by selling equities in the host country. If this can happen, the effects of FDI on the local stock markets will be positive according to Gallagher and Zarsky (2003).

2.7.1.3.5 Backward and forward Linkages

From the literature available on FDI, it is easy to derive the direct positive and negative effects that FDI brings to the receiving country. In practice the advantages and disadvantages are often found in the indirect linkages between different role-players in the host country.

Although the literature clearly shows the advantages and methods through which technology can be transferred to host countries there will still be arguments such as those of Blomström's (1991). According to him, another major aspect of technology transfer is inter-industry spillovers that occur through backward and forward linkages of industries and not necessarily through TNCs.

As FDI continues to increase the number of linkages, the rate of return to productive factors in industries will increase. This increase would cause

increases and expansions in production and exports. Furthermore, the proceeds of the linkages between different sectors will contribute to the absorption of domestic resources, helping FDI receiving countries to expand their potential and become more competitive in the global market (Gallagher and Zarsky, 2003).

2.7.1.3.6 Spin-off benefit

De Mello (1997) states that the degree to which an FDI receiving country can extract spillover effects from investors will determine the degree of growth in the country. It is not possible to determine the total effect of spin-off in a receiving country, as the continual influence of FDI cannot be measured. In practice, there will always be spin-offs on spin-offs as the interrelationships between different sectors are complex and interdependent.

One of the most important spin-off benefits of FDI is the increase in Research & Development (R&D) in the host country. McAleese & Foley (1991) investigated the R&D expenditures in the Irish manufacturing sector. Their results indicated that the bulk of R&D expenditures in this sector arise in the foreign sector. They also found that 25% of foreign enterprises located in Ireland have R&D departments, compared to only 20% of domestic firms. This is a clear indication of how foreign enterprises can contribute to the expansion on R&D activities in host countries.

Another important spin-off benefit of FDI is the development of entrepreneurship and innovation in host countries. In a study on clustering in indigenous manufacturing, Barry & Bradley (1997) finds that, in the indigenous software sector, one-third of entrepreneurs had worked in foreign firms immediately before the start up of the new firm, while two-thirds of entrepreneurs had worked in foreign firms at some stage in their careers. This is one example of how the presence of foreign enterprises contributed towards the development of domestic entrepreneurship.

Ramirez (2000), focusing on Mexico, also emphasises the importance of spillovers. In addition, he mentions the trade-off between the long-term benefits of spillovers and the short-term sacrifices often needed to attract

FDI. The long-term spin-off benefits are therefore more important to a host country than short-term sacrifices that are often required to attract FDI.

2.7.1.3.7 Stimulation of domestic investment

Macroeconomic country studies done by Gallagher & Zarsky (2003), found that FDI has a positive impact on domestic investment. Bosworth & Collins (1999) investigated the effect of foreign capital inflows on domestic investment in capital receiving countries. They found that an increase of US\$1 in foreign capital inflows is associated with an increase of about US\$0.50 in domestic investment.

Focusing specifically on FDI inflows as a form of foreign capital inflows, Brookings Institution studied 58 countries in Latin America and Asia, as well as Africa. They found that US\$1 provided by FDI generates another US\$1 in domestic investment (Gallagher & Zarsky, 2003).

Similar evidence by Agosin & Mayer (2000), underlines these positive outcomes. They studied America by using panel data for the period 1970-96 in developing regions. Their econometric study determined whether foreign direct investment crowds-in domestic investment and found that in Asia and Africa there has been strong crowding-in of domestic investment by FDI.

To determine the effect of FDI on China, Sun (1998) did a regression analysis of the determinants of domestic investment between 1983 and 1995. Their study focused on ten coastal provinces, which received about 90% of the FDI flowing to China. By using income per capita as a proxy for domestic savings, they found a strong positive correlation between FDI and domestic investment.

Finally, in Fry's (1993) macro econometric analyses about the macro impacts of FDI, he finds that rates of domestic savings and investment tend to increase together with an inflow of FDI.

2.7.1.3.8 Increases in the productivity of domestic firms

The question may be asked whether FDI contributes towards an increase in the productivity of domestic firms. To determine the impact of FDI on the development of local firms, Barrios et al (2004), used panel data for the manufacturing sector in Ireland and focused on two potential effects of FDI namely; (i) A competition effect which entry of domestic firms and (ii) positive market externalities that promote the development of local industry.

The results from this study indicated that the effect of FDI flows follows a “U-shaped curve” in the development of local firms. Initially the competition effect dominates and FDI can be seen as negative. Nevertheless, as FDI continues to flow, the positive external effects gradually outweigh the competition effect. This makes the impact of FDI largely positive for the domestic industry (Barrios et al, 2004).

Thus, before FDI starts to have a positive effect, a transition period occurs in the local market, during which the competition effect dominates. Therefore policies must be aimed at shortening this period to allow the local enterprises to compete with foreign enterprises. This can be done by training workers and increasing R&D initiatives (Barrios et al, 2004).

2.7.1.3.9 Increased integration in global markets

An increase in the number of TNCs operating in a host country has the potential advantage of providing export markets for existing and new activities. Enhanced contacts abroad that follow from partnering with foreign firms is an indication that the direct effects of FDI are indeed positive (Evenet & Voicu, 2003). As domestic markets gradually integrate into the global market, export markets will expand. This offers advantages in the balance of payments and brings additional benefits such as the realisation of economies of scale, technical information, competitive stimulus and market intelligence (Lall, 2000).

2.7.1.3.10 Tax revenue advantages

Profits generated by FDI contribute to corporate tax revenues in the host country (Loungani & Razin, 2001). In Vietnam, for example, foreign-invested companies contributed around 25% of total tax revenues (Freeman, 2002). When investigating tax, an important distinction between the short-term and long-term effects of FDI must be made. In the short term, a decrease in corporate tax revenues may be experienced due to lowered corporate tax rates resulting from attempts by policymakers to attract FDI towards those regions.

2.7.1.4 Other positive effects of FDI

Except for the advantages of FDI that can be identified under the headings of productive capacities and economic growth discussed above, a final set of FDI advantages can be identified. In this part of the chapter the “other” advantages of FDI will be discussed under the following headings, firstly FDI and the environment is discussed, followed by FDI and human rights and concluding with FDI and international conflict.

2.7.1.4.1 FDI and the Environment

Industrialisation, urbanisation and population growth will undoubtedly contribute towards environmental damage. TNCs are more willing than ever to prevent environmental damage with advanced production methods. According to Lall (2000), TNCs often possess advanced environmental technologies and can use them in all countries in which they operate.

Because FDI and TNCs are often associated with industrialisation, which goes hand in hand with pollution and negative environmental impacts, this argument may sound strange. Lall (2000) uses the following two examples to illustrate the positive impact of FDI on the environment.

According to Resnick (2001), the first argument derived from the studies of Garcia-Johnson. In this study he examined the behaviour of the US’s chemical enterprises that operate in Brazil and Mexico. A specific focus is placed on the importation of “voluntarist environmental ideology” from

American enterprises to local enterprises. These enterprises were forced by environmentalists to develop and apply such voluntarism in the U.S.A. He went on to apply these practices abroad. The local enterprises in Brazil and Mexico, who wanted to compete in the open global market with these MNEs simply had to comply with these more environmentally friendly methods for survival.

The second example is given by Talukdar and Meisner (2001) who focus on carbon dioxide emissions. They developed a cross-national quantitative analysis. The results indicated that FDI is associated with lower per capita CO₂ emissions due to advanced and cleaner environmental technology.

In both these examples, the authors suggest a “clear connection between a liberal global economy and improved environmental protection”.

The negative impact of TNCs on developing countries’ environments cannot be overlooked. Examples such as Shell’s environmental rampage in Nigeria can be used to illustrate these negative effects on host countries’ environments (Ramirez, 2000).

When comparing the positive and negative effects, Ramirez (2000) states that the following question needs to be asked: “Would the Nigerian government or domestic enterprises have done things better on their own?” Ramirez (2000) also mentions the Mexico’s Pemex as an example where a state-owned industry resulted in one of Mexico’s worst environmental disasters, making skilled TNCs in the form of FDI the better option to control natural resources.

2.7.1.4.2 FDI and Human Rights

“FDI serves to counterbalance the excesses of abusive authoritarian governments and usher in more democratic political regimes” (Apodaca 2002).

Hewko (2002) suggests that foreign direct investors play a positive role in the development of the rule of law. In the process of states attempting to

attract FDI to host countries, the legal system will improve. This is because investors have money at risk, which they don't want to be exposed to uncertainties such as human right violations in a country.

As stated in Ramirez (2000), Muchlinski provides an overview of moral, legal and practical matters related to MNE - LDC relationships. According to Muchlinski, TNCs themselves are far less likely to violate human rights than the state. The state regulates, and TNCs are subject to the state. His empirical evidence proves that the state is able to regulate human rights more effectively in the presence of higher levels of FDI.

Apodaca (2002) found that FDI in east and Southeast Asia reduces human rights abuse and infant mortality while also increasing economic development. Santoro (2000) makes similar findings in China where he suggests that TNCs are likely to provide a boost to human rights through different channels such as increased economic independence by workers who will enjoy a stronger middle class life.

2.7.1.4.3 FDI and International Conflict

Ramirez (2000) indicates that FDI serves as a catalyst for economic development and peace. According to Resnick (2001), the studies conducted by Rosecrance and Gartzke et al. indicated that, among other things, FDI supports peace in the host country. These writers found that cross-border economic contact raises a state's stake in maintaining linkages. FDI, as one of many aspects of interdependence, has a pacifying effect.

These are the effects of FDI which have a positive effect on the receiving countries. Not all effects of FDI are positive and therefore the negative effects of FDI will now be discussed under the disadvantages of FDI.

2.7.2 Disadvantages of FDI

When studying FDI it is important to know the potential risk FDI might bring to host countries. According to Gallagher and Zarsky (2003), MNEs have been the target of criticism for causing “direct harm” to FDI receiving countries. The main reason for this is that MNEs often operate without global oversight and often with inadequate local regulatory oversight.

Dixon and Boswell (1996) analysed the effects of FDI in LDCs and found that foreign capital penetration led to less growth and increased income inequality in these regions.

There is a risk that FDI will negatively impact the economic development process itself. Moran & Theodore (1998) warns of “the possibility that FDI might lead to fundamental economic distortion and pervasive damage to the development prospects of the country is ever present.”

The risks of FDI flows lie in the possibility that FDI will lower, rather than raise, domestic investment and saving, causing one of the biggest economic concerns, namely “crowding-out”. Economists identified a few more potential risks towards host countries of FDI. The following must be kept in mind by policymakers when attracting FDI and will be discussed subsequently in this part of the chapter: Firstly, the crowding-out effect of local business followed by the disadvantages of the transfer of control, creation of instability, spillovers and externalities, and concluding with the harm to the environment and violation of human rights.

2.7.2.1 Crowding-out:

Crowding-out can be defined as the process where foreign enterprises are preferred over and above domestic enterprises for business, investments and production. This usually occurs when TNCs enter the country and have a negative impact on the development of local business (Gallagher & Zarsky, 2003).

In Latin America, FDI has had a strong crowding-out effect (Braunstein & Epstein, 2002). Domestic enterprises often don't have the capacity and capital to compete with TNCs when attempting to attract investments. As FDI crowds-out domestic investment, foreign enterprises may often drive domestic enterprises out of business.

When looking at domestic financing, Huang (1998) argues that FDI probably crowds-out domestic investment because TNCs tend to be highly leveraged.

Firebaugh (1992) evaluates the crowding-out effect of FDI. One of the central arguments in his research is that the profits of industrialisation flow mainly to the home country of the foreign investor, resulting in potential losses for the host countries.

2.7.2.2 Transfer of control

As FDI implies transfer of ownership from domestic to foreign enterprises it also infers a mechanism that makes it possible for foreign investors to exercise a degree of control and management over host country enterprises. The circumstances under which the transfer of control occurs may not always benefit the host country as it may bring problems of excessive power (Feldstein & Horioka, 1980).

The transfer of control often occurs as the result of a crisis. In the light of this Krugman (1998) asks the following: Is the transfer of control that is associated with foreign ownership appropriate under these circumstances? This places the motive of some FDI under suspicion because of the absence of clarity about the transaction. It must be asked whether foreign enterprises, when taking control of domestic enterprises, have special competence in managing them. Is the transaction effected simply because foreign enterprises have access to more money than domestic enterprises?

2.7.2.3 Instability

FDI also creates the fear, in the view of some economists, that it may cause instability in the host countries. This may happen through the increase of financial volatility due to the increased capital flows, which are not always long-term (Moran & Theodore, 1998).

A second fear of FDI causing instability is through the country's balance of payments. When capital inflows are used to finance extended current accounts, imbalances might contribute to prolonging the application of unsustainable policies. Recent developments in the transition economies and Latin America offer examples in this respect (Gallagher & Zarsky, 2003).

The third fear associated with FDI and instability is the fact that it might cause political instability in host countries due to regulatory deviations and the perceptions of citizens (Moran & Theodore, 1998).

2.7.2.4 Spillovers and externalities

Spillovers and externalities are not given in the process of FDI flows to host countries. If TNCs prefer to protect technology rents rather than transfer technology it will reduce spillovers and externalities. The advantages of FDI will therefore not be as hoped for by host countries (Gallagher & Zarsky, 2003).

2.7.2.5 Environment

Because FDI is capital intensive, the probability of increased environmental pressure can be seen as another risk to host countries. TNCs activity may bring environmental harm in the form of pollution and natural resource degradation. According to Resnick's (2001) studies, foreign enterprises damage the environment less than domestic enterprises. The fact remains that damage to the environment is likely to occur.

2.7.2.6 Human rights

The potential occurrence of human rights violations remains a factor of risk in host countries. Violation can take place in the form of toleration of worker abuse by subcontractors, inadequate protection of worker health and safety, as well as the involvement in other human rights violations such as underpayment, the use of child labour and bad working conditions (Zarsky, 2002).

All these disadvantages are having a negative influence on countries because of FDI inflows. It is important, however, that FDI must be absorbed successfully in order for it to have a significant impact on a country's economy, therefore, in summarising this chapter, the prerequisites for successful FDI absorption are considered. This will give some basic insight on the absorption of FDI and will conclude the chapter.

2.8 Summary

In concluding this chapter, it is necessary to emphasise the importance of the absorption of FDI before summarising what has been said. The advantages make FDI a much-desired form of capital inflow. Nevertheless, even if all possible FDI could be attracted, it can only be advantageous to the receiving country if it can be absorbed effectively. This chapter concludes with literature on the prerequisites for successful FDI absorption.

The extent to which FDI contributes to growth depends on a combination of appropriate host-country policies, the quality of the economic environment and the basic level of development of the recipient country (Buckley et al, 2002). The quality of the economic environment relates to the degree of openness, the rate of savings, the level of technological development, the effectiveness of domestic industry policies, an effective tax system, and a minimum level of education (Gallagher & Zarsky, 2003).

In the last part of this chapter, the following points were stated and investigated. It was important to provide the necessary insight on what exactly is meant by FDI. Since FDI is not a well-known concept, the misconceptions about FDI were identified and corrected by defining FDI, from a theoretical point of view. The basic and most important findings were that FDI is not just any cross-border investment. FDI must account for an ownership of at least 10% in a foreign company with a long-term commitment and objectives.

The chapter developed by taking an overview of the development of FDI over the last few years. In studying the historical evolution of FDI, it became clear that FDI is not a new phenomenon. Even though it evolved over the years, evidence of it can be traced back to the Middle Ages.

This was followed by identifying the different determinants of FDI, which were subdivided and investigated as micro-determinants, macro-determinants and strategic determinants of this important form of capital flow. This chapter was concluded by looking at the different effects of FDI under the headings of the advantages and disadvantages of FDI and a brief consideration of FDI absorption.

CHAPTER 3

THE FINANCIAL SYSTEM

3.1 Introduction

Chapter 2 discussed the advantages of FDI that make it a much-desired form of capital inflow. Nevertheless, even if all possible FDI could be attracted, it can only be advantageous to the receiving country if it can be absorbed effectively. The extent to which FDI contributes to growth depends on a combination of appropriate host-country policies, the quality of the economic environment and the basic level of development of the recipient country (Buckley et al, 2002). The quality of the economic environment relates to the degree of openness, the rate of savings, the level of technological development, the effectiveness of domestic industry policies, an effective tax system, the level of education, and the efficiency of the local financial system.

This chapter will focus on the role of the financial system in the process of attracting and, more importantly, the absorption of FDI. Therefore, it is important to understand what the financial system of a country entails. This aim of this chapter is to explain the different aspects and elements of the financial system.

This chapter begins with a description of the financial system derived from the following theoretical points of view. Firstly the financial system is defined thoroughly, followed by a historical view of the financial system. The description of the financial system continues with the explanation of the basic functions of a financial system.

The second part of the chapter is about the importance of the financial system. This entails an explanation of the relationship between the financial system and growth, the basic functions of a financial system, and the relationship between the financial system and FDI. This section concludes with the other important characteristics and contributions of the financial system.

Finally, different types of financial systems are discussed by definition and explanation, followed by some background about the influence and importance of the legal system as part of the financial system. This final part of the chapter continues with the advantages and disadvantage of different financial systems, access to funding via different financial systems. It concludes with an explanation of the relationship between bank-based systems and market-based systems.

3.2. The definition of the financial system

In explaining the financial system, the most suitable point of departure would be to look at some different definitions of this topic. Although the financial system can be explained very broadly due to its extensive meaning, the following definitions as appear to be the most acceptable.

Scholten (2000) defined the financial system as the three factors, namely financial markets, financial institutions and financial regulations that regulate and manage money flows in a country. These three factors appear to be crucial in the composition of financial systems. Firstly, the financial markets comprise, for example, capital markets. Secondly, the financial institutions can be seen as intermediaries such as banks and, finally, the financial regulations are the legal systems used in a country for regulatory purposes.

According to Faure (2003) the financial system can be defined by looking at five essential elements. Firstly, the system consists of lenders and borrowers. The term lender can be better defined by the word debtor. A debtor can be defined as a person (or institution) that extends credit by giving permission to borrow money if the borrower promises to pay it back at a later date (Investopedia, 2005). A borrower, on the other hand, can also be better defined by the term creditor. A creditor is a party (e.g. person, organisation, company, or government) that claims that a second party owes the first party some property or service. The first party, in general, has provided some property or service to the second party under the assumption (usually enforced by contract) that the second party will return an equivalent property or service. The first party is frequently called a lender, and the second party is frequently called a debtor or borrower (Wikipedia, 2005). Creditors can be classified into either personal or real. Those who have lent money to friends or family are personal creditors. The type of creditor referred to in the financial system is usually real creditors. These creditors are usually banks or finance companies that have legal contracts with the borrower, granting the lender the right to claim any of the debtor's real assets if he or she fails to pay back the loan (Investopedia, 2005).

The second element of a financial system is the financial institutions, which intermediate the lending and borrowing process. A financial institution acts as an agent that provides financial services for its clients. Financial institutions generally fall under financial supervision from a government authority (Wikipedia, 2005). Such

financial intermediaries are usually finance companies. A finance company can be defined as a financial institution (often affiliated with a holding company or manufacturer) that makes loans to individuals or businesses (WordNet, 2005).

The third component is financial instruments for various participants' needs. Financial instruments can be thought of as easily tradeable packages of capital, each having their own unique characteristics and structure. The wide array of financial instruments in today's marketplace allows for the efficient flow of capital amongst the world's investors (Investopedia, 2005).

Fourthly, the creation of money is an essential element of a financial system. Money creation is done via the unique money creating ability of banks where deposits are lent to different clients.

The last element is the financial markets, which comprise several different institutional arrangements and conventions for the trading of different financial instruments.

Sylla (2003) expands on Faure's view by arguing that modern financial systems have several important components such as:

- Stable public finances and markets for government debt securities.
- Stable money and money markets.
- Sound banks and banking systems.
- An effective central bank.
- Efficient securities markets for business firms' debts (bonds) and equities (stocks).
- Sound insurance companies and insurance markets.
- Corporations with limited liability to facilitate equity share issuance and ownership.

The above-mentioned elements and components of the financial system can be effectively encapsulated and harmonise well with the definition of Scholtens' (2000), defined earlier.

3.3 Historical view of the financial system

“Since the first telegraph was sent between Europe and the US on 23 May 1844, the world’s financial system has witnessed unprecedented deregulation, global communication and integration” (Moshirian, 2002).

To understand the effective functioning of a country’s financial system, one must undertake a brief historical journey along the line of financial system development over the years. Moshirian’s quotation above states clearly that the financial system development over the years can be seen as phenomenal. Moshirian (2002) continues to explain this phenomenon by stating that there were few independent countries in the 19th century and that the events following the world wars of the 20th century lead to the emergence of political independence for many countries. Independent countries with individual characteristics and financial systems number more than 200, a clear testimony to the significant changes in the modern world’s financial development (Moshirian, 2002).

According to Sylla (2003) the different, well-developed financial markets are too easily taken for granted as they result in large advantages in the economies that have them. Sylla (2003) identified and compiled historical information on financial system development in the Netherlands, Britain, the United States (US) and Japan. The following important historical findings and occurrences will help overcome the inadequate perspectives on the importance of financial systems.

Firstly, Sylla (2003) investigated the financial system development of the Netherlands where the financial revolution occurred in the late sixteenth and early seventeenth centuries. In this period, the Dutch developed some of the most prominent and important components of the modern financial system. This is proved by the occurrence of a growing public debt market in those years. This market was realised to finance the Dutch wars in their struggle for independence from Spain. The Dutch banking development began in 1609 when “The Bank of Amsterdam” was founded. This bank could be seen as the Dutch central bank due to its nature of business. Financial market development did not lag behind as the world’s first common stock, the standardised, tradeable equity shares of the Dutch East India Company came into being during the same period. Banking and insurance facilities also developed and emerged due to the stability of the Dutch currency, the Guilder.

During the years following the financial revolution in the Netherlands, Dutch merchants and ships appeared throughout the world. This eventually led to the establishment of several Dutch colonies around the world such as today's Indonesia, South Africa, New Amsterdam, which later, under the English, became New York, and even in Japan. The Dutch had what historians variously describe as their "golden age" and it became the first modern economy (Sylla, 2003).

The British financial revolution came about a century later, when the Bank of England was founded in 1694. Similarly, to the Dutch, the public debt market and equity securities appeared a few years later in 1720. During this, the Pound Sterling (British currency) stabilised and resulted in the establishment of the first insurance companies. Britain had the first industrial revolution after its financial revolution (Sylla, 2003).

Financial revolution in the US followed because of a new Constitution, implemented under the new government in 1789. This era was once again characterised by financial stability and the appearance of an active public debt market. Financial revolution in the US is described by historians as somewhat compressed as it occurred over a relatively short period starting in 1789 and ending about 1795. In 1791, the US dollar was introduced and the banking system emerged. "The Bank of the United States" was founded as a central bank with interstate branches during the same year (Sylla, 2003).

The financial markets' development also followed during this period. The origin of the New York Stock Exchange (NYSE) can be traced back to 1792. Thus, efficient securities markets were established and insurance companies emerged. According to Sylla (2003), much of this financial development was the work of a brilliant finance minister and one of the founding fathers of the US, Alexander Hamilton, the first Secretary of the Treasury. During the years since the financial revolution, the US's economy expanded dramatically as they experienced an industrial revolution and transport revolution. Sylla (2003) continues by stating that the modern financial system appeared so quickly at the beginning of the country's history that historians took it for granted instead of appreciating it.

The final country investigated by Sylla (2003) is Japan, which can be seen as one of the fastest growing economies in the world today (UNCTAD, 2004). In Japan, the financial revolution occurred in the early-Meiji era, the 1870s and 1880s. The stability of the government's finances in this era resulted in the introduction of public

debt markets. Bonds primarily comprising Government bonds, were issued to replace Samurai rice stipends. The Tokyo and Osaka stock exchanges were founded in 1878 as modern securities markets. Other than the previous three countries, the banking system as part of Japan's financial system, developed after the foundation of financial market systems. After the Yen was established as a new currency, new banks were founded. "The Bank of Japan" was founded in 1882 and a modern banking system emerged. This was once again followed by insurance companies and other markets (Moshirian, 2002).

Meiji era finance minister, Masayoshi Matsukata, like Hamilton in the US, can be credited for the financial development during this period. Matsukata also studied best-practice finance around the world and then implemented the strategic mechanisms of a modern financial system in Japan. This resulted in rapid economic growth in Japan (Sylla, 2003).

The years following the two world wars of the twentieth century are described by Moshirian (2002) as an era characterised by increases in efficiency, transparency, free flow of information and deregulation in countries. The results of these changes in the economic environment are positive from the point of view of international financial development. The advantages of a well-developed international financial system lie in the fact that financial flows and trade can be conducted more efficiently in and between different economies. National financial systems that are more efficient are also more accountable for economic growth, resulting in increased investment and savings. During the post-war years, another important trend was the breakdown of nationalism and 'closed economy' policies, which were inherited from the 1930s. These previous systems were replaced by a more liberal approach of readiness to open up trade in different countries. During these years, another important occurrence was the establishment of international institutions such as the International Monetary Fund (IMF), the United Nations (UN) and the World Bank.

The main aim of these organisations was to address the increasing number of international issues facing all participating nations. Over the years, these institutions developed to meet the challenges and problems of a continuously changing international economic environment. They also became more interdependent and improved telecommunications and other factors made them some of the most important role players in the process of globalisation (Moshirian, 2002).

More recent trends, such as the formation of the Common Market in Europe, paved the way for the establishment of regionalism in Europe and expanded to other parts of the world. The most recent example is the establishment of the European Union (EU), with a single European currency and institutions such as the European Central Bank, European Parliament and the European Court of Justice. These are a demonstration of the international development of society since the 19th century (Moshirian, 2002).

Furthermore, the Bank for International Settlements and other international financial institutions are assisting the international community (Moshirian, 2002). A sound global financial system and facilitation of the international process of globalisation are, among others, some of the main responsibilities of the Bank for International Settlements (BIS, 2005).

3.4 The basic functions of a financial system

Due to the comprehensive nature of the financial system because of direct and indirect effects in the economy, it is difficult to summarise all the functions of a country's financial system. Nevertheless, financial economists Merton & Bodie, (1995) identified many basic functions of a financial system.

Firstly, the financial system is responsible for the transfer of economic resources among different sectors and industries. Transfer must also occur across geographical boundaries through different time intervals. Secondly, no trade can occur effectively without proper provision for making payments. The financial system must therefore provide ways of pooling capital resources and subdividing public and private debts as well as shares of enterprises into units attractive to investors. In order to facilitate effective trade among different role players, the financial system must have efficient ways of making payments. The third basic function of the financial system is to provide ways of dealing with incentive problems. These incentive problems are usually the result of asymmetric information. Asymmetric information occurs when some participants in the economy have more information than others, and when managers of companies are different from the owners and have different interests. A fourth basic function of the financial system can be derived from its responsibility to provide risk management in the total process of trade.

Providing price information to coordinate decentralised decision making in an economy can be seen as the final basic function of the financial system (Merton and Bodie, 1995).

3.5 Importance of the financial system

In the process of understanding the complexity of the financial system, it is not just important to understand the different types of financial systems as mentioned above, but also to know the importance of such systems.

In this part of the chapter, a closer look is taken at how the development of a country's financial system can contribute towards economic growth and development. If financial systems contribute positively towards economic growth in a country, a well-developed financial system must be encouraged by policy makers in such countries. This part of the chapter considers whether and how a well-developed financial system can enhance and improve FDI flows towards countries. To conclude this part of the chapter, other important factors of a developed financial system are discussed.

3.6 The financial system and growth

To determine the link between the financial system and economic growth, some crucial and critical literature and empirical findings are investigated. The first supportive findings can be found from the work of Allen (1999). Allen investigated the fundamental question of whether the development of the financial system matters in terms of influencing economic growth and found that it does.

Levine continues to support this view of a positive correlation between financial market development and economic growth in his earlier studies (King and Levine 1993) where it is clearly stated that there exists a growing literature on the effect of financial sector development on economic development. This highlights the importance of financial development for macroeconomic growth. Furthermore, Levine & Zervos (1998) discovered a positive relationship between financial development and growth in 40 different countries such as Australia, the US, the UK, South Africa etc. across all industries and enterprises.

Supportive evidence can be found in the work of other economists. According to Andrés et al. (2004), McKinnon and Shaw were among the first to provide insightful theoretical fundamentals to explain that the liberalisation and development of financial markets favour economic growth. Subsequent theoretical work has studied in depth this direction of causality, running from financial development to economic growth.

Ndikumana (2005) conducted a study where he intended to answer two related but different questions with regard to the impact of financial intermediation (as an important role player in the financial system) on real economic activity. His first question was whether financial development affects real economic activity. Ndikumana (2005) explored the first question extensively by looking at empirical studies of researchers such as himself, Rajan, Demirgu and, once again, King and Levine. These empirical studies showed evidence that firmly supports the view that financial development has a positive effect on various aspects of real economic activity. The positive effects could be seen in areas such as investment, employment, productivity, and long-term economic growth. Therefore, the evidence suggests that the expansion of the financial system results in faster and more positive economic growth patterns. Ndikumana (2005) made significant advances in establishing that financial development has positive effects on economic growth and development. The results further support and strengthen the view that financial development leads economic growth.

The second question Ndikumana (2005) intended to answer in his study was whether the structure of the financial system matters for real economic outcomes. He found that case studies, comparing the comparative advantages and disadvantages of bank-based versus market-based financial systems (see section 3.4), dominated discussions about the role of the structure of the financial system for economic activity. Ndikumana (2005) found that it is indeed difficult to make general conclusions on the comparative advantages and disadvantages of bank-based versus market-based financial systems. He concludes his findings on his second question by stating that both bank-based and market-based elements are important for economic growth and development and that they are complementary. This statement is also supported by Levine (2002).

A final supportive view comes from Moosa (1999) who presented empirical results in a study that showed that financial development leads real growth. His conclusion is

straightforward: "It follows from a finding of causality from financial variables to real growth variables."

Taking this literature and evidence into account, this study concludes that a positive relationship exists between financial system development and economic growth in a country.

3.7 The financial system and FDI

With the conclusion made in section 3.3.1, the question about the relationship between financial system development and the level of FDI attracted towards a country, needs to be investigated. Both the amount of FDI attracted towards a country and the level of efficient absorption of such attracted FDI are important.

When focusing on FDI, the role of financial markets as part of the total financial system is very important. Financial markets must be seen as an essential element of the financial system. The lack of development of financial markets can limit a country's ability to take advantage of potential FDI benefits (Alfaro et al., 2004).

Alfaro et al. (2004) provide evidence that proves that the link between FDI and growth is causal where FDI promotes growth via countries' financial markets. An improved domestic financial environment not only attracts foreign companies but also allow host economies to maximise the benefits of foreign investments.

An ineffective financial market is an indication of a country not in a position to deal with unregulated short-term capital flows. Effective and efficient FDI absorption of long-term stable flows may not be realised in the absence of well-functioning financial markets.

When looking from a bank-based point of view, several intermediation-related factors need to be taken into account to ensure effective FDI attraction and absorption. Positive investment effects are found by alleviating financing constraints. These effects are usually found in better functioning financial systems and allow market participants to invest more in response to increased demand for output.

Ndikumana (2005) continues by saying that, at an aggregate level, well-developed financial systems are associated with higher levels of investment. Investment can be domestic but also foreign, making FDI flows higher in countries with well-developed financial systems.

Another important element in the relationship between FDI and the financial system is the existence and efficiency of financial services. An improved and FDI friendly environment is created where financial markets provide essential service to the private sector and alleviate market imperfections (Levine, 1997). According to Ndikumana (2005), financial systems will become more efficient in delivering services as they develop over time. This will lead to economic development and the attracting and utilisation of FDI.

Levine (1997) also adds that financial systems “improve economic performance by assessing investment opportunities and exerting corporate control, easing risk management, and lowering the costs of mobilising resources.”

Ndikumana (2005) investigated whether greater financial development induces higher investment in host countries. From his theoretical investigations and empirical results, he drew the following conclusions: Firstly, he states that financial development facilitates investment because it is accompanied by an increase in the supply of funds to investors. Therefore, as a country’s financial system develops; capital is allocated more efficiently because of its availability and affordability. Investment levels will increase as investors are able to obtain the necessary funds to respond to increases in the demand for output. This evidence is consistent with the view that bank-based and market-based financial systems are complementary (see section 3.5).

From this information, this part of the study concludes that the level of development of the country’s financial system is fundamental for effective FDI attraction and absorption, resulting in growth effects in receiving countries.

3.8 Other important characteristics and contributions of the financial system

Well-developed financial systems contribute towards economic growth and the efficient absorption and attraction of FDI (Moosa, 1999). In this part of the chapter, a closer look is taken at how financial systems are able to promote economic development. A country is also able to receive other advantages due to a well-developed financial system. A well-developed financial system will gradually take care of agency and information problems. The financial system also provides

incentives to optimise the efforts by market participants and the cost of capital. (Scholtens, 2000).

These potential advantages will be discussed in this section. According to Moshirian (2002), “we should think about the great advantages an economy with such a financial system has over one that does not have it. Not everyone has an appreciation of the importance of well-functioning financial systems.”

3.8.1 The promotion of economic development

According to Moshirian (2002), financial capital, as the country's financial resources in an economy, is very scarce. Therefore, he places a strong emphasis on the importance of effective financial resource management. The more effective investment allocation with specific reference to yields received and the greater the mobilisation of resources, the more economies will prosper.

For a country to prosper from its financial system there must be some key elements in the basic mechanism and functioning of that particular economy (Sylla, 2003). The first key element that needs to be in place is stable money facilities. These facilities are the main payment-making vehicles and can be seen as a form of holding wealth. Governments, banks, and companies are the most important institutions in this category. They provide capital, goods and services. They are also known for creating bonds and shares attractive to investors.

The second key element and determinant for economic development via the financial system is the markets. Liquidity, one of the most important characteristics of a well-functioning market is provided by money markets and securities markets. They give liquidity to financial instruments such as notes, bonds, bills and shares. Insurance companies and the above-mentioned markets provide products and services that support effective risk management (Moshirian, 2002). This will be discussed in section 3.3.3.4.

3.8.2 Capital allocation

Section 3.3.3.1 focused on the promotion of economic development. Part of this focus is centred on capital allocation. The importance of capital allocation was pointed out, but the advantages of effective capital allocation were not mentioned specifically. This is explored in this section.

A possible result of effective capital allocation is an increase in a country's savings rate. Therefore, financial development may affect the real sector through the intermediation of savings towards investments (Scholtens, 2000). This will then provide more efficient capital allocation

Among the most prominent constraints in financial system development are agency and information problems (Boot & Thakor, 1997). The financial system develops in order to take care of agency and information problems, but it cannot solve them completely. An agency problem can be defined as a conflict of interest arising between creditors, shareholders and management because of differing goals. For example, an agency problem exists when management and stockholders have conflicting ideas on how the company should be run (Investopedia, 2005). Information problems occur when the correct or relevant information is not available to the different participants or role players. As the financial system develops in order to take care of these two problems, it will provide incentives to optimise the efforts by the manager/entrepreneur, the investment ratio, and the cost of capital (Shleifer & Vishny, 1997).

3.8.3 Project financing

In countries with high levels of natural and human resources, financial resources are often problematic and not so often available. Demirgüç-Kunt & Maksimovic (2002) state that the development of financial markets plays an important role in overcoming this problem. Countries with: (i) lower levels of financial development, (ii) differences in contracting environments that affect the relative development of the stock market and (iii) the effectiveness of the banking system will have implications for firms and projects attempting to obtain financing in that country.

Therefore, countries with better-developed financial systems are able to obtain financial resources for the financing of expansion projects more easily than countries with low levels of financial development.

3.8.4 Risk management

Well-developed financial systems provide products and services that support effective risk management (Moshirian, 2002). Economists identify three broad categories of risk management, namely: (i) hedging, (ii) diversification and (iii)

insurance. According to Moshirian (2002), the financial system uses these three elements to help market participants manage risk effectively.

Modern financial systems provide all three categories of risk management. We need to have an understanding of each form of risk management, the benefits they confer to the economic actors that use them, and the overall economic effects of the provision of risk management services.

Firstly, hedging is one way of eliminating a risk exposure. Gong & He (2005) state that, after several empirical investigations, hedging strategies are indeed effective for risk management. With the volatility of the market, managing risk is a priority and, with derivatives, hedging is one source of risk reduction that has successfully assisted investors in this process. Hedging attempts to reduce or even eliminate (in theory) the risk of holding an asset, which is kept for future sale or for anticipating the future purchase of an option.

Diversification is a second broad way through which financial systems provide risk management services. Wikipedia (2005) defines diversification as “a measure of the commonality of a population. Greater diversification denotes a wider variety of elements within that population. Diversification is of central importance in investments. Diversification reduces the risk of a portfolio. It does not necessarily reduce the returns. This is why diversification is referred to as the only free lunch in finance.”

How does diversification reduce risk? Moshirian (2002) explains that if an investor holds an equity stake in only one firm, the investment return to that equity holding will vary from year to year with whatever factors affect that firm. Modern financial systems, however, provide a host of equity securities in which investors can invest their capital. A diversified portfolio of securities can provide the same return as an individual security, but with much less risk in the form of the variability of that return (Moshirian, 2002).

Insurance is a third form of risk management provided by a modern financial system. Investopedia.com defines insurance as “a contract (policy) under which a corporation (the insurer) provides financial protection against losses to an individual, business or organisation (the insured) in exchange for periodic payments of a sum of money, known as a premium. For example, car insurance in exchange for a premium provides reimbursement for any damages in the event of an accident.”

Insurance companies are able to predict accurately how many unfavourable events will occur annually. Therefore, these companies can offer contracts that insure individuals and companies against the unfavourable consequences of risks. Insurance companies pool together the risks of a large number of companies and individuals, and offer them insurance against such unfavourable consequences. Modern and well-developed financial systems are able to provide such insurance services, which help their clients to manage risks effectively (Moshirian, 2002).

3.8.5 The impact of financial system development on the volatility of business cycles

Da Silva (2002) provides cross-country evidence that more developed financial systems have less volatile economic fluctuations. The reason for this is that developed financial systems are able to evaluate potential borrowers. This reduces the likelihood that projects with a greater probability of failure are externally financed. The question of why external financing is such a bad thing may be asked. The basic explanation for this is that external financing increases the shocks to economic activity by magnifying the fluctuations in spending, borrowing and investment.

Therefore, a well-developed financial structure can be seen as being 'sound', and contributing towards a stable economy. A stable economy has advantages that develop gradually. A stable environment increases profits, which cause expectations to be revised. The potential for new opportunities results in enterprises taking more risky positions. The effects of this occurrence are mainly positive for many enterprises as they become stronger in business. Some of these enterprises may become more exposed than others and financial structures may become weaker due to inadequate increases in their profits. When this occurs, there is some strain on the financial system's banks. The banks may eventually start refusing the refinancing of loans as the potential risks increase. As a result, the economy moves towards the downturn of the business cycle. This problem is better overcome by countries with well-developed financial systems, as they tend to be more efficient in identifying enterprises that wrongly overplay the extent of the explosion. To start with, banks are able to refuse extending credit to the wrong enterprises. Therefore, the more financial institutions use the available information about potential borrowers and market tendencies, the smoother the business cycles will be (Da Silva, 2002).

Da Silva (2002) concludes that a stable economy with low volatility in the business cycles, resulting from a well-developed financial system, is able to attract FDI more efficiently than countries characterised by an unstable economic environment.

3.8.6 *Entrepreneurship*

Schumpeter (1934) states that the driving force of economic development is entrepreneurship. The two most important entrepreneurs in Moshirian's (2002) mind are the individual and the banker. The individual with his or her innovation and creativity is very important for future business and economic development. The banker, on the other hand, is responsible for providing the entrepreneur with financing to implement these visionary ideas.

The individual entrepreneur and the banker are exposed to risks arising from the fact that the financed innovation may have only limited probabilities of success. A well-developed financial system will help to reduce these risks as explained earlier in this chapter. This reduced risk exposure can therefore be seen as an encouragement for individual entrepreneurs who tend to invest more in a low-risk environment.

Entrepreneurs and investors tend to take more risks where financial systems create an environment of reduced risk exposure. The financial facilities such as hedging, diversification, and insurance, which were discussed earlier, are responsible for this improved environment and are characteristic of modern financial systems. The advantages of entrepreneurship can be found in the fact that it encourages growth and development more rapidly than in economies whose financial systems provide fewer opportunities for risk management and entrepreneurship (Moshirian, 2002).

3.9 **Different types of financial systems**

When studying different economies, considerable diversity in financial systems can be found between different countries. In the process of investigating these different types of financial systems, a clear distinction can be made between market-oriented and bank-orientated financial systems. Most countries have a combination of financial markets and banks. Nevertheless, the relative importance of these focuses differs.

3.9.1 Definition and explanation of the different financial systems

Market-oriented financial systems, at one extreme, are found in countries like the US, where financial markets play a significant role and banks are less important. Moosa (1999) refers to this type of financial structure as a market-dominated Anglo-American system. Demirgüç-Kunt & Maksimovic (2002), who also studied different financial systems across the globe, confirm that a country like the US is market based.

In these market-oriented financial systems, financial markets are well developed and the financial industry is characterised by intense competition. Different types of investors make up a significant part of such a financial system, in contrast to bank-oriented systems. Equity finance is also very important in market-oriented systems, where corporate control is determined through stock.

The current global trend is increasingly toward such market-based systems (Allen, 1999). This is seen in the development and reconstruction of different countries' financial systems, such as France, which, as a matter of policy, has deliberately increased the importance of financial markets since the mid1980s. The focus towards a more market-based system can also be seen in the European Union, where there is a movement towards a "single European market." The EU's main goal and expected outcome is that this reform should increase European countries' competitiveness and exposure to financial markets. A final example of the tendency towards a more market-based approach is found when looking at Latin American countries, such as Brazil. Changes implemented in these countries are directed towards a more market-based financial system (Allen, 1999).

At the other extreme, countries like Germany have bank-orientated systems. In these countries, banks usually dominate credit allocation and financial markets are not very significant. Moosa (1999), again refers to this type of financial structure as a bank-dominated German system. Demirgüç-Kunt & Maksimovic (2002) support the different categories of financial systems and state that Japan can also be seen as a bank-based country.

In bank-oriented financial systems, bank finance can be seen as very important. Corporate control is thus enacted through board representation, long-term relations etc. If they exist, differences that occur between market-based and bank-based systems should be observable at the country, industry, or firm levels. The

advantages and disadvantages of these different systems will be discussed thoroughly in section 3.4.3.

These views are congruent with the summary of Scholtens (2000) in section 3.2.1, who identified the three elements of a financial system namely; financial markets, financial institutions and financial regulations. The market-orientated system explains the importance of the financial markets identified by Scholtens (2000) as the crucial element. The other extreme, bank-orientated financial systems explain the role of financial institutions like banks as intermediaries. Scholtens (2000) identified a final crucial element, namely financial regulation that is derived from a country's legal system, which will now be discussed.

3.9.2 The legal system

Among others, financial regulation was investigated by Levine (1999), who determined how the legal and regulatory environment affects financial development. Levine (1999) confirmed the fundamental link between economic growth and financial system development.

According to Moosa (1999), when discussing market-based versus bank-based financial systems, the historical question of whether one system is superior to another is likely to be futile. The reason for this is that differences in the financial systems of different countries are a by-product of differences in the legal system also defined by some countries' financial regulations.

The more pertinent question is exactly how the legal system influences the financial system. This question will be addressed by discussing the legal system's influence on the financial system and the form of the financial system.

3.9.2.1 The legal system's influence on the financial system

According to Demirgüç-Kunt & Maksimovic (2002), historians and economists such as Gerschenkron have been trying to explain a perceived relationship between bank-based and market-based financial systems. The recent differences in the relative performance of the Japanese and the US economies resulted in the assumption by economists that bank-based and market-based financial systems followed different growth patterns. This view is challenged by La Porta et al. (1997) who argue that a country's legal

system is the primary determinant of the effectiveness of its financial system. This is because the regulation of financial flows determines the level of security and efficiency in a financial system.

Economists identified important advantages and contributions arising from an effective legal system. These advantages include the development of the financial system, the protection of market participants' rights, the expansion of markets and the improvement of quality in the financial system. These advantages will be discussed subsequently in this part of the chapter.

Firstly, the legal environment and regulations are important for the development of the financial system. Scholtens (2000) states that the legal environment is a key factor, or even a prerequisite, for the sound development of banks and financial markets. Levine (1998), who focused more specifically on the banking system, supports this view by adding that there is a strong interaction between banking development and this legal environment. More particularly, the legal system plays a leading role in determining the level of growth-promoting financial services.

The second advantage of the legal system can be found in the protection of the rights of market participants. This protection arises primarily from the fact that different contracts are used in the legal framework to protect participants. Levine (1999) found that greater priority given to creditors, greater enforcement of contracts, and better information disclosure has led to more developed intermediaries.

The component of financial development defined by the legal rights of investors is very strongly associated with growth (Levine, 2002). Therefore, these views clearly support La Porta's view that the legal system determines financial development.

Demirgüç-Kunt & Maksimovic (2002) stress the importance of the legal system in determining the enforceable contracts between firms and investors. According to his view, an important difference between countries can be identified by the extent to which their financial systems protect investor rights. Investors are not the only ones needing protection by the legal system. When the legal system is able to protect creditors by enforcing contracts, the functioning of debt and equity markets will become more

effective. Therefore, countries with the ability to protect their investors will enjoy more market participation and attract more creditors (Demirgüç-Kunt & Maksimovic, 2002). Levine (2002) supports these statements by introducing the "law and finance view". The law and finance view argues that finance is a set of contracts. The efficiency of these contracts is determined by the legal rights and enforcement mechanisms. From Levine's (2002) perspective, "a well-functioning legal system facilitates the operation of both markets and intermediaries." Demirgüç-Kunt & Maksimovic (2002) conclude their empirical findings by saying that the absolute quality and efficiency of the financial system depends on the legal system's ability to enforce contracts.

A third important contribution is the influence of the legal system on the size of markets. Scholtens (2000) states that an ineffective legal system will result in "high levels of ownership concentration, low availability of external equity financing, narrow equity markets and small debt markets." Large capital markets can therefore be seen to be the result of a good legal environment.

The final identifiable advantage conveyed by a well-developed legal system is the improvements of quality in the financial system. Demirgüç-Kunt & Maksimovic (2002) argue that that the legal system in different countries can provide the comparative advantage in supporting a quality securities market or a quality banking system. Levine (2002) supports the statements of Demirgüç-Kunt & Maksimovic (2002) by adding that it is the overall level and quality of financial services, as determined by the legal system, that stimulate economic growth via the efficient allocation of resources.

3.9.3 Legal system and the form of the financial system

From the above-mentioned statements, the conclusion may be drawn that the level of development of a country's legal system can determine the quality of financial services supplied. Nevertheless, the comparative advantage in supporting intermediaries and markets determine the optimal mix of banks versus markets (Demirgüç-Kunt & Maksimovic, 2002). La Porta et al. (1997) argue that laws and enforcement mechanisms are a more useful way of distinguishing financial systems.

The distinction between bank-based and market-based financial systems is visible from a historical background perspective. Legal tradition has an important effect on whether a country's financial system is bank oriented or market oriented. Ergungor

(2004) investigated different financial systems to answer the question of why financial systems of common-law countries are market oriented and civil-law countries bank dominated.

One of the traditional views from the literature states that countries with less developed legal systems are characterised by bank-oriented systems. Ergungor (2004) went further and first investigated backgrounds as the foundation of different legal systems. It proved that civil-law financial systems are more bank oriented than common-law systems.

A civil law system is more focused on the relationship between individuals. The common law system, however, is characterised by the courts and given the force of law. It is, in itself, a more complex system of law than the civil law system (Beaudoin, 2000).

Firstly, Beaudoin (2000) investigated civil-law courts. He found that, historically, civil-law courts are less willing to interpret the laws and create new rules, a much different approach to that of common-law courts.

Civil-law courts can be seen as more conservative and as a result of this, less likely to reach a fair decision when contracts are breached in a manner that is not described in the laws of the country. The result of such a legal approach is often a reduction in the participation of individual investors. The reason for this is that the absence of court protection to investors creates problems. Nevertheless, banks will still be willing to lend in such an environment. The risks that banks carry are reduced because banks can influence firms' behaviour by withholding key services, crucial to those firms' operations. These services are usually services that only a bank is able to provide. As a result, this leads to bank-oriented financial systems in civil-law countries (Ergungor, 2004).

Common-law courts, on the other hand, enforce laws and regulations effectively and strictly. In such a legal system, security is ensured to market participants, especially to shareholders, creditors and all other investors. The result is an increase in the stock market and bank development (Ergungor, 2004).

3.9.4 Advantages and disadvantages of different financial systems

There is a positive correlation between financial intermediary development and long run economic growth (Allen, 1999). Moreover, trading systems and securities

exchanges are very diverse across different financial systems. An increasingly important topic is the understanding of the importance, advantages and disadvantages of these different systems.

3.9.4.1 Advantages of bank-based systems

This discussion of the advantages and importance of an efficient financial system comes from the bank-based view, which highlights the positive role of banks in the financial system. This study will investigate the different ways in which banks can enhance investment. Factors such as economies of scale, risk management, reduction of costs, processing information, corporate governance, capital allocation, innovation, entrepreneurship and other diverse advantages will be discussed subsequently.

According to Ndikumana (2005), the first investment-enhancing role of banks lies in the fact that banks increase the amount of funds available by pooling savings for investment. Countries with a well-developed banking system will have higher levels of savings and investments. The reason for this is that banks in these developed systems are able to collect savings more efficiently with available information systems and economies of scale. This results in higher per capita allocation of domestic savings towards these financial intermediaries. Levine (2002) supports this view by highlighting the importance of the mobilisation of capital in order to exploit economies of scale.

A second important advantage that derives from a well-functioning banking system is the availability of, and effective risk management. Managing cross-sectional, intertemporal, and liquidity risk will enhance investment efficiency and economic growth (Levine, 2002). Ndikumana (2005) focuses specifically on the way in which banks enhance investment by reducing liquidity risk. When investing, the commitment of large amounts of capital for a long period is often required. Investors are not always able to live up to this expectation because they need to maintain a comfortable degree of liquidity in their asset portfolios. In the process of savings, borrowing short term and lending long term, banks are able to facilitate a trade-off between portfolio liquidity and returns on investment. An important emphasis must, however, be placed on efficient resource allocation and balance between short-term and long-term investments (Ndikumana, 2005).

The third important role of the banking system is the reduction of costs in the process of investing and funding. This is made possible by significant economies of scale. Another contributing factor is the acquisition and processing of information. This information is mainly about potential investors and investments and contributes positively towards the financial system because it reduces potential losses and risks. According to Scholtens (2000), establishing long-term relationships is considered the comparative advantage of bank finance. Banks acquire information and apply corporate control, which improves decision making by managers, leads to more effective capital allocation and corporate governance (Levine, 2002). Therefore, the more developed banking systems will support higher volumes of investment due to the banks ability to perform the monitoring function potential investors. This will improve the allocation of savings and other funds across projects (Ndikumana, 2005).

Another advantage of the banking system is that it specialises in offering customised financial products that are tailored to the needs of individual firms (Ndikumana, 2005).

In a bank-based financial system, the access to financial markets is often not easy. In such cases, banks are still the primary source of external finance to investors. Banks are better suited for low-volume products, which make them important and convenient for financing the creation of new firms and the operation of small and upcoming firms (Ndikumana, 2005).

From the above-mentioned points of view, it is possible to say that banks play an important role in financial innovation. This innovation can be seen in the development and creation of new financial products. Furthermore, banks do not only support the development of financial innovation but also the development of business innovation in the form of entrepreneurship. This is achieved by providing capital to entrepreneurs for the financing of projects and new businesses. This is an important function as evidence from industrialised countries shows that small firms tend to rely more heavily on bank finance than larger firms (Ndikumana, 2005).

Finally, Rajan & Zingales (1998) argue that bank-based systems are better at promoting growth in countries with poor legal systems. Ndikumana (2005)

adds that proponents of bank-based systems emphasise the ability of banks to overcome market friction, promote long-term investment, and enhance efficiency in the allocation of capital. Levine (2002) concludes by saying that banks, as coordinated coalitions of investors, are better than uncoordinated markets at monitoring firms.

3.9.4.2 Advantages of market-based systems

In this part of the discussion about financial system importance, the advantages of a market-based financial system are discussed. In having a well-developed financial system, countries can benefit in several ways. Rajan & Zingales (1998) argue that market-based systems have a competitive advantage in countries with a well-developed legal system.

Firstly, when large projects are launched there is often great diversity of opinion among investors. The advantage of financial markets is that they allow people with similar views to join together to finance projects. This leads to greater efficiency since finance can be provided by the market even when there is diversity of opinion (Allen, 1999).

Allen (1999) introduces the second advantageous factor of the market-based financial system by stating that market-based systems will probably lead to more innovation than bank-based systems.

Thirdly, for financial markets, the most important transmission channel is their creation of liquidity (Scholtens, 2000). This important function of the financial system is effected by fostering greater incentives to research firms, since it is easier to profit from this information by trading in large, liquid markets (Levine, 2002). Liquid financial markets reduce investment risk and create the opportunity for diversification by investors. Therefore, the facilitating role in risk management played by the financial system can be seen as the fourth important advantage of the market-based financial system.

The fifth advantage of the market-based financial system can be discussed under the heading of the “predictive power” given by stock market variables. These predictions are made possible by indicators of future profitability such as historical profit patterns. This makes it easier for investors when conducting strategic planning for investing in these markets (Ndikumana,

2005). Ndikumana (2005) continues by saying that the process of the supply of this information to market participants can be seen as a result of a well-functioning market system that will contribute positively towards the expansion of investment projects.

Levine (2002) supports this view by saying that: "competitive capital markets play a positive role in aggregating diffuse information signals and effectively transmitting this information to investors, with beneficial implications for firm financing and economic performance." The reason for this is that profitable projects and investments are identifiable with the availability of market information. Therefore, that quality of investment or the allocation of capital to the most profitable investment activities will occur, profits and effectiveness will be improved and inherent inefficiencies will be reduced in these well-functioning market systems (Levine, 2002).

Another advantage of some market-based financial systems can be found in the way in which the market affects investment through its effects on the cost of capital. Borrowers care about both the cost of financing and their private control rents. Henry (2000) found evidence that shows that stock market liberalisation is accompanied by an increase in aggregate stock market valuation together with a decrease in the cost of equity capital and an increase in investment. Therefore, the cost of equity finance becomes lower as the opportunities of risk sharing expand because of expanding stock markets that become more liquid (Ndikumana, 2005). Thakor (1998) states that the cost of capital market financing is lower than the cost of bank financing only for higher quality borrowers.

Finally, financial markets stimulate information acquisition and help improve corporate governance. This can be seen as the seventh advantage of the market-based financial system (Scholtens, 2000). This occurs in efficient market systems where the market affects investment by exerting pressure on corporate management (Ndikumana, 2005). Enhancing corporate governance is identifiable in the easing of takeovers and the simplicity of the process in which managerial compensation is related to firm performance (Levine, 2002). Ndikumana (2005) studied the functioning of the U.S. sugar markets for particular functions relating to the process of collecting information, facilitating takeovers, and the impact of these factors on economic performance. His results clearly indicated that the world's

functioning stock markets expand and contribute towards higher levels of profitability. The reason for this can be related to the process of survival of the fittest in the corporate sector (Ndikumana, 2005).

3.9.4.3 *Disadvantages of bank-based systems*

From the statements and information preceding this part of the chapter, it must be noted that a well-developed financial system clearly holds positive advantages for economies. There are also problems or disadvantages in the different forms of the financial system. In this part of the chapter, a specific focus is given to the disadvantages of the different systems. The following disadvantages of the bank-based financial system will be discussed. Firstly, there are disadvantages when there is any form of conspiracy among market participants, a second disadvantage can be found in the consequences experienced when one part of the system is having problems. Another major criticism of the bank-based system is its inability to enhance investment. This is discussed under the following headings. Firstly, the reduction of the payoff by extracting rent, bias toward prudence, and the problems with close bank-firm relationships. This part of the chapter concludes with a critical view of state-owned banks.

Firstly, according to Levine (2002) a disadvantage of the bank-based system can be found when powerful banks conspire with firm managers against other creditors. This conspiracy will lead to the hampering of efficient corporate governance and is often found in banks with few regulatory restrictions on their activities.

A second disadvantage of the bank-based financial system is the unfavourable consequences experienced in a country when the financial system encounters serious problems. These problems may be the result of one or more components in the financial system that are not functioning effectively (Sylla, 2003). An example of such a scenario can be found in the economy of Japan during the 1990s. In this example, the banking system of Japan became burdened with many non-performing loans. The banking sector was not alone in experiencing losses and problems during this period. The consequences for the rest of the economy were serious and resulted in major losses across the entire financial and economic spectrum.

Ndikumana (2005) identified a number of drawbacks and weaknesses in the bank-based financial systems and these can be seen as a third group of disadvantages in this financial structure. The collective problem he identified was the inability of banks to enhance investment and economic performance. He continues by discussing them under the following headings; the reduction of the payoff by extracting rent, bias toward prudence and the problems with close bank-firm relationships.

The payoff receivable by firms can be reduced by banks, since banks may be tempted to extract rent from the information collected on prospective investment projects. Levine (2002) states that banks will discourage innovation by extracting these informational rents. The reduced innovation due to the extraction of rent will eventually lead to a decrease in potential economic development in the financial system and the country's economy.

The second factor identified by Ndikumana (2005), refers to banks having a "bias toward prudence". This can be best explained by looking once again at the example Japan. Evidence from the Japanese banking sector shows that firms that are closely related to a "main bank" tend to use innovative technologies less and have lower profit rates than those without close relations to a "main bank". According to Ndikumana (2005), this suggests that banks extract rent from their relationships with firms. This is not in the best interest of all participants.

The final problematic factor that, according to Ndikumana (2005) restricts the ability of banks to enhance investments is that close bank-firm relationships may handicap competition in credit markets. This problem is not restricted to hindered competition in the credit markets, but also results in the reduction of banks' ability to enforce efficiency in corporate governance.

Studies by Weinstein and Yafeh have shown that "while close bank-firm relationships may facilitate access to capital, they do not necessarily reduce the cost of capital, nor do they increase investment for firms with close ties to bank groups" (Ndikumana, 2005).

Thakor (1998) states "banks are sufficiently inefficient". In making this statement, he focuses specifically on state-owned banks. These state-owned

banks cause many borrowers to forsake the capital market for banks. Therefore the development of the capital market is often restricted.

3.9.5 *Disadvantages of market-based systems*

This part of the chapter focuses specifically on the disadvantages of the market-based financial system. Firstly, the incentives for individual investors to acquire market information are problematic. A second disadvantageous factor is the tendency towards a narrow-minded investor climate. The third disadvantage, similar to the bank-based system, can be found through the consequences experienced when one part of the system experiences problems. There is also concern about the ability of stock markets to increase the volume and quality of investment.

Firstly, Levine (2002) argues that, "well-developed markets quickly and publicly reveal information, which reduces the incentives for individual investors to acquire information. " The reason for this can be related to stock markets' ability to facilitate the collection of information on investment opportunities. This information is made available to all market participants for decision making and strategic planning, especially in the process of investment planning. Therefore, all market information is accessible (Ndikumana, 2005).

According to Ndikumana (2005), this creates a "free-rider problem", which discourages investors from expending resources on collecting information.

The second disadvantage of the market-based financial system is the tendency of increased narrow-mindedness in the investor climate (Levine, 2002). The primary driving force behind this tendency is that these markets are extremely liquid. Scholtens (2000) confirms this statement by saying that liquidity might encourage myopia with investors. He also adds that this tendency will weaken investors' commitment and reduce their incentives to apply corporate control. In the liquid market-based financial system, investors can sell their shares relatively easily without significant financial implications. This results in a situation where the motivation to exercise corporate control is inherently discouraged (Levine, 2002). Levine (2002) concludes by saying that greater market development may hinder corporate control and economic growth.

A problem similar to one found in the bank-based financial system is also present in the market-based system. The third disadvantage can be found in the unfavourable

consequences experienced in the country due to the financial system encountering problems. These problems might be the results of problems in one or more components in the system (Sylla, 2003). Japan can once again be used as an example. After the 1990s the stock market encountered a large deflation. The spin-off experienced by the rest of the economy and the financial system resulted in major financial losses. A similar situation occurred in the US after 1999 (Sylla, 2003).

The final disadvantage of the market-based financial system arises from all the critiques about the ability of stock markets to increase the volume and quality of investments. One of the most important functions of the market-based financial system is that it facilitates takeovers. The problem with this, however, is that the facilitation process does not necessarily result in higher efficiency. According to Ndikumana (2005) "stock markets do not fully eliminate information asymmetries and insiders may have more information than outsiders." The total process of takeover can therefore not be seen as an efficient and fair process because outsiders might have difficulty in outbidding insiders who have more information. Ndikumana (2005) points out that, according to Singh, who used evidence from the United Kingdom, large firms are able to survive by increasing their relative size through takeovers and not by improving profitability. Therefore, takeovers do not necessarily result in a net increase in the quantity of investment. This is confirmed by evidence from the US where major takeovers in the nineteen eighties left the corporate sector highly leveraged and not generating much investment or increased gains in efficiency.

Ndikumana (2005) concludes by stating: "the mechanism of takeovers leads managers to emphasise short-term outcomes to the disadvantage of long-term investment, with negative consequences on macroeconomic performance."

3.9.6 Access to funding via different financial systems

Borrowers need funds that can be acquired from either the capital market or a bank (Thakor, 1998). "Banks and stock markets can have a comparative advantage in selecting different types of investment projects (Demirgüç-Kunt & Maksimovic, 2002)." The market-based and the bank-based systems affect firms' ability to obtain financing in different ways.

The development of a market-based financial system is more related to long-term financing. Demirgüç-Kunt & Maksimovic (2002) offer a simplified example. They state that if a market-based and a bank-based country each starts firms in the same industry, entrepreneurs in the market-based country will have a greater choice of organisational forms and technology since they have greater access to long-term financing. Therefore the market-based economy will benefit more and be more efficient.

On the other hand, the bank-based financial system is more suited to the availability of short-term financing and therefore banks can be seen as having a comparative advantage in providing such short-term financing. To continue with the example of Demirgüç-Kunt & Maksimovic (2002), firms in the bank-based country grow faster. The reason for this is that they can switch to a superior technology as they accumulate sufficient funds over time to self-finance their capital projects.

Certainly one of the most important decisive factors in the process of decision making about financing is the cost of financing for borrowers and their private control rents. The cost for high quality borrowers when financing capital via the banking sector is lower than that of the market sector. This implies that there must be a level of credit quality "cut-off". Borrowers above this so-called credit cut-off will access the market for capital financing while borrowers below the cut-off will go to banks for financing (Thakor, 1998).

Managers of high-quality borrowers will often show their ineptitude by exposing themselves to market discipline. This is what happens when a market-based route for financing of capital is preferred with the objective of accumulating higher profits. Therefore, these borrowers face a trade-off between the cost of financing and potential profits through control rents when borrowing in the market. When bank inefficiency in monitoring generates additional value to borrowers, the trade-off tends to favour the banking system. When the value added to borrowers favours borrowers at large, borrowers may choose not to go the capital market route.

Thakor (1998) summarised these ideas by saying that the combination of the competition and complementary effects (which will be discussed in the next part of this chapter) produces a non-monotonic relationship between bank efficiency and the credit quality cut-off that determines which borrowers go to banks and which go to the capital market.

To conclude, the developments in the different financial systems are important as the relative development of the market-based and the bank-based system may have implications for which firms and which projects obtain financing (Demirgüç-Kunt & Maksimovic, 2002).

3.9.7 Relationship between bank-based and market-based systems

From a historic point of view, no evidence can be found of countries with either well-developed banking systems or effective market systems that did not experience high levels of investment and economic growth Ndikumana (2005).

In the previous parts of this chapter, there is an indication of competition between market-based and bank-based financial systems when financing of capital projects is needed. Thakor (1998) confirms this by stating that the dominant view in the literature on financing-source choice is that banks and markets compete. Levine (2002) suggests that it may be better to think in terms of banks and markets instead of thinking in terms of banks versus markets. Thakor (1998) continues by stating that, according to his analysis, the importance of the complementary roles of banks and markets needs to be highlighted and valued. An interesting comment on competition between banks and markets emerged from the studies of Thakor (1998). A competitive relationship exists between banks and markets. This complementary relationship must not be forgotten by policy makers when planning strategically for future regulations and projects.

The interaction between these different systems is not static as migration between the bank and market systems occurs constantly. This is the process where borrowers move from one market structure to the other. This usually occurs under the following circumstances. When banks that are very inefficient suddenly start to increase their efficiency, borrowers will migrate to the capital market. It can therefore be assumed that banks complement markets. Beyond the point that the competition effect begins to dominate due to increased efficiency in banking, borrowers will bank financing. This preference of borrowers is mainly driven by bank financing becoming cheaper than market financing.

Finally, banks and financial markets can be seen as complementary due to the "financial innovation spiral". The financial innovation spiral can be described as the process where banks and markets develop new ways to lower participation costs.

This allows everybody to benefit from improved cross-sectional risk sharing (Merton & Bodie, 1995).

3.10 Summary

In this chapter, the different aspects and elements of the financial system were discussed to help understand financial systems and their importance in the process of attracting and absorbing FDI.

A proper definition was needed at the beginning of the chapter and it was found that the financial system comprises several different elements such as: financial markets, financial institutions and financial regulations. An explanation of the basic functions of a financial system followed where the functioning of the different elements became clearer.

The importance of the financial system was also discussed with an investigation into the relationship between the financial system and growth, the basic functions of a financial system, the relationship between the financial system and FDI and other important financial system characteristics.

An important outcome for this chapter was the identification of the different financial systems. Two different types of financial systems were identified, namely bank-based and market-based financial systems. These two types of financial system were discussed by explaining and defining these systems. The influence and importance of the legal system as part of the financial system, the advantages and disadvantages of different financial systems, access to funding via different financial systems and, finally, the relationship between bank-based and market-based systems was explored.

CHAPTER 4

THE CURRENT AFRICAN AND INTERNATIONAL SITUATION

4.1 Introduction

During the previous two chapters, the literature on FDI and the financial system were discussed thoroughly. In this chapter, an overview of the status quo of these topics will be given. It is important to understand the current trend of FDI in Africa and in the rest of the world and to place this into a financial development perspective. The aim of this chapter is to assess the current state of affairs.

The chapter is constructed as follows: Firstly, FDI is investigated to understand the current African situation. Even though Africa is discussed, an international overview is presented to place the discussion into perspective. Secondly, economic growth is discussed. One of the aims of this study is to determine whether FDI has a significant influence on economic growth in receiving countries. In this part of the chapter, international as well as African growth is discussed. This is followed by an investigation and discussion on international and African Banking. As discussed in previous chapters, banking makes up a very important part of the financial system, therefore the current situation must be understood in this study. The fourth topic discussed in this chapter is International and African markets that, like banking, make up the financial system. In this part of the chapter, specific emphasis is placed on stock markets. Finally, to conclude this chapter, the future prospects of Africa are discussed, focusing on FDI flows and economic growth.

4.2 FDI flows

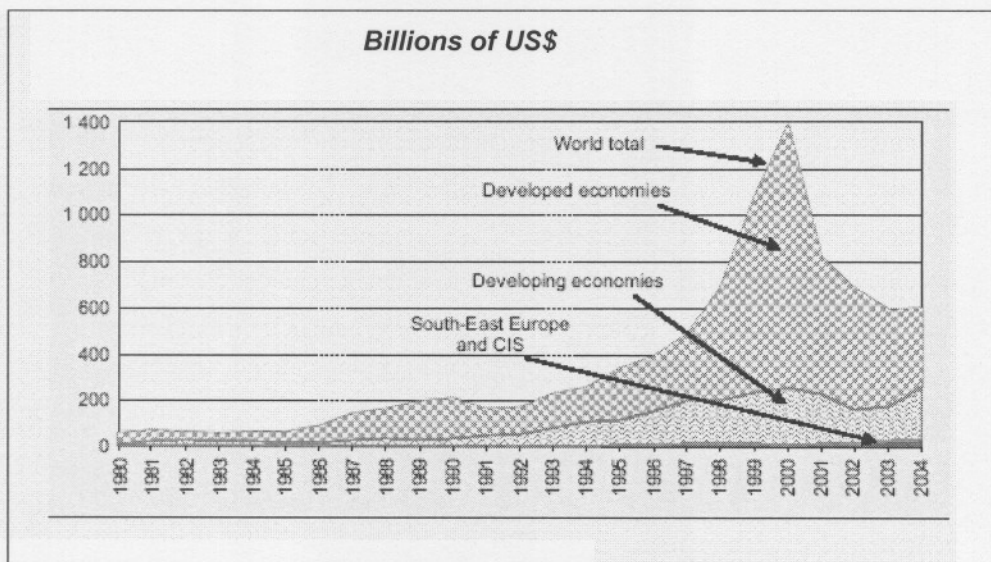
When investigating international as well as regional FDI trends and flows, the most important source of information and research is the World Investment Report, published annually by the United Nations Council on Trade and Development (UNCTAD). In this part of the chapter, the international and African FDI trends and flows are investigated to attain a basic knowledge and background of the status quo of FDI under those headings. This will help to understand FDI in context for the rest of this study.

4.2.1 International FDI

Firstly, international FDI is investigated to get a boarder view of the global FDI situation. When looking at the latest FDI information it must be noted that there are signs of recovery in this capital flow. International FDI inflows rose discreetly in 2004 to \$648 billion, 2% higher than in 2003. This is a significant statistic as FDI experienced large declines in 2001 (41%), 2002 (13%) and 2003 (12%). Global inflows of FDI therefore rose for the first time in four years in 2004 (UNCTAD, 2005).

The largest FDI recipient for 2004 was the US followed by the UK, China, and Luxembourg. In that year, cross-border mergers and acquisitions (M&As) increased following three years of decline. Greenfield investments continued to rise for the third year in a row, strengthening the possibility of a reversal of the global downward movement in flows (UNCTAD, 2005).

Figure 4.1 FDI inflows, global and by groups of economies, 1980 – 2004



(Source: UNCTAD, 2005).

4.2.1.1 FDI towards different economies

Different economies experienced different results in FDI flows. Firstly, the developed countries are investigated as a whole, followed by the LDCs. Finally, the developing economies are investigated. UNCTAD (2005) stated the following about these different countries:

4.2.1.1.1 Developed countries

Even though global FDI increased in 2004, and despite economic upturn in many countries, returning improved corporate earnings, and investor confidence, FDI inflows still fell by 14% (to \$380 billion) in this period in the Developed Economies.

FDI inflows to developed economies are now just 30% of their peak level of \$1.1 trillion in 2000. The low levels of FDI towards this region are not just a result of the declining trends in 2004. Significant falls in 2001-2003 with the latest decline led to this result.

Not all the developed economies experienced declining levels of FDI flows. Examples of increasing FDI flows can be found when looking at the Countries like the US, where FDI flows rose for the first time since 2000, to more than 300% of the 2003 flows. Even though this statistic seems good it must be noted that the US's latest level of FDI flows are only at about one-third of their peak level of 2000. The UK also received large FDI inflows in 2004, which were nearly four times their 2003 level. New Zealand, Japan and Australia also experienced increases in their levels of FDI flows.

Even though these countries experienced increases, the net level of FDI flows in developed economies still experienced a remarkable decline. The decline was mainly marked in the EU, where FDI fell by 36% to reach its lowest level since 1996. This decline was concentrated in a few members. Denmark, Germany, the Netherlands and Sweden accounted for 86% of the total decline that was spread over 10 countries.

Other developed countries in Western Europe (particularly Norway and Switzerland) also experienced a fall (of 66%) in their combined inflows.

4.2.1.1.2 Least developed countries (LDCs)

In contrast to developed economy flows, FDI inflows to the LDCs reached the highest level ever in 2004, at \$11 billion, an increase of 3% in comparison with 2003. UNCTAD (2005) identified 50 LDCs for investigation and monitoring. From the 50, 35 LDCs received higher

inflows. The reason for this increased amount of FDI flows to the LDCs can be attributed to the good performances of countries in this group such as the Democratic Republic of the Congo (470%), Myanmar (91%) and Equatorial Guinea (16%).

Despite the good performers and the overall level of increase in LDCs, FDI flows remain poor.

4.2.1.1.3 Developing countries

Similarly to the LDCs, developing economies also experienced a rise in the levels of FDI inflows. Flows to developing countries rose much more aggressively to reach an increase of 40% in 2004. This significant increase caused FDI inflow to reach a level of \$233 billion in this period. The reason for this recovery and the overall good performance of FDI flows in 2004 can be attributed to the increased and improved functioning of macro, micro and institutional factors in this region. These higher levels of FDI flows caused developing economies now to have a 36% share of the global FDI inflows, the largest share since 1997 (UNCTAD, 2005).

From a country-specific view, FDI flows to developing economies remained concentrated. China, Hong Kong, Brazil, Mexico and Singapore (from the highest to the lowest) remained the main receivers of FDI inflows in 2004 and accounted for more than 60% of total flows to developing economies.

From a regional perspective, all regions experienced significant increases, with the exception of Africa which remained almost exactly the same. Even though Africa attracted constant levels of FDI, it still remains relatively high at \$18 billion (even though it is the lowest in the group). In the Asia-Oceania region, FDI reached \$148 billion, an increase of \$47 billion in 2003. FDI flows to Latin America increased to \$68 billion, a 44% increase after four consecutive years of decline. FDI flows amounted to \$35 billion in 2004 compared with \$24 billion in 2003 in the new regional category of South-East Europe and the CIS (UNCTAD, 2005).

4.2.1.1.3.1 Sectoral FDI Distribution in developing economies

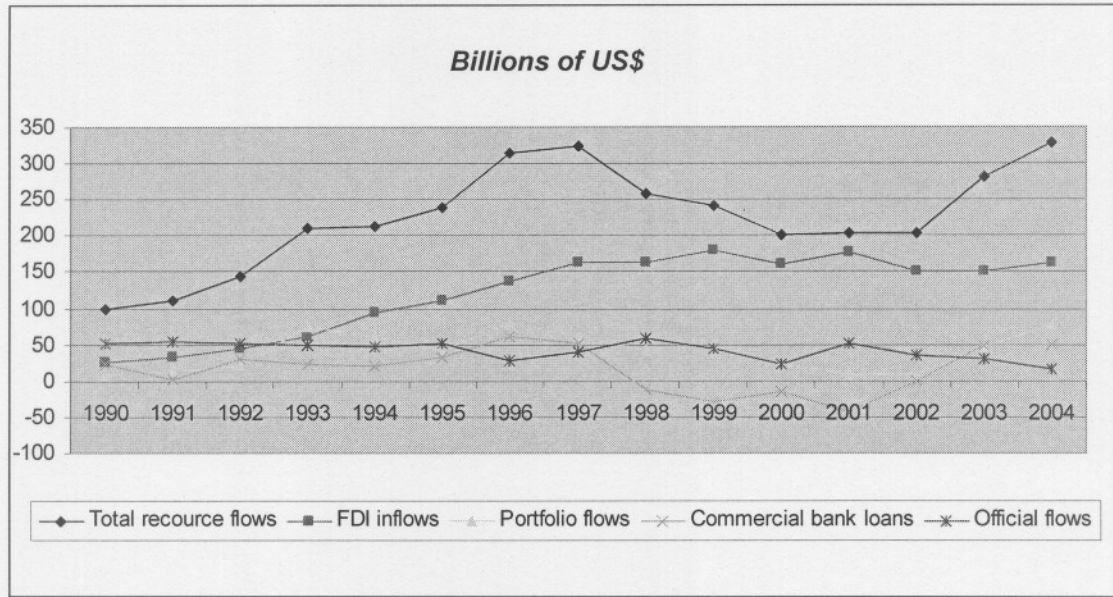
From an international sectoral perspective, there was no notable change in the sectoral distribution of FDI from 2003 to 2004.

A demand for a broad range of commodities was the driving force behind the performances in the primary sector FDI. A good example is oil, which started to grow significantly in some regions in 2004. In Latin America and Africa the mining and oil-related industries performed exceptionally well. The service sector FDI with specific emphasis on financial services, continued to grow constantly. Services accounted for 63% of the total value of cross-border M&As in 2004. This is a significant rise when compared to the 54% in 2003. A phenomenon that is growing increasingly in developing countries is research and development (R&D), which, once again, experienced growth of FDI in 2004. This is visible in the number of foreign Greenfield investment projects in R&D, which rose by 126 in 2004, a 24% increase.

4.2.1.1.3.2 Different capital flows to developing economies

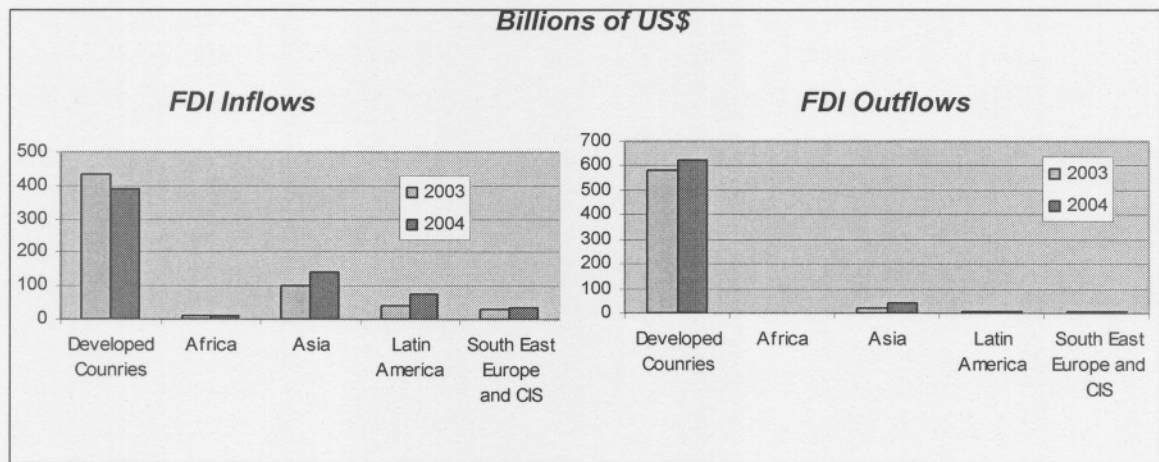
FDI continued to be the largest component of all capital flows to developing countries in 2004. This flow is not just a prominent capital flow but is also increasing. FDI has been notably larger than official flows in recent years as it accounted for 51% of all resource flows to developing economies. This is indicated in figure 4.2

Figure 4.2 Total resource flows to developing countries, by type of flows from 1990 - 2003



(Source: UNCTAD, 2005).

Figure 4.3 FDI flows by region for 2003 & 2004



(Source: UNCTAD 2005).

4.2.2 Africa FDI flows

Africa's FDI inflows remained at about \$18 billion, a 39% increase from 2003 to 2004. However, although FDI inflows were relatively high compared to its previous performance, Africa's share in world FDI remained small at 3% of total global FDI. The worrying factor in Africa is that over the past ten years this share has risen by less than one percentage point. When looking at Africa from a per capita basis, FDI inflows to Africa increased from \$8 in 1995 to \$20 in 2004.

Africa has 53 different countries, which were investigated by UNCTAD. Inflows increased in 40 out of the 53 African countries. In 13 of the 53 countries, FDI showed a decrease including some of the region's top FDI recipients such as Nigeria, Angola and Morocco. The 5 top FDI supplying countries for Africa in 2004 were France, the Netherlands, South Africa, the UK and the US. These five countries together accounted for more than 50% of the flows to Africa.

From a sectoral point of view, most of the inflows were in natural-resource exploitation, fuelled by rising commodity prices. These higher prices for minerals such as diamonds, gold, copper, platinum and particularly for oil improved the profitability of investment in natural resources. The gains in these sectors resulted in the encouragement of investment in the region by TNCs. Furthermore, cross-border M&As in the mining industry rose to more than three times their 2003 value.

4.2.2.1 Regional overview

From an African regional perspective, West and East Africa received increased levels of inflows in 2004 while FDI levels declined in Southern and Central Africa.

UNCTAD (2004, 2005) furthermore reported the following about regional development in the World Investment Reports of 2003 and 2004:

Most of the small host economies in Africa received higher inflows even though FDI flows to South Africa fell. As in previous years, such flows remained below the \$0.1 billion level in 2004, especially in LDCs and the countries poor in natural resources. In countries such as Somalia and Burundi, which have long been affected by political conflict, there were, with a few exceptions, almost no inflows until 2003.

In many of these LDCs, the size of the domestic market is small and some of the market-access initiatives put in place to support investment in export-oriented industries have been constrained by the lack of appropriate human and other resources.

Increasing oil prices contributed to high levels of FDI inflows to the most important oil-producing African countries, especially Sudan and Equatorial Guinea. Although FDI inflows decreased in Nigeria and Angola. However, the levels remained high in those two countries. These four countries,

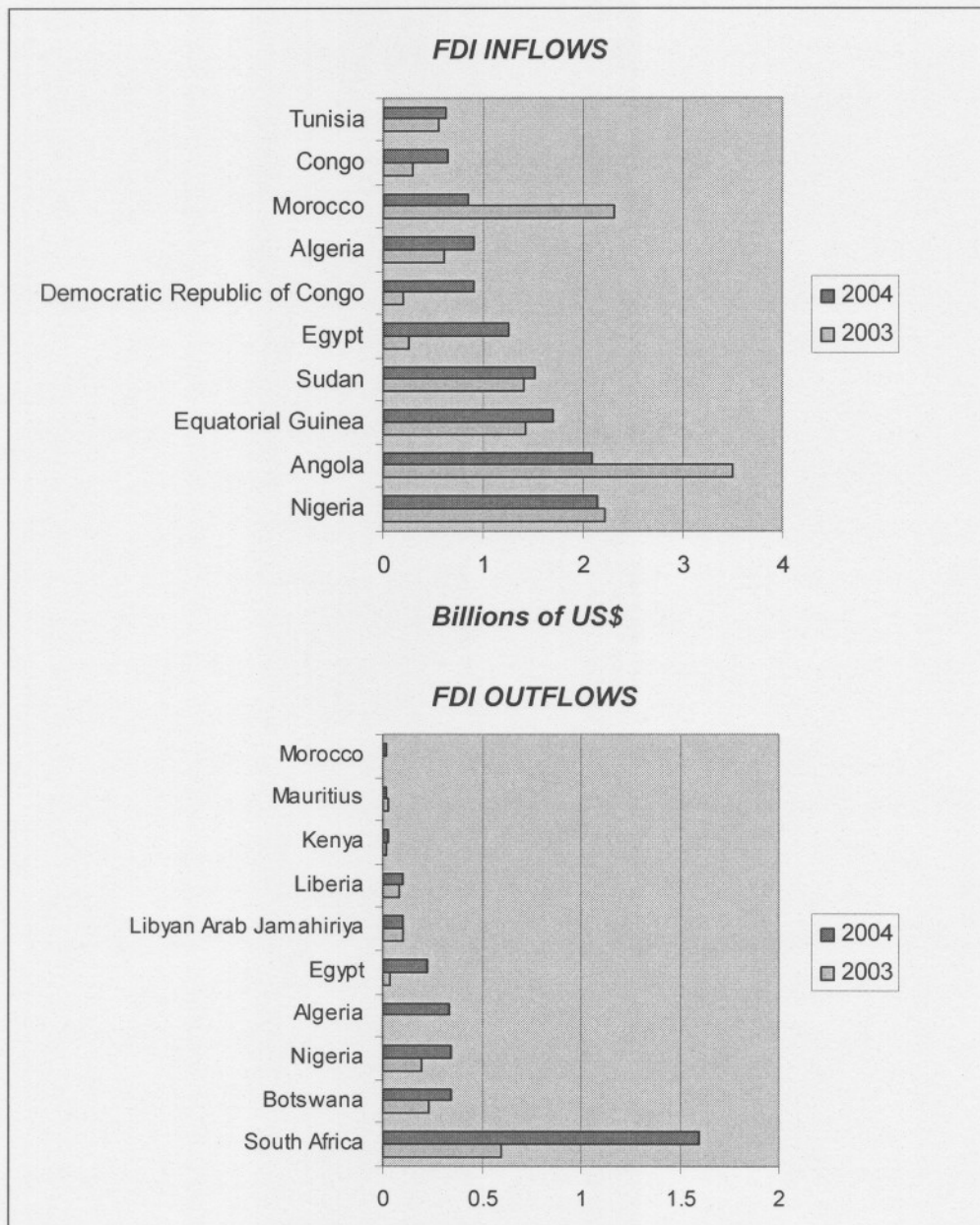
together with Egypt, were the top recipients of FDI to Africa in 2004 (UNCTAD, 2005).

The composition of FDI inflows to Africa in 2004 and 2003 was considerably tilted towards natural resources, particularly in the petroleum industry. The share of this industry exceeded 60% of total inflows in Angola, Egypt, Equatorial Guinea and Nigeria, four of the five largest host countries in Africa. It has also accounted for the largest share of FDI in Algeria, the Libyan Arab Jamahiriya and Sudan in recent years. In South Africa as well, a major transaction in the oil industry in which Tullow Oil Plc of the UK merged with Energy Africa Ltd dominated FDI inflows in 2004 (UNCTAD, 2005).

About 63% of the cross-border M&As in Africa in 2004 were related to mining activities, up from 13% in 2003. Greenfield FDI inflows to natural resources also increased marginally. About a third of all registered Greenfield FDI projects were in manufacturing and nearly half were in the services sector. Notwithstanding growing interest among Asian investors, most of Africa's FDI inflows originate primarily from developed countries (Western Europe, the United States) and South Africa (UNCTAD, 2005).

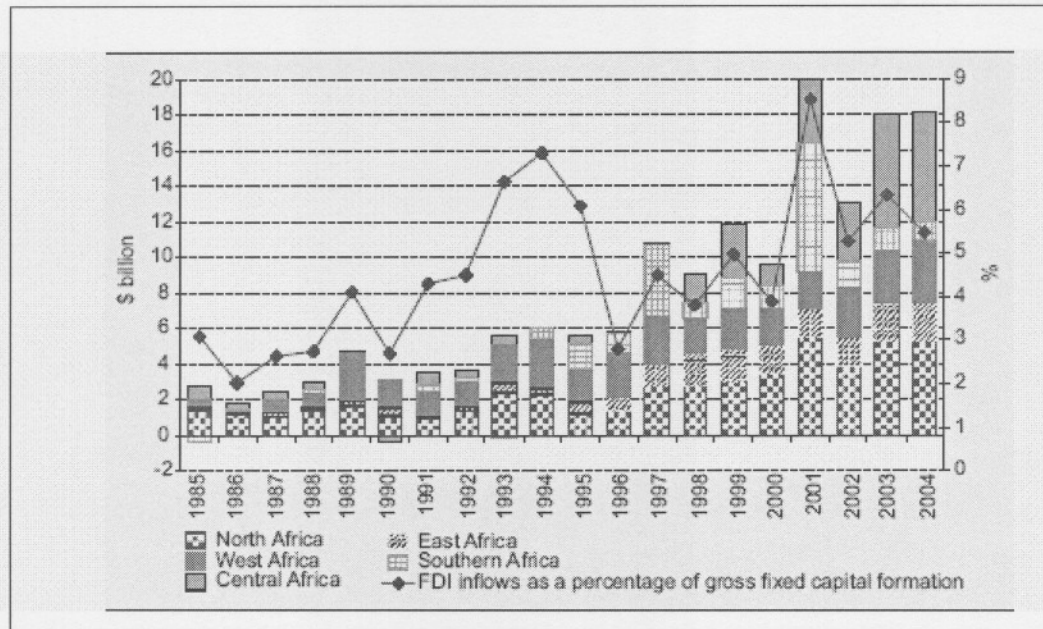
FDI outflows from Africa more than doubled, to \$2.8 billion in 2004. Most of these outflows, about 57%, were the result of cross-border acquisitions by TNCs from South Africa, following an increasingly liberalised outward investment policy in the country. Figure 4.4 illustrates the top ten African economies based on FDI flows. This gives an indication of which African countries are strong FDI role-players on the continent. Furthermore, figure 4.5 illustrates the FDI inflows and their share in gross fixed capital formation. This gives a good overview of the regional distribution of FDI over the last 20 years (UNCTAD, 2005).

Figure 4.4 Africa: FDI flows, Top 10 economies for 2003 & 2004



(Source: UNCTAD, 2005).

Figure 4.5 Africa: FDI inflows and their share in gross fixed capital formation for 1985 to 2004



(Source: UNCTAD, 2005).

Among the different sub regions, North Africa attracted the highest inflows in 2004, with all the countries in the sub region, except the Libyan Arab Jamahiriya, on the list of the top 10 host countries for FDI in Africa.

The sub region attracted 29% of Africa's total inflows, particularly in oil and gas. Sudan topped the list, mainly because of FDI in petroleum from China, India and Malaysia. Investment links have also been established with several members of the CIS (e.g. the Russian Federation) and with some Gulf countries. Oil and natural gas exploitation also contributed to inflows to Algeria and Egypt. Inflows to Morocco declined by more than half to \$0.9 billion in 2004 because of a slowdown in the privatisation of the country's public enterprises. In Tunisia, inflows were stable.

In conclusion, it can be said that, from the above stated figures, Africa receives a very small part of international FDI flows. The flows are currently almost unchanged from last year but good prospects are ahead (see section 4.5)

4.3 Economic growth

4.3.1 International Economic growth

To determine the level of economic activity in a specific region, the total gross domestic product (GDP) is normally a good indicator. The statistics and information used in this study are built on the basis that GDP consists of the total gross value added, at buyer prices, converted at market exchange rates to current US\$, by all resident producers in the economy together with any product taxes (less subsidies) not included in the valuation of output. It is calculated without deducting for depreciation of fabricated capital assets or for reduction and degradation of natural resources. GDP is equal to gross national income less net receipts of primary income. Value added is the net output of an industry after adding up all outputs and subtracting intermediate inputs (World Bank, 2005c).

When determining annual GDP output of a country or region, the economic growth derived from the difference in economic activity in that region can be determined. When determining the GDP of the world it is found that the world economy grew by 3.8% in 2004. This was the best international performance since 2000. Furthermore, global growth continued into 2005 even though it was at a less rapid pace (World Bank, 2005c).

4.3.1.1 Economic activity in developed countries

When investigating the global economic leaders and their economic activities today, the following brief summary can be made.

The US experienced growth of 3.8% in 2004. The main driving force behind growth in the US was domestic demand with private domestic investment growing at a two-digit rate and personal consumption maintaining a significant rate of growth, especially in durable goods. US exports furthermore grew at a considerable pace in both volume and value. This can result in a real depreciation of the dollar. Imports, however, increased even faster resulting in more negative trade contributions towards GDP (World Bank, 2005a).

Table 4.1 World output growth, 1990-2005

<i>(Percentage change over previous year)</i>						
<i>Country/Region</i>	<i>'90-'00</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>
World	2.7	1.3	1.8	2.5	3.8	3.0
Developed Countries	2.4	1.0	1.3	1.7	3.0	2.3
<i>Japan</i>	1.4	0.4	-0.3	1.4	2.6	1.8
<i>US</i>	3.4	0.3	2.4	3.0	4.4	3.5
<i>EU</i>	2.1	1.7	1.1	0.9	2.1	1.5
<i>France</i>	1.7	2.1	1.2	0.5	2.1	1.5
<i>Germany</i>	1.6	0.9	0.2	-0.1	1.0	0.8
<i>Italy</i>	1.6	1.8	0.4	0.3	1.0	-0.4
<i>UK</i>	2.7	2.1	1.7	2.2	3.1	2.0
Developing Countries	4.8	2.4	3.5	4.7	6.4	5.4

(Source: World Bank, 2005a).

In other developed countries, rising interest rates as well as a decline in housing prices affected countries such as Canada, the UK and Australia where private consumption has been partly sustained by booming house prices and increasing household indebtedness. Australia and Canada benefited from major gains in terms of trade, in large part due to their primary commodity exports. However, real appreciation hindered export volumes and boosted imports, resulting in a negative contribution of net exports to GDP growth in these countries.

Japan's growth rate of 2.6% in 2004 was driven primarily by private and public consumption and non-residential investment. Growth was strong in the first quarter but declined in the second half of 2004 as domestic and foreign demand weakened.

In Europe, economic growth has slowed down towards the end of 2004. Economists expect a further decrease in GDP output in the EU as they expect the GDP growth to fall from 2.1% to 1.5% or even lower in 2005. Decreased exports due to the appreciation of the Euro contributed to the lower levels of economic growth (World Bank, 2005a).

4.3.1.2 Economic activity in developing countries

In 2004, all developing regions posted significantly higher growth rates than in previous years (see table 4.2).

The Latin American economy expanded on average by 5.7% in 2004 which is a remarkable improvement following five years of stagnation and crisis. The main driving forces in this region were export expansion and the terms-of-trade improvement in most countries in Latin America.

West Asia also performed strongly in 2004 as they reached a growth level of 6.2% in comparison to 5.3% in 2003. These performances can be directly related to the massive injection of additional revenues flowing into oil exporting countries.

Furthermore, East and South Asia recorded its strongest expansion since the financial crisis in 1997. China was the primary contributor with an output growth of 9.5%. Growth was also strong in most other countries in the region. The driving engines in this region were a combination of robust domestic demand supported by strong foreign demand. Africa continued to grow at the same rate as in 2003, the highest level reached in about a decade with a GDP growth of 4.6%. The African situation will be discussed further in 4.2.2 (World Bank, 2005a).

Table 4.2 GDP growth in selected developing economies, 1999-2005

<i>(Percentage of change over previous year)</i>						
<i>Country/Region</i>	<i>'90-'00</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>
Developing economies	4.8	2.4	3.5	4.7	6.5	5.4
Latin America	3.3	0.4	-0.6	2.0	5.7	4.2
<i>Argentina</i>	4.1	-4.4	-10.9	8.7	9.0	7.5
<i>Bolivia</i>	4.0	1.5	2.8	2.9	3.6	3.5
<i>Brazil</i>	2.9	1.5	1.5	0.6	4.9	3.0
<i>Chile</i>	6.6	3.1	2.1	3.3	6.1	6.0
<i>Colombia</i>	2.9	1.4	2.5	2.0	4.0	3.5
<i>Ecuador</i>	2.2	5.1	3.8	3.1	6.9	3.0
<i>Mexico</i>	3.1	-0.2	0.9	1.3	4.4	3.3
<i>Paraguay</i>	2.2	2.7	-2.3	2.6	4.0	3.0
<i>Peru</i>	4.6	0.3	4.9	4.0	4.8	5.5
<i>Uruguay</i>	3.4	-3.4	-11.2	2.5	12.3	5.5
<i>Venezuela</i>	1.6	2.8	-8.9	-7.5	17.9	8.0
Africa	2.6	3.4	2.9	4.7	4.6	4.9
<i>Algeria</i>	1.9	2.1	4.1	6.7	5.8	7.5
<i>Cameroon</i>	1.8	4.6	4.0	4.0	4.8	4.5
<i>Cape Verde</i>	6.0	3.0	4.6	5.0	4.0	6.0
<i>Cote d'Ivoire</i>	3.3	0.1	-1.2	1.8	-1.0	-1.0
<i>Democratic Republic of Congo</i>	-4.9	-1.1	3.1	5.0	6.8	7.0
<i>Egypt</i>	4.2	3.2	3.1	2.8	3.2	5.0
<i>Ethiopia</i>	3.8	7.9	1.2	-3.8	11.6	6.0
<i>Ghana</i>	4.3	3.2	4.5	4.7	5.8	5.0
<i>Kenya</i>	2.1	1.1	1.0	1.8	2.6	3.0
<i>Morocco</i>	2.3	6.3	3.2	5.2	3.7	4.0
<i>Nigeria</i>	2.9	2.6	1.5	10.7	5.1	5.4
<i>South Africa</i>	2.1	2.7	3.6	2.8	3.7	4.0
<i>Tunisia</i>	4.7	4.9	1.7	5.6	5.7	5.0
<i>Zimbabwe</i>	2.5	-8.4	-5.6	-13.2	-8.2	-3.0

<i>Country/Region</i>	'90-'00	2001	2002	2003	2004	2005
Asia	6.0	3.2	5.5	5.9	6.9	6.0
West Asia	3.2	-0.1	4.3	5.3	6.2	5.2
<i>Iran</i>	3.5	3.2	8.0	6.7	5.4	5.5
<i>Jordan</i>	4.6	3.5	4.9	3.0	6.2	5.0
<i>Lebanon</i>	6.3	1.4	2.0	3.0	4.0	2.0
<i>Saudi Arabia</i>	1.7	1.2	0.1	7.2	5.3	5.5
<i>Turkey</i>	3.8	-7.5	7.8	5.8	8.9	5.0
<i>United Arab Emirates</i>	2.6	5.0	1.6	6.3	5.9	6.0
<i>Yemen</i>	5.5	3.9	3.3	4.2	2.0	3.0
East & South Asia	6.6	3.9	5.7	6.0	7.1	6.1
<i>China</i>	10.4	7.5	8.0	9.1	9.5	9.0
<i>Hong Kong</i>	4.0	0.5	2.3	1.5	8.1	5.0
<i>India</i>	6.0	5.5	4.3	7.6	6.7	6.5
<i>Indonesia</i>	4.2	3.4	4.3	5.0	5.1	6.0
<i>Malaysia</i>	7.0	0.5	4.1	5.3	7.1	5.5
<i>Pakistan</i>	3.5	2.9	5.8	5.3	6.3	7.5
<i>Philippines</i>	3.3	3.0	4.4	4.7	6.1	4.0
<i>Republic of Korea</i>	5.8	3.1	6.4	3.1	4.6	3.5
<i>Singapore</i>	7.7	-2.4	3.2	1.4	8.4	2.5
<i>Taiwan</i>	6.3	-2.2	3.9	3.3	5.7	3.5
<i>Thailand</i>	4.2	1.8	5.4	6.7	6.1	4.0

(Source: World Bank, 2005a).

When comparing the above information about GDP growth internationally, it can easily be misleading as Africa compares well with other regions. The dilemma is illustrated by looking at the volumes of GDP and comparing them to the rest. Another worrying factor is the GDP per capita in Africa when comparing it with the rest of the world.

Table 4.3 Comparative GDP and population statistics

<i>Economy</i>	(1) GDP 2004	(2) POPULATION 2004	(3) GDP PER CAPITA
World	40 887 837	6 345 127	6.44
European Union	9 370 924	307 446	30.48
Africa	1 144 246	1 013 016	1.13

(Source: World Bank, 2005a).

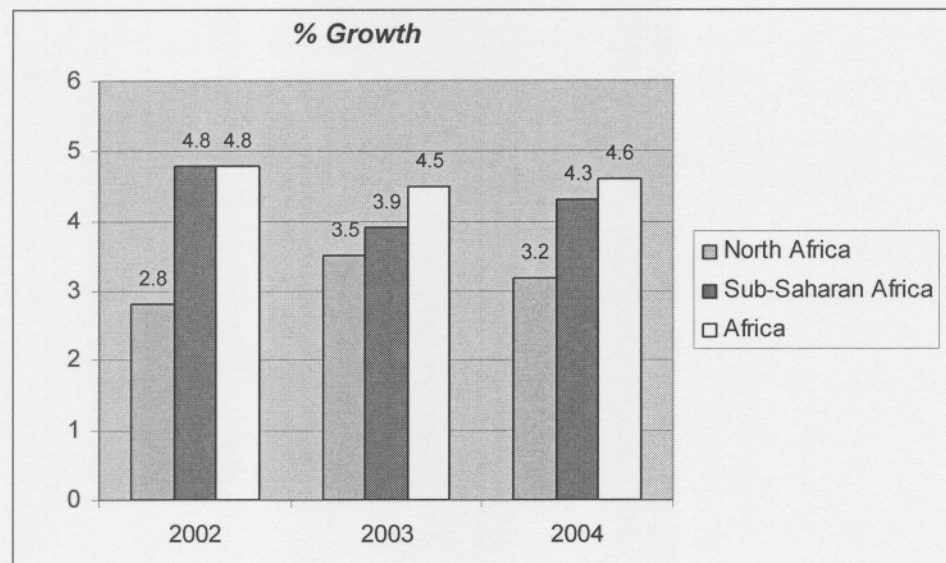
From the above information, the African problem is illustrated clearly. If column 1 gives the GDP for 2004 and column 2 gives the population, then column 3 = (1) / (2). This is a comparable indication of the per capita GDP in the different regions. Even though the European Union had a smaller GDP growth, the GDP per capita is still 2697% higher than the GDP per capita in Africa. Even when comparing Africa with the rest of the world, Africa is still \$5.31 per capita less than the rest of the world. Therefore, GDP growth must not be mistaken for the level of economic development in the country.

4.3.2 *Economic growth in Africa*

4.3.2.1 African overview

With a GDP growth of 4.6%, Africa continued to grow at the same rate as in 2003, the highest level reached in about a decade (UN, 2005). The present report is based on the UN's "Economic Report on Africa 2005", which indicates that Africa's GDP grew by 4.6% in 2004, the highest rate in almost a decade, up from 4.3% in 2003

Figure 4.6 Real growth in GDP in Africa, 2002-2004



(Source: UN, 2005).

4.3.2.1.1 Driving forces behind Africa's 2004 economic growth

The above-mentioned expansionary economic conditions in Africa in 2004 can be derived from two main contributing factors, namely internal and external sources of growth. Internal factors that explain the growth recorded in Africa in 2004 include macroeconomic stability, current account improvements, and as increases in tourism. The second contributing factor is external factors such as the strong global economic growth, rising commodity prices, increased Official Development Assistance (ODA) as well as higher levels of FDI. The following internal and external factors will be discussed subsequently (UN, 2005).

4.3.2.1.2 Internal sources of growth for 2004

The first internal driving factor is the increased macro-stability that was experienced in Africa in 2004. Macro-stability was firstly improved by easing fiscal deficits as Africa's fiscal deficits declined between 2003 and 2004. The success of African economies as a whole in improving their fiscal stance in 2004 was attributable to revenues generated from gains in oil prices and sensible fiscal policies. Macro-stability was furthermore improved with the declining

of inflation. Inflation in Africa declined on average from 10.3% to 8.4% between 2003 and 2004.

The second internal source of growth in 2004 was Africa's improved current accounts. Twenty-six out of fifty-one (51%) African countries experienced improvements in their current accounts. This moved Africa from a deficit of 0.1% of GDP to a surplus of 0.4% overall.

The final internal source of growth is the expansion of the tourism sector on the continent. This inflow is rapidly becoming an important source of foreign exchange income in Africa (UN, 2005).

4.3.2.1.3 External sources of growth for 2004

The external factors explaining African economic growth in 2004 are firstly the strong global economic growth due to general increased global demand.

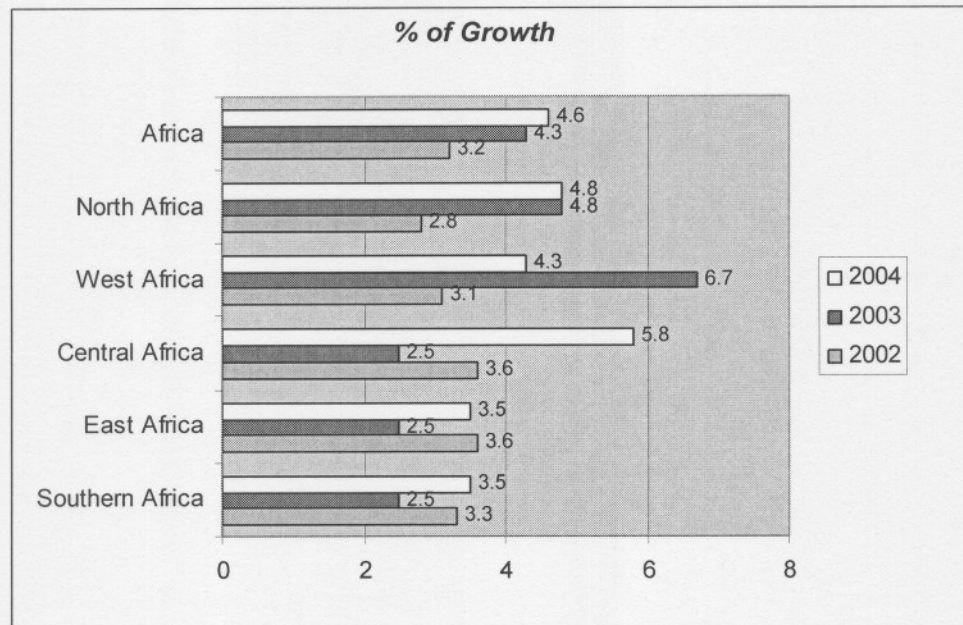
The second external contributing factor is the increase in commodity prices. The commodity price index, denominated in US dollars, increased by 26.3% in 2004. These increases were experienced in both oil and non-oil commodity prices.

The third important expansionary factor is the rises in Official Development Assistance (ODA). The recovery in ODA flows was largely driven by debt relief. ODA to Africa recovered from a low of \$15.7 billion in 2000 to a new high of \$26.3 billion in 2003. The final external source of growth that contributed towards Africa's improved economic stance is the higher levels of FDI as discussed earlier in this chapter (UN, 2005).

4.3.2.2 Sub regional performance

When investigating Africa's growth from a regional perspective, the following illustrations and information are relevant.

Figure 4.7 Sub regional real growth in GDP in Africa from 2002 - 2004



(Source: UN, 2005)

Central Africa experienced the highest level of growth during 2004, followed by East Africa, North Africa, West Africa and Southern Africa as illustrated in Figure 4.7 above. The only region that experienced a reduction between 2003 and 2004 is West Africa.

A possible explanation for the poor economic performance in West Africa is the decline in real growth in GDP in Nigeria where GDP fell almost 50% from 2003 to 2004 due to a declining and unstable economic and political environment. A second contributing factor in West Africa was the constant political crisis in Côte d'Ivoire, which resulted into yet another year of sluggish growth of only 0.9% GDP growth in 2004. Finally, a locust invasion badly affected the agricultural sectors of Niger, Senegal and Mali, which resulted in low levels of growth of GDP output.

East and West Africa benefited from increased agricultural production coupled with rising commodity prices. Rising oil prices ensured growth in Central and North Africa. North Africa is also singled out as the African sub region that shows the most remarkable progress with respect to achieving the Millennium Development Goals.

In Southern Africa, real growth in GDP also increased in 2004. This is mainly a result of steady growth in South Africa, which benefited from strong

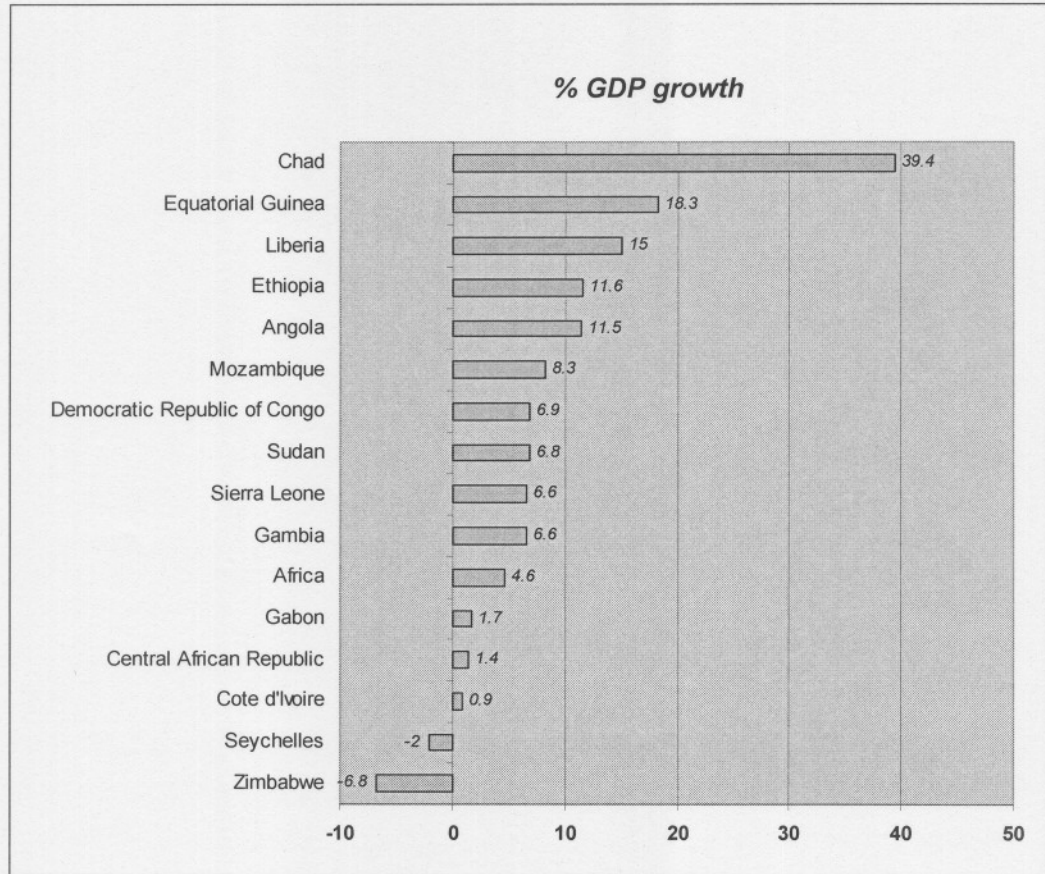
international and domestic demand created by its relatively low interest rates. Despite higher growth in South Africa, the Southern African region recorded the worst economic performance of all the African sub regions. This can largely attributed to the constant economic contraction experienced by Zimbabwe because of drought and economic and political uncertainties.

Despite reflecting a real growth in GDP since 1998, Sub-Saharan Africa is making slow progress towards meeting the Millennium Development Goals, particularly on reducing infant mortality, halving poverty and increasing the primary education completion rate.

In 2002 and 2003, Africa's growth was driven mainly by North Africa. However, the latest escalation in economic growth on the African continent between 2003 and 2004 was attributable to an improvement in the performance of sub-Saharan Africa (see figure 4.7). Economic activity in Sub-Saharan Africa that grew by 4.5% in 2004 is the best economic performance for the region since 1996 and the eleventh straight year of growth. Furthermore, the real GDP per capita increased by 2.7% in the region. Strong oil and other commodity prices contributed to this robust performance and were further boosted by high agricultural and metal prices (UN, 2005).

4.3.2.3 Africa's best and worst performing countries

Figure 4.8 Top ten and bottom five performers in Africa, 2004



(Source: UN, 2005).

Figure 4.8 illustrates the top ten and bottom five performers in 2004. It is clear that Chad's 39,4% growth is the leading performer with exceptional growth results in 2004. The worsening political situation in Zimbabwe was the main reason for this country's poor economic performance. The 6,8% negative growth made Zimbabwe Africa's worst performer in 2004.

4.3.3 Conclusion on growth

Summarising the current economic growth trend globally, it can be stated from the above mentioned information that global economic activities increased in the previous year.

Globally, economic growth was recorded as 3,8%, an increase of 1,3% higher than in 2003 when growth was only 2,5% (Figure 4.1). When analysing the different types of economies, the developed countries experienced growth of 3%, also 1,7% higher

than in 2003 when growth was only 1.7%. The best growth performance was experienced by the developing countries, which recorded a 6.4% growth in comparison with the 4.7% recorded in 2003, a 1.7% increase. Africa, as part of the developing countries had the same growth rate as the total developing countries in 2003 when growth for both was 4.7%. However, Africa did not keep up with the increased levels of growth experienced in 2004, as Africa's growth rate was 1% at 4.6% lower in 2004 than in 2003.

4.4 Banking

4.4.1 International Banking

When investigating the status quo of international banking, one of the most reliable organisations is the Bank for International Settlements (BIS, 2005), which was established in 1930 as an international organisation governed by international law with the privileges and immunities necessary for the performance of its functions.

The Bank for International Settlements (BIS) serves as a forum to facilitate cooperation among central banks. The BIS currently has 55 member central banks. The role of the BIS has undergone continual transformation as the requirements for international monetary cooperation have changed over the years. Today, the BIS have two primary functions. Firstly, the BIS assists central banks and other financial authorities in their efforts to promote better monetary and financial stability. Secondly, it acts as a bank, almost exclusively for central banks, providing services related to their financial operations (BIS, 2005).

The BIS recorded the following information about what is currently happening in the international world of banking. Firstly, new lending to all sectors, especially to banks, resulted in an expansion in BIS reporting banks' cross-border claims in the fourth quarter of 2004. Much of the swelling in interbank activity reflected intra-euro area lending and the channelling of US dollars to banks in major financial centres.

Claims on non-bank borrowers increased as well due to new loans to borrowers in offshore and other major financial centres, but primarily reflecting larger credit to non-banks in Japan and the US. In the emerging market economies, net inflows of funds were experienced. However, there are several differences across different emerging market regions (BIS, 2005).

Repatriation of deposits by banks in China and Korea contributed to a net inflow to Asia-Pacific while large deposits at BIS reporting banks were behind a net outflow

from Latin America. In emerging Europe, an all sector increase in claims by euro area banks compensated for the outflow of deposits abroad by Russian banks. Over the longer term, BIS reporting banks have channelled funds into investment in debt securities. This shift has coincided with growth in the euro area bond market and an expanding external deficit in the US (BIS, 2005).

According to BIS statistics, the degree of foreign bank participation in national lending markets has been increasing in the last few years. While foreign banks continue to play a smaller role in domestic lending in the euro area than in the United States, cross-border claims account for a growing share of total credit to non-banks in most industrialised countries (BIS, 2005).

4.4.2 Banking in Africa

This part of the chapter attempts to summarise the current trends in Africa's banking sector. By examining this, a better understanding of this sector is attained.

According to Anon (2005), BMI-TechKnowledge (BMI-T) market research analysts reported that banking in Africa is approaching an exciting and dynamic phase. BMI-T's latest publication, entitled "The African Banking Overview" provides valuable information on the status quo of Africa's banking sector. This latest research report highlights a few important aspects.

An important recent phenomenon was the several new advances by South African banks expanding towards rest of the continent. Examples of this trend are ABSA taking over banks in Angola and Mozambique as well as numerous Standard Bank banking operations in Africa. This expansionary trend was not restricted to South African Banks as foreign based banks have also been developing operations in Africa. Banks from the US, the UK, as well as Germany have all been searching for opportunities as CitiBank, Barclays and Deutsche Bank all expanded their regional presence on the continent.

However, the percentage of control to remain in the country and the implications for monetary policy and exchange controls remain important issues that must be considered by these foreign and African banks who wish to find international partners. Furthermore, issues such as technology choices and the use of legacy systems or adoption of prevailing systems and applications must also be considered. The regulatory environment relating to risk management and initiatives such as Sarbanes-Oxley, Basel II, and King II (in South Africa) are also crucial decisive factors (Anon, 2005).

BMI-T notes that it is important that Africa is not viewed as a homogenous market, but that investors consider the diversity in geographies, economic development, and infrastructural sophistication as well as cultural and language differences. These varying factors not only occur among countries but also even within countries where different regions can differ greatly (Anon, 2005).

Another factor contributing to the expansion of banking initiatives on the continent is the large percentage of the population which is un-banked or under-banked. This opens the way for micro-financiers and the potential for mobile banking as mobile telephony in Africa increases rapidly. The potential is manifested in the fact that mobile and wireless Internet access technologies enable rural populations to access new banking services and become bank clients (Anon, 2005).

There are a number of inhibiting factors in banking operations on the continent. Africa's poor communications infrastructure is a limiting factor for Internet banking. Another limiting factor is general access as ATM and branch banking services are expensive and are difficult to access. Furthermore, issues such as corruption, restrictions on the establishment of foreign banks, poor corporate governance, lack of a savings culture, coupled with inability to save and a mistrust of banks and banking instruments (Anon, 2005).

Anon (2005) concludes that, according to BMI-T, potential rewards may outweigh the inherent challenges as Africa provides unique challenges for bankers to overcome in order to operate successfully.

This potential reward is confirmed as Anon (2004a) predicts rising fortunes for Africa's banks. The Banker's Top 100 ranking of African banks shows an upward trend in Tier 1 capital, assets and profits for the region.

Tier 1 capital is a measure of a bank's financial strength used by the BIS. It comprises shareholders' equity plus irredeemable and non-cumulative preference shares and excludes hybrid forms of capital such as goodwill. The BIS sets a minimum Tier 1 capital requirement of 4% of risk weighted assets.

According to Anon (2004a), the top positions in 2004's listing of the Top 100 sub-Saharan African banks were occupied by the 'big five' South African banks, Standard Bank Group Limited, FirstRand Bank Holdings Limited, Investec Group Limited, ABSA Group Limited and Nedcor Limited . They are joined in the listing by African Bank at six, Capitec Bank (27), Teba Bank (35), Sasfin Bank (50), RENNIES

Bank (59) and Mercantile Lisbon (78). Together the South African banks account for the following:

- 73.9% of the total Tier 1 capital of the Top 100,
- 83.2% of the total assets and
- 69.3% of the total pre-tax profit.

The increase in the number of South African banks represented in the Top 100 has come about largely through an unbundling of banking activities from both financial and non-financial industrial groupings.

The overall total Tier 1 capital of the Top 100 rose by 34.3% to \$17.6 billion, combined total assets rose by 41.9% to \$303.9 billion, and combined pre-tax profit grew 42.4% to \$5.3 billion. Of the banks in the Top 100, 27 are owned by banks from outside of the region. The current negotiations between Barclays Bank and ABSA in which the former is seeking to acquire the South African bank may, if successful, result in a future realignment of the reporting line for Barclays' other African holdings (Anon, 2004a).

However, except for South African banks, Nigeria, once again, provides the largest block of banks in the listing with 26. First Bank of Nigeria is rated the highest in seventh place followed by Union Bank of Nigeria in eighth place. Zenith International Bank follows in fourteenth place. Nevertheless, the banking sector in Nigeria remains weak and fragmented with significant scope for consolidation. This is because Nigeria only accounts for the following:

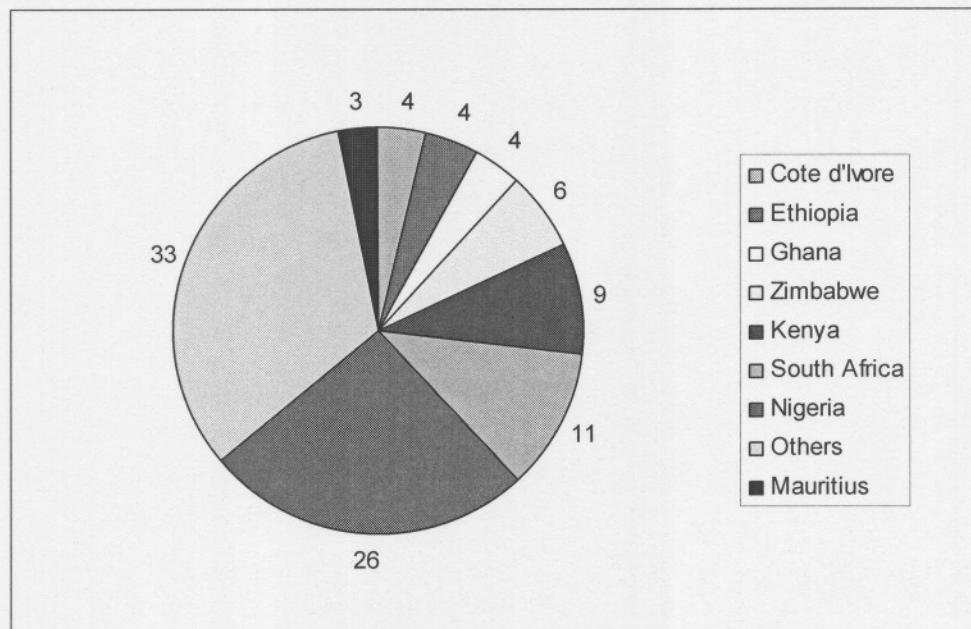
- 9.0% of the aggregate Tier 1 capital,
- 5.3% of aggregate assets and
- 10.6% of aggregate pre-tax profits.

Following Nigeria in terms of share of the total Tier 1 capital are the 33 banks encapsulated in others, which account for 6.2% followed by Zimbabwe with their 6 banks who contributed only 2.8% of the total. The Zimbabwean banks' figures continue to reflect the use of inflationary accounting as the economy continues to deteriorate, with the consumer price index for 2003 running at 598.7% and 133% at the end of 2004 (CIA, 2005). Zimbabwe is followed by Mauritius whose 3 banks account for 2.6%. The Mauritian banks are led by Mauritius Commercial Bank (9) and State Bank of Mauritius (11), both of which increased their capital. Finally, the 9 banks from Kenya contribute 2.3% of the total Tier 1 capital (Anon, 2004a).

4.4.3 Conclusion on banking

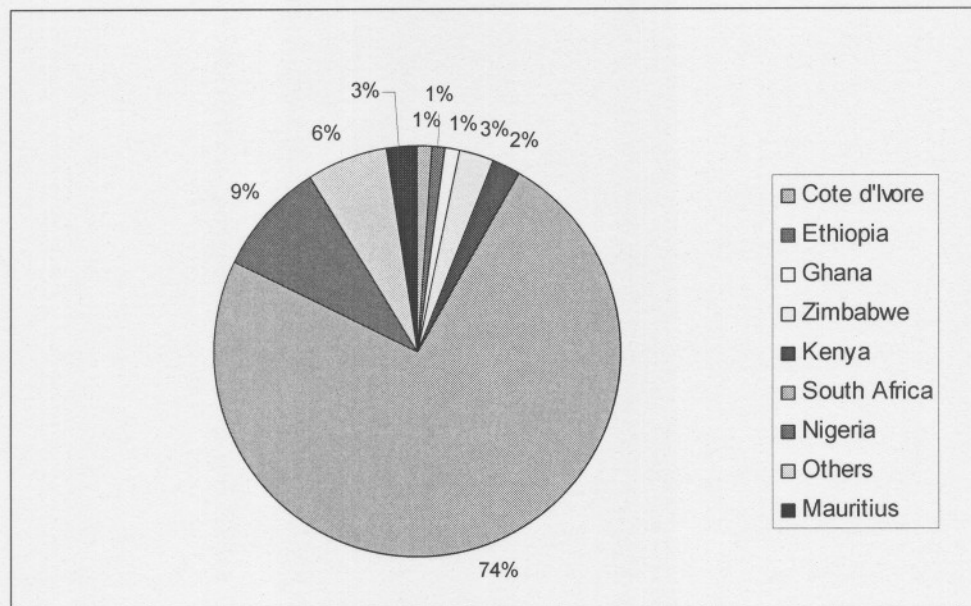
To summarise the current trends in global and African banking from a global perspective, BIS reporting banks experienced an expansion in cross-border claims in the fourth quarter of 2004 in new lending to all sectors. Thus cross-border banking grew in the previous year. Furthermore, Africa is more complex due to different levels of development in infrastructure and technology. Africa has good future prospects for banking on the continent especially with the development of mobile telecommunication (BIS, 2005).

Figure 4.9 Countries that provided Tier1 Capital in 2004



(Source: Anon, 2004a).

Figure 4.10 Percentage of Tier1 capital in Africa for 2004



(Source: Anon, 2004a).

4.5 African capital markets

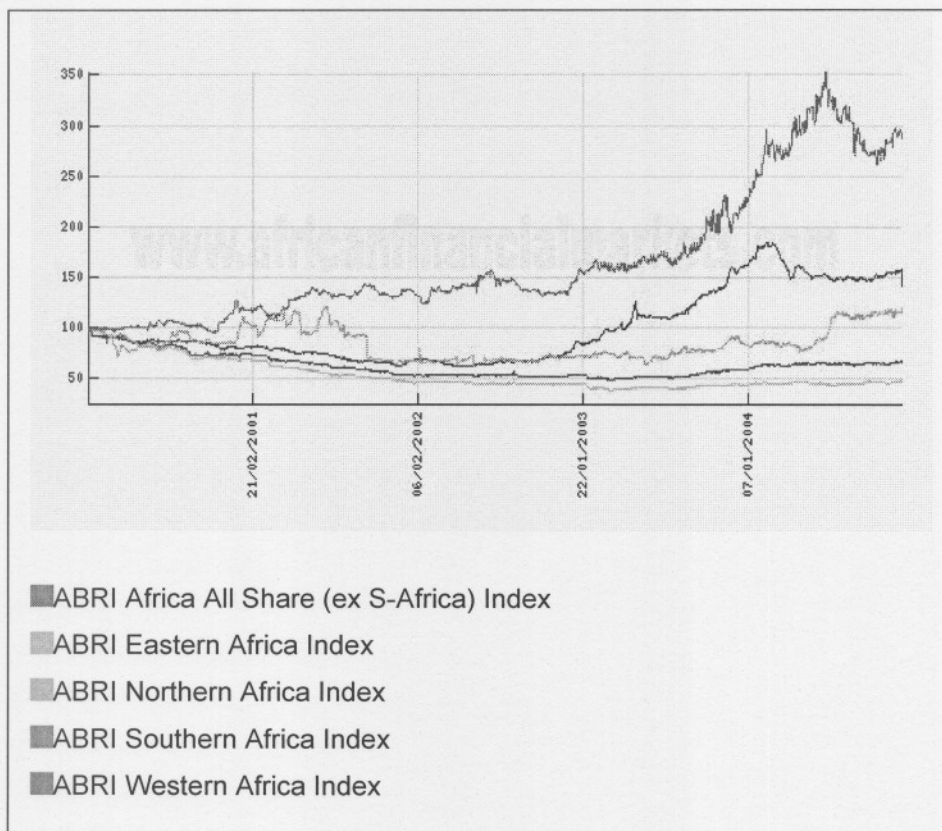
“The future of Africa's stock markets is the future of the poor in Africa, the jobs, the businesses, the prosperity and the future of the region lies in its stock.” (Browne & Kim, 2003).

According to Browne & Kim (2003) the returns in Africa are starting to be very impressive and that is linked to the future of the poor, since economic development is essential for mobilising resources. In this study, the financial market focus is mainly on the equity markets in Africa.

Liberalisation and privatisation have become dominant themes in development strategies in Africa over the past 15 years (1990-2005). Changing attitudes towards the role of the private sector in the development of African economies have facilitated the development of the capital markets. In the 1990s, many countries in Africa set up stock exchanges as a precondition for the introduction of market economies under the structural adjustment programmes propagated by the international monetary institutions and to facilitate the privatisation of state-owned enterprises (Kibuthu, 2005). During the last decade, the number of African Stock Exchanges has risen from 10 to 18. Currently, Africa has 18 securities exchanges, 11 of which began operations in the 1990s. These stock markets are in Botswana,

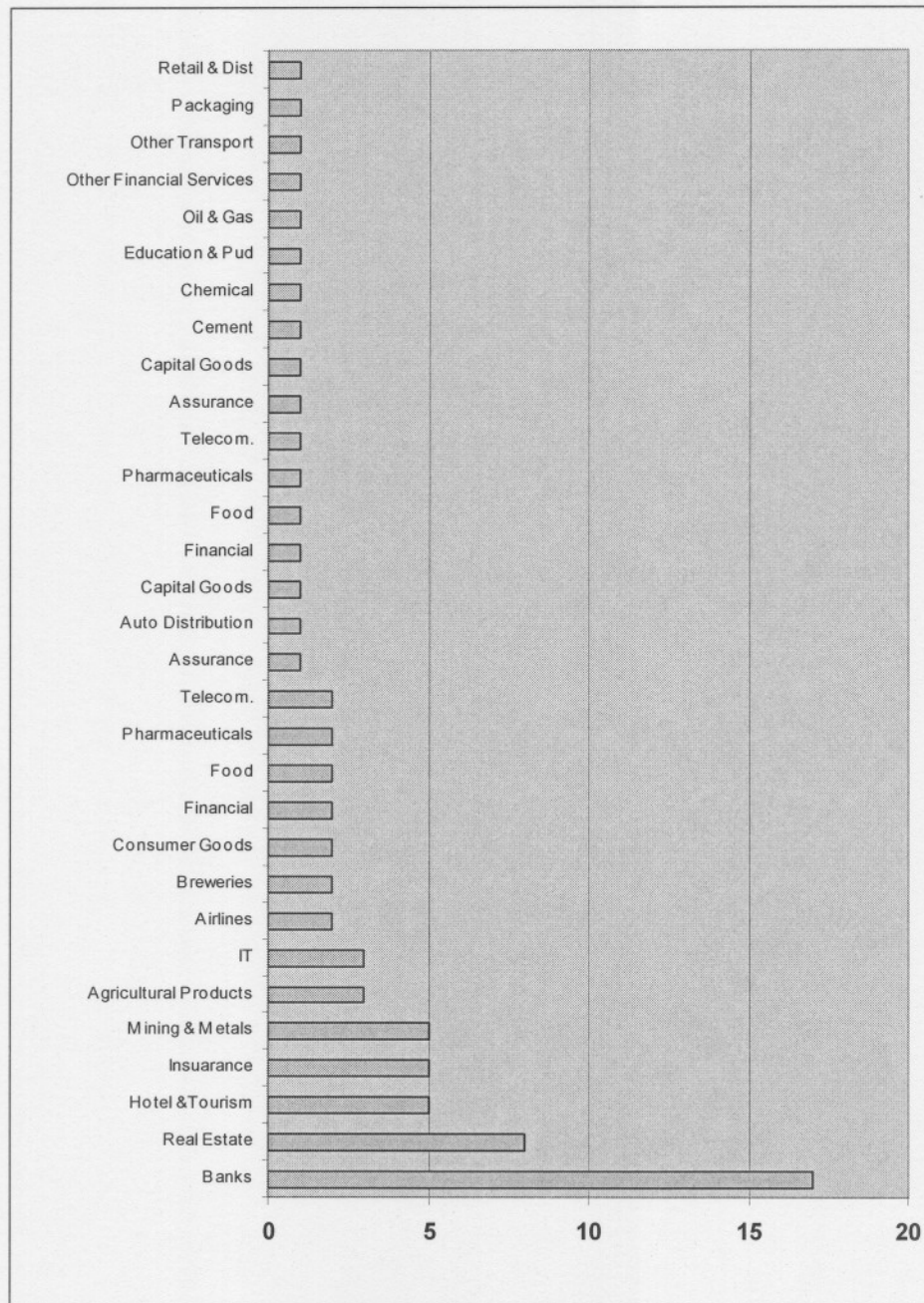
Côte d'Ivoire, Egypt, Ghana, Kenya, Malawi, Mauritius, Morocco, Mozambique, Namibia, Nigeria, South Africa, Swaziland, Tanzania, Tunisia, Uganda, Zambia and Zimbabwe. These stock exchanges range from the larger South African and Egyptian exchanges that were established in the 1880s to smaller exchanges in Uganda and Mozambique that were only established in the past four years (Anon, 2004b). The following figures will indicate the current situation and recent developments on the continent's capital markets. Figure 4.11 illustrates the movement of all the African stock market indices over the last few years while figure 4.12 illustrates the dominant sectors of trade for 2004 in Africa.

Figure 4.11 Recent performances of African indexes



(Source: AfricanFinancialMarkets, 2005).

Figure 4.12 Dominant African sectors in 2003



(Source: UN, 2003).

Remarkable growth and expansion in market capitalisation in Africa occurred in the last few years as more countries outside the more advanced economies of Northern and South Africa venture into the development of their capital markets (Sheehan & Zavala, 2005).

Regional integration is also part of the innovative development that contributed to the growth in market capitalisation on the continent. Africa has one of the only

regional stock exchanges in the world, linking eight French-speaking countries in West Africa. These French-speaking members of the West African Economic and Monetary Union, namely, Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo created the world's first regional exchange, the Bourse Regionale des Valeurs Mobilières (BRVM- Regional Stock Exchange) (Mbendi Information For Africa, 2005).

Another example of integration, even though it is not so specialised and formally structured as the BRVM- Regional Stock Exchange, is found in East African Countries where Uganda, Kenya and Tanzania are currently integrating their stock markets into another potential regional stock market. The main aim of these integrations is the consolidation of the value of developing a focal point for capital market development in the geographical zone where these countries are located (Kibuthu, 2005).

To ensure success and general efficiency, regional stock exchanges in Africa must use the most modern electronic and satellite communications equipment, which will enable them to ensure performance despite the underdeveloped communications infrastructure in the individual countries in these regions (Kibuthu, 2005). BRVM-Regional Stock Exchange is a good working example of such technological advances. These high technology standards are not only part of regional stock exchanges, Africa also performed well in technological areas as Stock exchanges in Johannesburg and, more recently, in Lagos have made huge strides towards state-of-the-art technology. According to Kramer (2003), it will be possible, sooner rather than later, to sit in Hong Kong or Hartford and trade in Harare and throughout Africa.

However, Carol Frost, research associate at Dartmouth College's Tuck School of Business states that there are many improvements needed to meet international standards and expectations. According to her, 12 of the 18 active African exchanges she surveyed have websites that work, and many of those offer only limited information (Kramer, 2003). Therefore, a wider availability of information on African markets, the implementation of robust electronic trading systems and the adoption of central depository systems must be seen as priorities (Anon, 2004b).

Another reason why investors are showing new enthusiasm to invest in African enterprises is the economic and political reforms that have taken place across the continent (Kramer, 2003). The majority of the countries that established new exchanges in Africa have also established new legal and regulatory regimes (Kibuthu, 2005). The 1990s witnessed a deliberate shift by a number of African

governments to free market policies driven by the desire to reduce the burden on government finances. This was achieved by implementing market-friendly reforms (Anon, 2004b). These reforms have been provided by International financial institutions such as the World Bank and a range of other experts from national securities exchanges in industrialised countries. Therefore they provided assistance to ensure improved regulatory, legislative and accounting principal. These improvements will form the basis for proper functioning of African stock exchanges (Mbendi, 2005). Part of these broader economic reforms has been the privatisations undertaken by a number of governments (Kramer, 2003). Privatisation, as a central component of the reformed process occurred mainly in State-owned companies. A number of these privatisation initiatives were effected by listing on the local stock markets. In order to further stimulate the development of a local capital market, many subsidiaries of large international companies were also encouraged to list their local operations (Anon, 2004b).

The good performance of African equity markets can however not only be attributed to the emerging of new stock markets in the region. The traditionally strong markets also expanded their business. This can be seen when looking at South Africa. With a market capitalisation of over US\$ 180 billion, South Africa hosts one of the largest stock markets in the world (Anon, 2004b). The JSE experienced several records from 2004 to 2005. It is not just that the all share index broke through the 16000-point barrier for the first time in 2005; it is the speed at which it got there, climbing from 14000 in three months in 2005. A 40% increase from 2004 to 2005 was realised. Even though the latest improvements have been driven by a weaker Rand and stronger US dollar gold price, the longer-term improvement has resulted in improved economic fundamentals in the country (African Financial Markets, 2005).

Another positive contributor is that it is not only in Africa that African stocks are performing above average. The seven African companies listed on the New York Stock Exchange (NYSE) recorded trading volumes that were twice as great as that of all other non-US listed firms (African Financial Markets, 2005).

However, with the exception of the South African market, African stock markets are described as "frontier markets". These markets are typically characterised by relatively small capitalisation and liquidity levels. Size has, however, proved to have one advantage in Africa as several of the smaller African exchanges have been relatively "immune to global jitters hitting stock shares worldwide. This distinct characteristic of African equity markets offers positive benefits in terms of risk

diversification and has often recorded higher returns than their much larger counterparts in other parts of the world” (Anon, 2004b).

Finally, inflation rates are on the decline and currencies are generally considered stable in Africa, which has also had expansionary and positive effects on the continent's' equity markets (Mbendi, 2005).

According to Browne & Kim (2003), the development of African stock exchanges is becoming increasingly important as it contributes towards the following important areas on the continent: more efficient corporate governance through increased transparency, higher domestic savings rates, the offering of a variety of securities to as many people as possible; distribution of capital in the most productive sectors of the economy, redistribution of wealth in the economy and the flow of foreign direct investment into long-established or recently introduced companies.

Table 4.4 illustrates and explains the different countries' stock markets. The countries are listed from the country with the largest to the smallest market capitalisation.

In this table, it is seen that the Johannesburg Stock exchange in South Africa is by far the dominant and biggest exchange on the continent with a market capitalisation share of 75.28% of Africa's total market capitalisation. Furthermore, the yields on the different exchanges are impressive. The Cairo and Alexandria Stock Exchanges reached the best yield of 602.3% over the last three years.

Table 4.4 Africa's Stock Exchanges

Country	Name of Exchange	Market Capital¹	Listed Companies	Revenue 1Y%²	Revenue 3Y%³
South Africa	<i>JSE Securities Exchange</i>	323,832,892	472	31.1	81.2
Egypt	<i>Cairo and Alexandria Stock Exchange</i>	44,426,504	1151	217.7	602.3
Morocco	<i>Bourse de Casablanca</i>	23,820,293	56	5.2	82.6
Nigeria	<i>Nigeria Stock Exchange</i>	13,324,526	195	-18.6	59.8
Zimbabwe	<i>Zimbabwe Stock Exchange</i>	6,400,013	77	244.8	120.7
Kenya	<i>Nairobi Stock Exchange</i>	4,748,394	50	37.2	237.8
Tunisia	<i>Bourse de Tunis</i>	2,957,789	46	11.5	40.8
Botswana	<i>Botswana Stock Exchange</i>	2,534,924	19	15.6	55.8
Mauritius	<i>Stock Exchange of Mauritius</i>	2,361,586	40	5.9	109.1
Cote d'Ivoire	<i>Bourse Re'gionale Des Valeurs Mobilieres S.A</i>	2,133,809	38	39.8	93.2
Ghana	<i>Ghana Stock Exchange</i>	1,901,296	24	-9.9	320.2
Zambia	<i>Lusaka Stock Exchange</i>	549,900	11	143.7	n.a.
Tanzania	<i>Dar-es-Salaam Stock Exchange</i>	509,966	5	n.a.	n.a.
Namibia	<i>Namibia Stock Exchange</i>	310,013	13	0.2	77.2
Swaziland	<i>Swaziland Stock Exchange</i>	181,695	5	1.0	31.2
Malawi	<i>Malawi Stock Exchange</i>	178,191	8	77.5	12.9
Uganda	<i>Uganda Securities Exchange Ltd.</i>	96,902.56	3	n.a.	n.a.
Mozambique	<i>Mozambique All Share Index</i>	63,046	n.a.	n.a.	n.a.
AFRICA		430,153,558			

1 – Total Market capital in Exchange on 15 September 2005. Source: www.africanfinancialmarkets.com, 2005

2 – 1 Year revenue as percentage of total exchange from 15 September 2004 – 15 September 2005. Source: www.africanfinancialmarkets.com

3 - 3 Year revenue as percentage of total exchange from 15 September 2002 – 15 September 2005. Source: www.africanfinancialmarkets.com

4.5.1 Challenges of Markets in Africa

Kibuthu (2005) identified the following existing problems in the market structures of Africa that must be seen as challenges in order to develop Africa's equity markets to such an extent that they can serve as a solution to the continent's poverty situation.

Firstly, the establishment of new stock exchanges in many African countries was rushed. This caused inefficiency and failed to attract large numbers of investors and participants.

Small, underdeveloped and illiquid exchanges on the continent tend to operate in isolation from other markets, resulting in low trading volumes. As a result of highly concentrated exchanges in Africa, the best shares are being held by local banks, pension funds and insurance companies. They do not want to sell because they have few alternative assets to buy with sales proceeds.

Manual systems and processes as methods for settlement and delivery dominate their operations. This is the result of underdeveloped market infrastructures.

Bond markets are relatively underdeveloped in Africa's capital markets. A well functioning financial system that provides an accurate and timely information service to individuals and corporate institutions is necessary for the development of bond markets, which will assist and boost equity market activities.

Political unrest, disease and war have resulted in a large portion of the African population living on less than US\$1 a day. This results in a low savings rate and constrains the demand and supply of equity in stock markets. The scarcity of institutional investors is also constraining equity demand.

Enforcement actions are rare and abuses are not uncommon, as some African stock exchanges have limited institutional capacity to police and enforce rules. Creating efficient regulatory systems is a big challenge for the continent.

Political and economic instability in some countries make those countries' risks too high for investing.

Finally, most of the new African exchanges lack diverse and attractive types of investments to offer foreign investors. Generally, there may be only two or three corporations of interest to foreign investors.

4.5.2 Conclusion

In summarising the African stock exchanges, the following can be said; firstly, Africa has 18 stock exchanges of which one, the Bourse Regionale Des Valeurs Mobilieres S.A is a regional exchange. Some of these exchanges, such as the JSE and the Bourse Regionale Des Valeurs Mobilieres are highly sophisticated and use some of the best available technology. However, most exchanges in Africa are small from a capitalisation as well as a listed shares perspective, and are mostly primitive in their methods of doing business.

African equity markets are active in 25 main sectors, which are listed in Figure 4.12. Yields on the different exchanges are relatively high with Egypt's stock exchange being the best performer over the last three years.

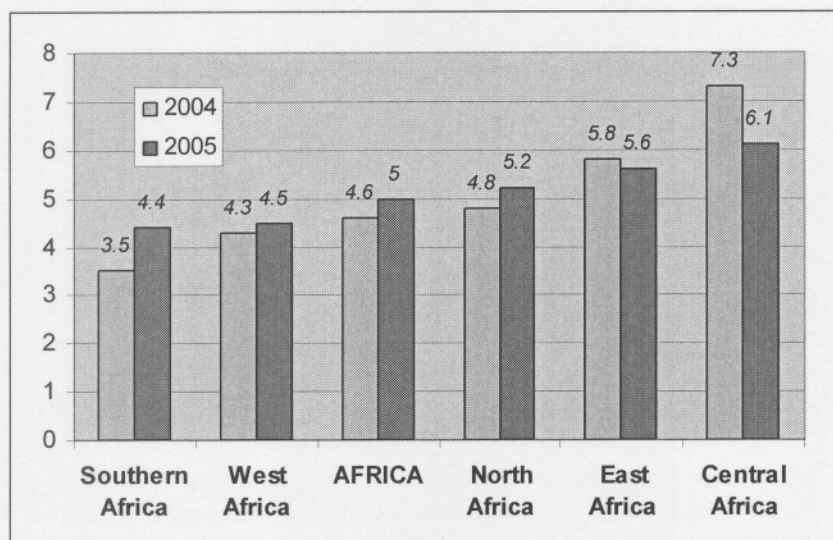
There considerable potential for the expansion of Africa's stock exchanges and especially for regional exchanges such as the one in East Africa.

4.6 Future growth and FDI prospects

4.6.1 African growth prospects

The African economy will grow at a projected 5% in 2005 and increase by 0.4% from 2004's 4.6%. Growth will be encouraged and driven by increased macroeconomic stability, growing African exports as a result of rising global demands and growth, continued improvement in agricultural output, assuming favourable weather conditions and vibrant growth in the mining and tourism sub-sectors (UN, 2005).

Figure 4.13 Projected real GDP growth at sub regional level in 2005



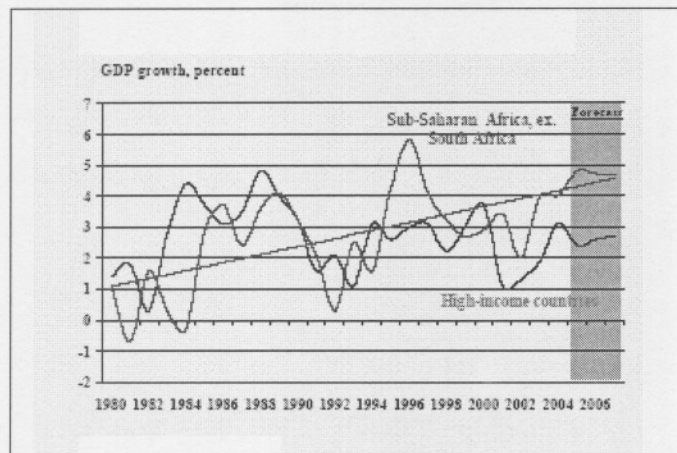
(Source: UN, 2005).

From a regional perspective, the following individual performances can be expected to contribute to the good growth prospects on the continent.

Firstly, Sub-Saharan Africa is expected to strengthen somewhat with a GDP increase of about 4% during the period 2005-2007. This economic increase in the region will be fuelled by high metal, mineral and oil prices, which are projected to stay consistent in 2005 before moderating gradually in 2006 and 2007. Growth ought to strengthen once again among oil exporters as new capacity comes on line in response to past investments. The easing of oil prices should improve the current account position of oil importers and reduce the surplus among exporters.

Furthermore, a positive expectation awaits both the medium-term and the longer-term regional outlook as planned reforms in a number of countries, including Ethiopia, Kenya Madagascar, Mozambique, Rwanda, Tanzania and Uganda should contribute positively in the future (World Bank, 2005b). Southern Africa will also contribute positively with growth expectations of 4.4% in 2005 compared to a growth rate of 3.3% in 2004 (UN, 2005). Finally, inflation is projected to remain broadly stable in the sub-Saharan region (World Bank, 2005b).

Figure 4.14 Reforms underpin rising trend growth



(Source: World Bank, 2005b)

Growth in Central Africa is expected to decrease. The winding down of construction activities on the Chad-Cameroon oil pipeline will have a major impact on the region. This will cause a drastic drop in Chad's growth from 39.4% in 2004 to only 13% in 2005. Cameroon's growth is expected to remain stable, while a further decline in oil production in Gabon is expected to slow the economy's growth to 0.8% in 2005. From a positive point of view, the expansion in the non-energy sectors is expected to strengthen the growth outlook in the Congo and Sao Tome (UN, 2005).

The third region, East Africa, is expected to remain firm in 2005 despite an anticipated decline in its 2004 growth level. The driving forces behind this expected economic stability will be the strong growth in the tourism sector, general increases in donor support, good harvests across the region, increased FDI flows, good macroeconomic management, and improved political stability.

North Africa's growth is anticipated to increase in 2005 due to improved agricultural growth and sustained revenues from the oil sector. More foreign investment inflows to the oil sectors of the Libyan Arab Jamahiriya, Mauritania and the Sudan, tax cuts in Egypt, which are expected to boost private consumption and investment, strong tourism growth in Tunisia and Morocco and strong growth in services in Tunisia and Mauritania will contribute positively to growth in the region. A decisive factor for sustained growth in the region will be country's ability to maintain peace and political stability, especially in the oil producing areas (UN, 2005).

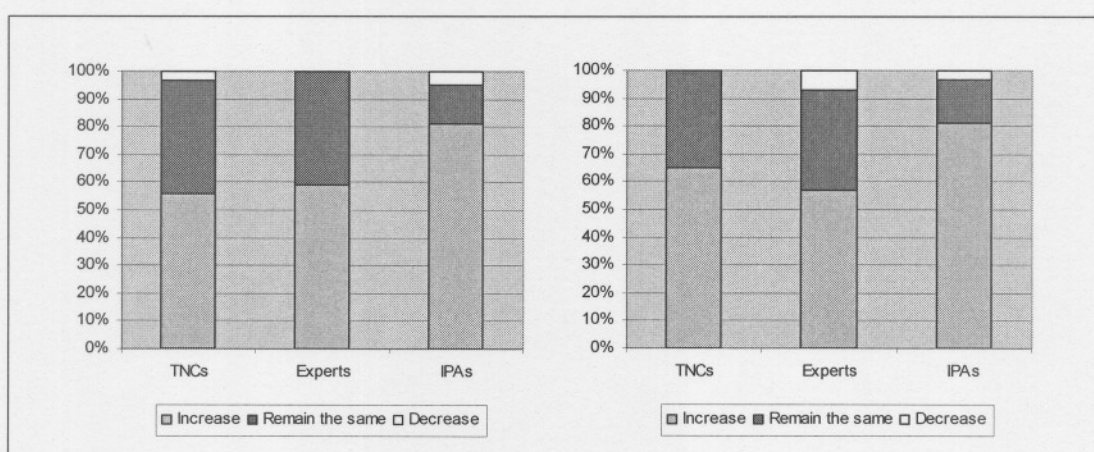
West Africa's growth performance is projected to improve somewhat from its 2004 performance. From the 15 countries that form this region, 8 are expected to improve

on their 2004 growth performance. Liberia is once again projected to lead the region with a 15% growth rate. Foreign direct investment inflows, anticipated agricultural growth; expansions in the mining sector and increased donor support will be the main factors behind the expected rise in West Africa's growth (UN, 2005).

4.6.2 Global FDI prospects

According to FDI experts, transnational corporations (TNCs) and investment promotion agencies (IPAs), FDI will continue to grow over the short and medium term (UNCTAD, 2005).

Figure 4.15 Global prospects for FDI, 2005-2006 and 2007-2008



(Source: UNCTAD 2005).

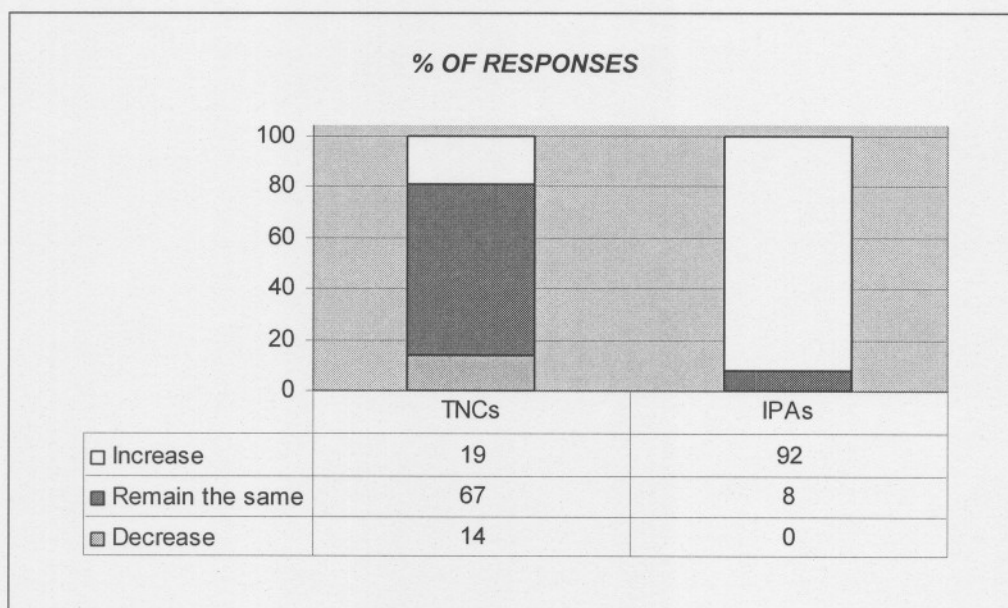
The main message from the 2005 global surveys, as indicated in figure 4.15, is positive. The findings suggest that countries need to utilise investment opportunities whilst paying attention to the quality of FDI, given the fierce competition for investment (Panitchpakdi, 2005).

Between 50% and 60% of the responding TNCs and experts contacted and 81% of the IPAs, predicted short-term (2005-2006) growth in FDI flows. The majority of the remaining respondents expected FDI levels to remain the same. A small number of respondents predicted decreasing levels of FDI flows for the immediate future. According to the respondent's predictions, FDI prospects are similarly optimistic on medium-term (2007-2008) as 65% of TNCs, 57% of experts, and 83% of IPAs expected FDI to increase over this period. Similarly to the short-term predictions, most other respondents foresaw FDI levels remaining unchanged while only a few

expected a decline. This last category of respondents who predicted negative prospects for FDI based their opinions on the following factors. Firstly, they believe that protectionism and reduced growth in industrialised countries might cause problems. Secondly, the financial instability of some major economies, global terrorism, as well as the volatility of petroleum and other raw material prices are potential threats.

From a regional perspective, predictions stated that Eastern Europe and Asia are the two regions with the most promising FDI prospects. Investors' focus appears to be shifting away from traditionally important regions towards certain emerging markets. Flows to Africa are likely to remain stable at a low level while Latin America is expected to uphold its recent FDI recovery. The US is predicted to receive the most FDI in the developed world, while expectations are less promising for the major European economies (UNCTAD, 2005).

Figure 4.16 Prospects for FDI flow to Africa, 2006-2007



(Source: UNCTAD 2005).

When predicting the most important vehicles of FDI, there was a difference of opinion. Most IPAs expected Greenfield investment (new investment projects) to be the most important source of FDI. However, more than 50% of experts and TNC respondents expected mergers and acquisitions to be the primary future vehicle for FDI in the short and medium term. In whatever form FDI occurs, there was general acceptance that the US (by far), followed by the UK, Germany and China will be the most important sources of global FDI flows in the future.

FDI is a much wanted and favoured commodity in our global environment (Chakrabarti, 2001). This is still very true today as competition for FDI is increasing worldwide. Therefore, countries' investment promotion efforts will be more proactive as most IPAs intend to employ a more targeted approach over the next two years.

In conclusion, the above-mentioned surveys all predict a similar picture: "the FDI recovery will continue, although there are some threats which may weaken the momentum. The recovery is increasingly fuelled by investment in developing countries. The overall mood is one of cautious optimism" (UNCTAD, 2005).

4.6.3 African FDI prospects

When combining the Global Investment Prospects Assessment for 2004 and 2005 a credible opinion about Africa can be derived. Focusing specifically on Africa, the IPAs view Africa as an attractive location for FDI in the short term. The expectations of the TNCs and experts differ somewhat from IPA's views as only a fifth of the responding TNCs expected increasing FDI flows into the region. The strongest prediction by respondents was that FDI flows would remain the same (UNCTAD, 2004).

Figure 4.17 Sectoral prospects for 2005



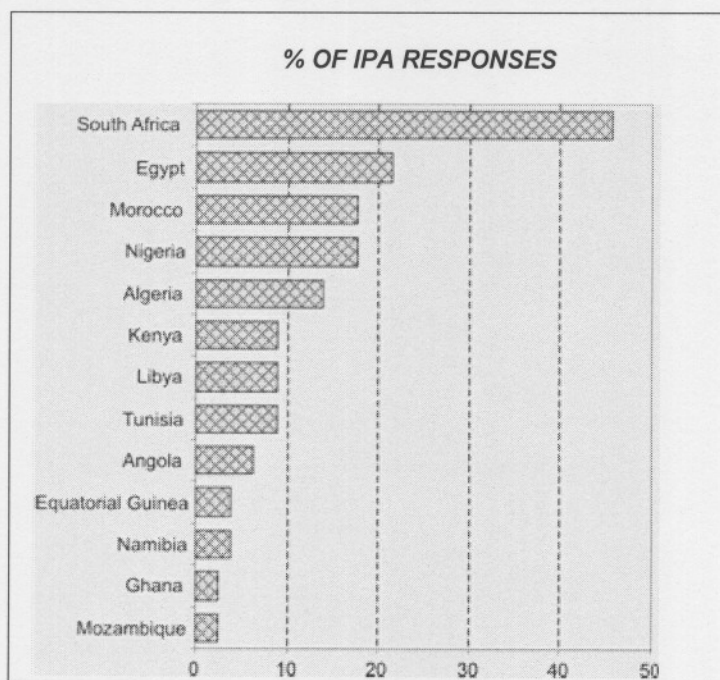
(Source: UNCTAD, 2004).

When comparing these predictions about Africa with the general global predictions mentioned in 4.5.2, it is clear that Africa is not yet part of the strategic planning of the world's largest TNCs. According to the critics of TNCs who do not predict positive prospects for the continent, companies prefer non-equity engagements to reduce political and economic risk, which is relatively higher in Africa than in other regions. On the positive side, FDI prospects are expected to improve in the medium term according to the consensus among IPAs and experts as indicated in Figure 4.17.

From a sectoral perspective, the most positive expectations are predicted to occur in the services sector as IPAs expect more FDI in the retail and wholesale industries. Tourism, hotels, and restaurants are also expected to perform well in the service sector. In the manufacturing sector, food and beverages have the most promising prospects for FDI. Finally, in the primary sector, agriculture is ranked the highest

and is expected to be better than mining and petroleum. This is indicated in Figure 4.18.

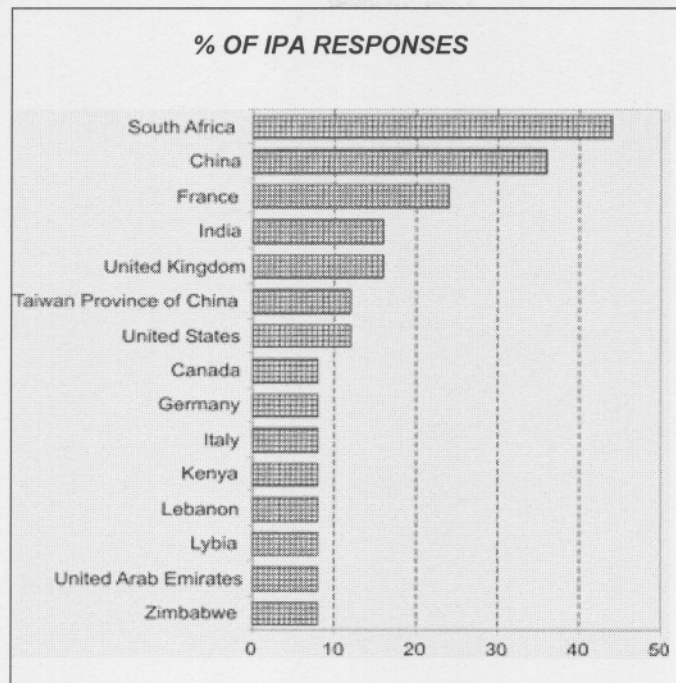
Figure 4.18 Countries' attractiveness to FDI in 2006 – 2007



(Source: UNCTAD, 2004).

According to the responding IPAs, countries like South Africa and Nigeria in sub Saharan Africa, and Egypt, Morocco and Algeria in North Africa, are expected to hang on to their positions as the highest recipients of FDI flows. Kenya, Libya and Tunisia are expected to attract the same amount of FDI, following these countries (UNCTAD, 2004).

Figure 4.19 Sources of FDI 2006 – 2007



(Source: UNCTAD, 2004).

In 4.5.2 it was mentioned that the US is expected to be, by far, the largest source of global FDI flows. However, the same commitment and contribution is not expected to be received by Africa from the US. On the African continent, South Africa and China are expected to be the largest investors. This predicted pattern of FDI flows implies that countries that have traditionally been the most important investors such as the UK and France will no longer hold these positions (UNCTAD, 2004).

CHAPTER 5

EMPIRICAL INVESTIGATION

5.1 Introduction

The previous theoretical chapters gave an overview of FDI, financial systems and the current state of affairs concerning these in the African context. In chapter 1 the goals of this research were described and it was indicated that the relationship between FDI, the financial system and eventually growth would be analysed. This chapter therefore aims to address this analysis and the three empirical goals are stated as: (i) What are the elements (if any) of Africa's financial system that deter FDI inflows to the continent? (ii) How effective is the absorption of FDI in Africa and which elements of the financial system are able to absorb FDI effectively? (iii) Do FDI inflows and the financial system absorption capacity significantly affect economic growth on the continent?

This part of the study will attempt to answer these questions through an empirical analysis of Africa's financial system, FDI and growth. This chapter will firstly describe and discuss the data used and this will then be followed by an investigation of the influence of different financial system variables on FDI and growth. The chapter concludes with a summary of the results attained from the empirical analysis.

5.2 Data sources and description

This section describes the data used in the empirical analysis, specifically the measures of FDI, financial market development and economic growth. The different variables, methods, timelines and other information used in this empirical study will be explained in this part of the chapter.

5.2.1 FDI and GDP data

There are several sources for data on FDI. An important source is the International Monetary Fund (2000) publication "International Financial Statistics" (IFS), which reports the Balance of Payments statistics on FDI. However, these FDI statistics are somewhat outdated and therefore the most important source for FDI was the World Bank. The World Bank issues the World Development Indicators (WDI), which are the World Bank's premier annual compilation of data about global, regional and country-specific development. All necessary FDI figures were found in the WDI. The

FDI data used are based on FDI net inflows. FDI is the net inflows of investment required to acquire a lasting management interest (10% or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. This series shows net inflows in the reporting economy. Data are in current US\$. The model used in this study focuses on the inflows to the economy; therefore, the FDI net inflow measure is preferred.

The source for GDP is also the World Bank's World Development Indicators (WDI). GDP is expressed as GDP in current US\$. GDP at purchaser's prices is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of assets or for depletion and degradation of natural resources. Data are in current US\$. Dollar figures for GDP are converted from domestic currencies using single year official exchange rates. For a few countries, where the official exchange rate does not reflect the rate effectively applied to actual foreign exchange transactions, an alternative conversion factor is used (World Bank, 2005).

Furthermore, these two variables, GDP and FDI, were used to formulate the relationship of FDI to GDP (F2G). F2G will be used throughout this study and is FDI expressed as a percentage of GDP (thus, $FDI/GDP \times 100$).

5.2.2 Timeframes and countries

Finding data about all the different variables over an extended number of years was a difficult task. The study did, however, manage to collect substantial data from World Bank Financial Structure Database. The study used data of all the different financial system variables from 1980 to 2002 as it was the period of most comprehensive, available data. Over these 22 years, 26 different African countries were identified on the basis of complete data being available for this period. These countries represent all the different sub regions of Africa and can be found in Table 5.1.

5.2.3 Financial system variables

The data for this study, associated with different financial system variables, are available from the World Bank Financial Structure Database, as mentioned in section 5.2.2. As quoted in a study by Alfaro et al. (2004), King and Levine, Levine

and Zervos and Levine et al. constructed several financial market series. These variables were classified into two broad categories - those relating to the banking sector and those relating to the stock market.

5.2.3.1 Bank-related variables

For the first set, Levine & Zervos and King & Levine identified four bank-related variables (Alfaro et al. (2004)). In this study the number of bank-related variables was expanded as the World Bank Financial Structure Database introduced several other variables that may have an influence on GDP and FDI. The following bank-related variables were identified:

- Deposit money bank as a percentage of central bank assets.
- Liquid liabilities to GDP.
- Central Bank Assets to GDP.
- Deposit Money Bank Assets to GDP
- Private credit by deposit money banks to GDP
- Private credit by deposit money banks and other financial institutions to GDP
- Bank deposits
- Financial system deposits

5.2.3.2 Market-related variables

According to Alfaro et al. (2004), the market-related data consists of variables introduced in Levine and Zervos and expanded by the World Bank Financial Structure Database. These variables are primarily focused on stock market variables as they are the most prominent element in the financial markets. They also have best available data. These variables are:

- Stock market capitalisation to GDP
- Stock market total value traded to GDP
- Stock market turnover ratio

5.2.4 *Description of the data used in the empirical investigation*

This part of the chapter will attempt to give insight into the financial system, FDI, and growth in the 26 countries investigated in this study. Table 5.1 will be used to

introduce and explain the data used. This Table presents descriptive statistics for FDI, GDP, banking, and stock market information in the different countries used in this study. There is considerable variation in most of the countries' statistics. This will be discussed subsequently Table 5.1.

Table 5.1: African GDP, FDI and other financial system indicators

	1	2	3	4	5	6
Country	% GDP	% FDI	FDI GDP	% Bank Credit	Stock Market	Market Cap. %
Burundi	12.757	5.245	0.39	25.13	No	-
Burkina Faso	0.593	0.152	0.24	10.91	No	-
Central African Rep.	0.259	0.080	5.88	14.87	No	-
Cote d'Ivoire	2.496	3.189	1.11	36.65	Yes	0.512
Cameroon	2.351	1.380	0.67	23.22	No	-
Algeria	12.757	5.245	0.39	63.09	No	-
Egypt, Arab Rep.	12.960	20.932	1.81	99.78	Yes	10.54
Ethiopia	1.670	1.052	0.63	47.09	No	-
Gabon	1.097	-0.327	0.02	20.96	No	-
Kenya	2.079	0.815	0.37	49.43	Yes	1.12
Lesotho	0.161	1.926	8.53	16.13	No	-
Morocco	6.334	11.286	1.39	70.26	Yes	5.64
Madagascar	0.835	0.471	0.50	29.04	No	-
Mauritius	0.679	0.740	0.88	64.13	Yes	0.561
Malawi	0.385	0.229	0.55	26.30	Yes	0.042
Niger	0.497	0.313	0.51	14.17	No	-
Nigeria	8.559	22.040	2.83	28.30	Yes	3.16
Rwanda	0.438	0.249	0.55	12.35	No	-
Senegal	1.043	0.970	0.85	35.47	No	-
Sierra Leone	0.214	-0.053	-0.59	42.48	No	-
Swaziland	0.228	1.245	5.08	8.48	Yes	0.043
Seychelles	0.095	0.703	6.81	64.43	No	-
Togo	0.314	0.496	23.00	24.09	No	-
Uganda	1.072	1.605	1.20	11.78	Yes	0.022
South Africa	28.194	18.985	0.54	110.70	Yes	76.85
Zimbabwe	1.933	1.032	1.45	46.83	Yes	1.51

This part of the chapter focuses specifically on the understanding of the different countries involved in this study. Table 5.1 attempts to explain each country's role and relevance in terms of the 26 countries investigated.

The different columns can be interperated as follows:

Column 1: %GDP

In this column, each country's GDP is expressed as a percentage of the total GDP of Africa t generated over the 22-year period (1980 – 2002). In this column there is large variation and an unbalanced picture. This is illustrated by the fact that three countries, South Africa (28.194), Egypt (12.960) and Burundi (12.757) together account for more than the remaining 23 countries' contribution to Africa's GDP.

Column 2: %FDI

In this column, each country's FDI is expressed as a percentage of the total FDI inflows received over the same 22-year period. The variability in FDI is similar to the trend experienced in Column 1 as only four countries have double-digit percentages of FDI flows. South Africa, Nigeria, Egypt and Morocco received 73.24% of the FDI flows to the 26 investigated countries from 1980 to 2002.

Column 3: FDI/GDP

This column displays the average of $(FDI/GDP) \times 100$ over the same 22-year interval. Thus, the part of a country's GDP that was made up by FDI as an average over the relevant years. The smaller economies such as Swaziland (5.08) and the Seychelles (6.81) are very reliant on FDI inflows. The country with the highest percentage of FDI to GDP is Togo with 23%. The cocoa, coffee, cotton and large phosphate production attracts most FDI towards this small Sub-Saharan country (CIA, 2005).

Column 4: Bank Credit %

The next column consists of the domestic credit provided by the banking sector (as a percentage of GDP). Domestic credit provided by the banking sector includes all credit to various sectors on a gross basis, with the exception of credit to the central government, which is net. The banking sector includes monetary authorities and deposit money banks.

as well as other banking institutions where data are available (including institutions that do not accept transferable deposits but do incur such liabilities as time and savings deposits). Examples of other banking institutions are savings and mortgage loan institutions and building and loan associations (World Bank, 2005). South Africa, Morocco and Mauritius have the highest percentage in this column while Swaziland (the only country in the group with a single-digit figure) is the lowest.

Column 5: Stock Market

This column indicates which countries actually have domestic stock markets. From the 26 countries included in this study, 11 have domestic stock markets of which the majority were only established in the last 8 years.

Column 6: Market Capitalization %

This column shows the percentage that the individual country's stock market capitalisation contributes to the total stock market capitalisation for all the countries in this study that have a domestic stock market. When stock market capitalisation is investigated, it is clear that these stock markets are still very small and underdeveloped. South Africa overshadows all the countries with 76.85% of the total stock market capitalisation followed by Egypt with 10.54%. The smallest contribution comes from Uganda with 0.022% of market capitalisation.

5.3 Empirical analysis

5.3.1 Method

The previous section introduced the empirical analysis and the data that will be used in the analysis. In this important part of the study, the following will be answered; firstly, do the financial system variables have an influence on FDI flows to the different countries investigated, and secondly, is there any evidence of a relationship between FDI and growth (measured in GDP) as previous theory claims?

In order to answer these questions the panel data of the 26 African countries, from 1980 to 2001 are used. Alfaro et al. (2004) completed a similar study where the

influence of FDI on growth was determined by evaluating the financial system. In their study Alfaro et al (2004) used data relating to the credit market indicators and equity market indicators in 20 OECD and 51 non-OECD countries.

The purpose of Alfaro et al.'s (2004) empirical analysis was, as they describe it, "to examine the financial market channel through which FDI may be beneficial for growth." As quoted in Alfaro et al. (2004), Mankiw et al, drafted an influential paper where Mankiw et al. derived an empirical specification based on the hypothesis that countries are not likely to be at their steady states. For this reason, transitional dynamics ought to be more important. Alfaro et al. (2004) used similar specifications to determine the direct effect of FDI on economic growth. The following equation was estimated:

$$\text{GROWTH}_i = \beta_0 + \beta_1 \log (\text{INITIAL GDP}_i) + \beta_2 \text{FDI}_i + \beta_3 \text{CONTROLS}_i + v_i$$

They found, by using this method, that FDI was not significant for growth in either of the samples. According to them, their findings summarised the predicament that exists in the literature. Theoretically, there are no grounds for saying that there is a strong basis for FDI to have a positive role in growth.

They continued their investigation by using regressions to examine the role of FDI on growth through financial markets. This was done by interacting FDI with financial market variables. To ensure that the interaction term did not proxy for FDI or the level of development of financial markets, Alfaro et al (2001) included both of the latter variables into the regression independently. The following regression was estimated:

$$\text{GROWTH}_i = \beta_0 + \beta_1 \log (\text{INITIAL GDP}_i) + \beta_2 \text{FDI}_i + \beta_3 (\text{FDI}_i \times \text{FINANCE}) + \beta_4 \text{FINANCE}_i + \beta_5 \text{CONTROLS}_i + v_i$$

Each regression used a different variable for financial market development. The result was that the interaction term turns out to be positive and significant.

The main finding was that the interaction term was significant at the 10% level for the entire range of financial sector variables used. Moreover, the interactions with some of the variables were significant at the 1% level. On the other hand, financial market indicators, by themselves, were insignificant and even negative for the non-stock market variables. Alfaro et al. (2004) state that having a strong and effective

financial sector is a means to an end and not an end in itself. What is remarkable is the fact that the coefficient of FDI shows large variation as the financial sector variable changes even within the same sample of countries.

This study of Alfaro et al. (2004) included only 14 African countries and expanding this study to 26 African countries representing the entire African sub regions may lead to more meaningful conclusions. This study expands on Alfaro et al.'s (2001) research by analysing Africa alone using a similar approach and method. This is important as an "only African" study might result in interesting findings. By using the same basic principles, a similar regression is conducted on the 26 African countries examined in this study.

This study differs from the one completed by Alfaro et al. (2004) in that this study is focused primarily on the role of financial system variables and not on other control variables such as population, literacy rates and demographics used by Alfaro et al (2004) to determine the relationship between FDI and growth.

From a FDI perspective, it must be noted that Alfaro et al (2004) used data up to 1995. With the development of FDI over the last few years (see section 4.1), this study wants to determine more time-relevant relationships between the different elements used in this study of FDI in Africa.

More financial system variables are used in this study as the study attempts to indicate the influence of these different financial system variables on, firstly, FDI flows and, secondly, how FDI flows are absorbed to enhance growth in African countries.

5.3.2 Results

The first regression is estimated by determining the influence of financial variables on FDI flows. The 8 bank-related variables and 4 market-related variables are used in the following regression model to test for a significant influence of these financial variables on FDI flows.

$$\text{Log}(F2G)_i = \beta_0 + \beta_1 \text{FINANCE}_i$$

F2G is the ratio of FDI flows towards a country as a percentage of that country's GDP. F2G is used as the dependant variable in this regression with all the different

financial systems tested separately to prevent the variables from influencing each other. The results are reported in Table 5.2.

Table 5.2: Regression results: Financial variables and FDI flows

Dependent Variable: LOG(F2G)				
Method: Panel Least Squares				
Sample: 1980 – 2002				
Bank variable	Abbreviation	Coefficient	t-statistic	Probability
<i>Bank deposits</i>	BDS	0.807	3.508	(0.0005) ³
<i>Central Bank Assets to GDP</i>	CBA	-0.548	-5.349	(0.000) ³
<i>Deposit Money Bank Assets to GDP</i>	DMB	0.568	3.063	(0.002) ²
<i>Deposit money bank vs. central bank assets</i>	DVC	1.660	5.533	(0.000) ³
<i>Financial system deposits</i>	FSD	0.498	2.116	(0.034) ²
<i>Liquid liabilities to GDP</i>	LLY	0.254	0.889	(0.374)
<i>Private credit by deposit money banks to GDP</i>	PCD	0.238	1.772	(0.077) ¹
<i>Private credit by deposit money banks and other fin. Inst. to GDP</i>	PCO	0.042	0.291	(0.771)
Financial Market variable				
<i>Stock market Dummy</i>	STM	-	-	-
<i>Stock market capitalisation to GDP</i>	SMC	0.181	3.164	(0.001) ³
<i>Stock market turnover ratio</i>	SMT	0.021	0.201	(0.840)
<i>Stock market total value traded to GDP</i>	SMV	-0.052	-0.953	(0.342)

³ = p < 0.01; ² = p < 0.05; ¹ = p < 0.1

All these variables were tested for any relationship of significance with FDI as a percentage of GDP. Only those bank-related variables that were significant were used for the further empirical investigation into the financial system variables, FDI and GDP. The bank-related variables; bank deposits, central bank assets to GDP and deposit money bank vs. central bank assets were all highly significant for enhancing FDI flows while deposit money bank assets to GDP and financial system deposits were significant. Finally, private credit by deposit money banks to GDP was moderately significant.

From the market-related variables perspective, stock market capitalisation to GDP was also highly significant for the improvement of FDI flows. This supports the literature in section 2.6.1.1 where market size was identified as an important determinant of FDI.

From these results it can be stated that there is evidence that financial variables enhance FDI flows towards African countries. This result is similar to the results of Alfaro et al. (2004). The financial system is therefore an important determinant and attracting element for FDI, not only in the rest of the world (as indicated by Alfaro et al. (2004)), but also in Africa.

Another important finding is that both bank-related and market-related financial variables have a significant influence on FDI attraction and enhancement. The fact that significance was proven in both these different types of financial system variables supports the literature (see section 3.9.6) where a relationship between bank-based and market-based systems was suggested to be the best practice in a country to ensure total financial system development. Africa does not have a simple bank-based or market-based financial system. There are elements of both types of systems which, according to the literature, (Ndikumana, 2005), is a good sign.

It must be noted that there are more bank-related variables that showed significance in the regression than market-related variables. This is a result of better developed banking systems in Africa. Financial markets on the continent are still low in numbers and underdeveloped when compared with other regions of the world (UNCTAD, 2004). Despite the underdevelopment of these market systems, they are still significant.

The second set of regressions indicated in Table 2.3 show the role of FDI on growth through the financial system variables. FDI is interacted with financial system variables and used as a regressor to test for the significance of financial markets in enhancing growth. To ensure that the interaction term does not proxy for FDI or the level of development of financial markets, both of the latter variables were included in the regression independently.

The following regression is estimated:

$$\text{GROWTH}_i = \beta_0 + \beta_1 \log(\text{INITIAL GDP}_i) + \beta_2 \text{FDI}_i + \beta_3 (\text{FDI}_i \times \text{FINANCE}) + \beta_4 \text{FINANCE}_i$$

As shown in Table 2.3, the interaction term turns out to be positive and significant. Each regression uses a different indicator for financial system development and, therefore, samples may differ from one regression to another.

This empirical investigation will use a fixed effects estimator to control for unobserved country effects.

Table 5.3: Regression results: A Financial variable, initial GDP and FDI flows to GDP

Dependent Variable: DLOG(GDP)												
Method: Panel Least Squares												
Sample: 1980 – 2002												
Effects: Fixed												
Variables	Bank variables								Market variables			
	DVC	LLY	PCD	PCO	BDS	CBA	DMB	FSD	SMC	SMV	SMT	STM
Observations	477	472	465	471	470	466	470	479	147	143	136	482
Log (initial GDP)	<i>0.412</i>	<i>0.407</i>	<i>0.404</i>	<i>0.404</i>	<i>0.416</i>	<i>0.411</i>	<i>0.406</i>	<i>0.411</i>	<i>0.388</i>	<i>0.376</i>	<i>0.347</i>	<i>0.379</i>
	[14.865]	[14.431]	[13.933]	[13.942]	[14.169]	[14.892]	[13.929]	[14.210]	[-5.551]	[6.719]	[6.673]	[12.840]
	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³
FDI/GDP	<i>-0.0165</i>	<i>-0.029</i>	<i>-0.029</i>	<i>-0.032</i>	<i>-0.040</i>	<i>0.008</i>	<i>-0.029</i>	<i>-0.034</i>	<i>-0.019</i>	<i>-0.019</i>	<i>0.105</i>	<i>-0.010</i>
	[-1.454]	[-1.866]	[-1.469]	[-1.694]	[-2.108]	[0.409]	[-1.648]	[-1.949]	[-0.748]	[-0.457]	[1.839]	[-1.115]
	(0.147)	(0.063) ¹	(0.143)	(0.091) ¹	(0.036) ²	(0.683)	(0.099) ¹	(0.052) ¹	(0.456)	(0.648)	(0.068) ¹	(0.265)
(FDI/GDP) x Financial variables	<i>-0.035</i>	<i>-0.022</i>	<i>-0.014</i>	<i>-0.015</i>	<i>-0.023</i>	<i>0.001</i>	<i>-0.0169</i>	<i>-0.019</i>	<i>-0.012</i>	<i>-0.006</i>	<i>0.032</i>	<i>0.016</i>
	[-2.163]	[-1.944]	[-1.655]	[-1.686]	[-2.304]	[0.113]	[-1.771]	[-2.105]	[-1.257]	[-0.746]	[1.833]	[0.976]
	(0.031) ²	(0.053) ¹	(0.099) ¹	(0.093) ¹	(0.022) ²	(0.910)	(0.077) ¹	(0.036) ²	(0.211)	(0.457)	(0.069) ¹	(0.329)
Financial variables	<i>-0.241</i>	<i>-0.130</i>	<i>-0.040</i>	<i>-0.064</i>	<i>-0.100</i>	<i>0.097</i>	<i>-0.059</i>	<i>-0.096</i>	<i>-0.066</i>	<i>-0.041</i>	<i>-0.067</i>	<i>0.046</i>
	[-4.491]	[-2.720]	[-1.504]	[-2.381]	[-2.421]	[5.391]	[-1.779]	[-2.337]	[-1.927]	[-2.462]	[-2.408]	[0.890]
	(0.0000) ³	(0.007) ³	(0.133)	(0.018) ²	(0.016) ²	(0.000) ³	(0.076) ¹	(0.0199) ²	(0.056) ¹	(0.015) ²	(0.018) ²	(0.374)
R ²	0.372	0.357	0.354	0.348	0.358	0.385	0.352	0.356	0.320	0.323	0.340	0.344
F-Statistics for financial variables	9.129	8.472	8.232	8.126	8.465	9.418	8.242	8.393	4.822	4.726	5.283	8.179
	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³	(0.000) ³

³ = p < 0.01; ² = p < 0.05; ¹ = p < 0.1

italic = coefficient; [] = t-statistic; () = Probability

As with the previous regression, all the financial variables in this regression were estimated separately to ensure that the different variables did not influence each other. Thus, the regression stated above was estimated separately 12 times, each time using another financial variable in the regression.

The discussion that follows will take each part of the regression and evaluate the influence of the 12 different financial variables. The significant variables that have an influence on GDP growth will be highlighted each time.

In the first part of the regression, Log (initial GDP) was used. From the results it is clear that the initial GDP influences the GDP growth. In all 12 cases, initial GDP was highly significant. Therefore, the bigger the initial GDP, the better it influences GDP growth. It can be assumed that size matters.

The second component of the regression was FDI as a percentage of GDP. This was an attempt to estimate the influence of FDI on GDP growth. It was found that one bank-related and one market-related variable was significant. The market variable, namely stock market turnover [SMT (11)] was moderately significant with a positive coefficient. This might be the result of foreign investors being attracted by an efficient and active stock market. Higher turnovers and efficient transaction finalisation are the building blocks for this variable. Therefore, the better this function of a stock market, the more FDI that can be converted into GDP growth.

There is a problem with the significant bank-related variables. Liquid liabilities to GDP [LLY (2)], private credit by deposit money banks and other financial Institutions to GDP [PCO (4)], bank deposits [BDS (5)], deposit money bank assets to GDP [DMB (7)] and financial system deposits [FSD (8)] were all significant. However, the coefficients of all these variables are negative, which implicates that an improvement in these different bank-related variables will result in significant negative levels of GDP growth. This phenomenon is not unique to this study, as Alfaro et al. (2004) also found several examples of the occurrence of a negative relationship between financial variables and GDP growth.

In the third component of the regression, (FDI/GDP) x financial markets, this phenomenon, which is in strong contrast with the literature, continues. In this part of the estimation, the financial variables with FDI are used to determine the influence on GDP growth. In this part of the regression even more variables proved to be significant. Deposit money bank vs. central bank assets [DVC (1)], liquid liabilities to

GDP [LLY (2)], central bank assets to GDP [CBA (6)], private credit by deposit money banks and other financial Institutions to GDP [PCO (4)], bank deposits [BDS (5)], deposit money bank assets to GDP [DMB (7)] and financial system deposits [FSD (8)] were all significant. All these significant bank-related variables again indicated a negative relationship with GDP growth. A similar pattern of significant, negative relationships was found once again, similar to the findings of Alfaro et al. (2004). However, the only significant market-related variable, namely stock market turnover [SMT (11)] was again significant with a positive coefficient that indicates a positive relationship with GDP growth.

In the final part of the regression, the effect of financial variables on GDP growth is assessed. An important finding is made here. Suddenly, almost all the variables are significant. However, all of them are negatively significant. Only two financial variables were not significant. One bank-related variable, namely private credit by deposit money banks to GDP [PCD (3)] and one market-related variable, namely the stock market dummy [STM (12)] were the two insignificant variables. All the other variables performed in a similar way. There is thus a similarity between the market-based and the bank-based variables as they follow the same patterns of significance and influence on GDP. Thus neither type of financial system is better, or perfect. Bank-related variables and market-related variables are therefore closely related in this example.

Alfaro et al. (2004) found similar results, highlighting the problem raised earlier of the difference between the literature and empirical results. The most important finding, however, was to see the balance and similarity in the functioning and results of the bank-related and market-related systems. There is therefore a balance between Africa's bank-related and market-related variables.

Finally, the R^2 is satisfactory for this study. The R^2 value is less important in this study as the study is not so focused on growth but rather on the absorption effect of FDI. As far as the F-statistic is concerned, the probability of all variables is highly significant.

It can be concluded that even though FDI is an important source of potential growth, Africa's absorptive capacity are not developed thoroughly enough to convert FDI flows into economic growth. This is proved through the results which indicated that a more market-based financial system does better in absorbing FDI in the economy, maximizing the economic benefit.

While Africa's financial system is not a deterrent to attracting FDI towards the continent, it is unable to utilize this optimally towards the advantage of its people. This inability to absorb FDI is a very important question as it holds a potential solution for Africa's high levels of poverty and underdevelopment.

5.4 Conclusion

This chapter was the empirical contribution of this study to answer the questions of: (i) what are the elements (if any) of Africa's financial system that deter FDI inflows to the continent? (ii) How effective is the absorption of FDI in Africa and which elements of the financial system are able to absorb FDI effectively? (iii) Finally, do FDI inflows and the financial system absorption capacity significantly affect economic growth on the continent?

The study of Alfaro et al. (2004) was used as the basis for this investigation. Alfaro et al. (2004) investigated countries from across the world to answer similar questions about FDI, absorption and growth.

This study however, used the data of 26 African countries to attain an African perspective on the relationship between FDI, the financial system and GDP growth. It was found that when estimating the relationship between financial variables and FDI, financial variables enhance FDI flows towards African countries. There is also some evidence of a balance between the reactions of the bank-related and market-related variables in the regressions. This implies that there are similarities between bank-based and market-based elements. However, markets are still small and underdeveloped.

When determining the influence of initial GDP, FDI, and financial variables on GDP growth, the following can be said; Initial GDP has a significant influence on GDP growth. FDI and FDI combined with financial variables resulted in a few significant but negative relationships from a bank-related perspective. In contrast with that, the significant variable from a market perspective indicated a positive relationship.

Finally, when using financial variables to determine their effect on GDP growth, there was a similarity between bank-related and market-related variables as both indicated a strong significant but negative relationship with GDP growth. This negative is in contrast the literature. Nevertheless, the same results from a global study were found by Alfaro et al. (2004).

CHAPTER 6

CONCLUSION AND RECOMMENDATIONS

6.1 Conclusion

FDI flows to Africa are substantially less than that to other emerging economies. In contrast to many other continents, Africa's performance in terms of growth and development is falling behind. The aim of this study was to investigate and analyse the relationship between FDI, the financial system, and growth on the African continent. The advantages of FDI for economic growth were proven empirically in the past and therefore it is important to determine the effect and possible deterrents of this important capital flow to Africa as well as Africa's absorptive capacities.

When studying FDI it becomes clear that FDI has become progressively more important over the last few years. It is also remarkable that FDI became a major focus area for policy makers when looking at the current competitive efforts by countries to attract this well sought after form of capital flow.

The first objective of this study was to create a theoretical understanding vis-à-vis FDI. This was done in chapter 2, where it was found that several misconceptions about FDI exist and that the definition is not a very familiar concept. An overview of the development of FDI over the last few years was provided and the different determinants, advantages, disadvantages and prerequisites for successful FDI absorption were investigated and identified to give better insight into the rest of the study. From the literature, it was found that FDI can bring two broad kinds of substantial economic benefits to countries.

The first benefit, economic growth, is associated with advantages such as increased capital flows, income, employment and foreign exchange. Improvements in balance of payments as well as income distribution are also positive spin-offs. The second economic benefit is the expansion of productive capacities. Countries benefit from advantages such as the transfer of technology and management practices, the expansion of local stock markets and integration into global markets. FDI also stimulates domestic investment, productivity and innovation. Other positive effects were identified and it was concluded that, from a theoretical perspective, FDI is a

positive contributor to the economy, and that countries should work to attract FDI, especially Africa with its immense economic backlogs.

To translate capital into optimal output, there must be an optimal absorption of the inflowing resources into a country (Alesina & Dollar, 2000). The more effective this absorption, the greater the growth that can be expected (Magarinos, 2000). One of the factors that influence the absorption of FDI is the efficiency of the receiving country's financial system (Faure, 2003).

The second objective was to determine, also from a theoretical perspective, the functioning, composition and elements of the financial system. Chapter 3 focused on the role of the financial system and an explanation of the financial system was provided. Once a thorough definition was made, a historical point of view illustrated, and the basic functioning was understood, the financial system was identified as one of the best vehicles to attract FDI. The importance of the financial system, the relationship between the financial system and growth, basic functions, and an explanation of the relationship between the financial system and FDI helped to reach the objective of understanding this important concept.

Most importantly, two primary types of financial systems were identified, namely: a bank-based and a market-based financial system. These two types of financial system were explained and discussed to give more insight on their roles in attracting and absorbing FDI on the African continent.

These market-based and bank-based systems affect firms' ability to obtain financing in different ways.

The development of a market-based financial system is better suited to long-term financing. Therefore the market-based economy will benefit more and be more efficient in attracting FDI for the long term.

A bank-based financial system, however, is better suited to the availability of short-term financing and therefore banks can be seen as having a comparative advantage in providing such short-term financing.

The third objective was to analyse current global and African FDI, economic growth and financial system trends. This status quo overview indicated, firstly, that Africa is receiving very low levels of FDI relative to the rest of the world and other emerging economies. Even when comparing Africa with other emerging economies, Africa is still way behind. Secondly, it was found that the rate of Africa's economic growth,

which leads to social and economic development are not in tandem with the increasing levels of FDI flows to the African continent. This contributed the question of effective FDI absorption in Africa. The elements of the current financial systems such as banking and stock markets were identified. This led to the identification of different financial system variables, which spurred the empirical investigation.

The last objective and main aim of the study was to answer the following three questions: (i) what are the elements (if any) of Africa's financial system that deter FDI inflows to the continent, (ii) how effective is the absorption of FDI in Africa and which elements of the financial system are able to absorb FDI effectively and (iii) do FDI inflows and the financial system absorption capacity significantly affect economic growth on the continent?

Data from 26 African countries from 1980 to 2002 were used to attain an African perspective on the relationship between FDI, the financial system, and GDP growth.

It was found that the different financial system variables have a positive influence on the attraction of FDI towards African countries. There was also some evidence of a balance between bank-related and market-related variables, which implies that developing a balanced financial system can contribute to FDI inflows in Africa. Equity markets on the continent are, however, still small and underdeveloped.

FDI and FDI combined with financial variables resulted in a few significant but negative relationships from a bank-related perspective. In contrast, the significant variable from a market perspective indicated a positive relationship. This indicates that a more market-based financial system does better in absorbing FDI in the economy, maximising the economic benefit.

Finally, when using financial variables to determine their effect on GDP growth, there was a similarity between bank-related and market-related variables as both indicated a strong significant but negative relationship with GDP growth. This negative is in contrast the literature, however the same results from a global study were found by Alfaro et al. (2004).

From this study, theoretically, FDI is an important source of potential growth globally. However, Africa's absorptive capacity is insufficiently developed to convert FDI flows into economic growth. Africa and its financial systems are able to attract FDI towards the continent but are unable to use this optimally for the advantage of

its people. This inability to absorb FDI is very important as it holds a potential solution for Africa's high levels of poverty and underdevelopment.

6.2 Recommendations and future studies

When comparing the availability of data in the two different financial systems, namely the bank-based and market-based systems, it became clear that Africa's markets are very underdeveloped compared with other emerging market economies. The bank-related development in Africa is much more advanced than the market-related development.

From the empirical analysis, it was found that bank-related variables had a negative impact on GDP growth in the 26 African countries investigated. The only positive and significant relationship was found in a financial market variable. Therefore, African countries need to develop their equity markets, which are currently very small in numbers and size. In doing this, Africa will not only attract more foreign investors as a result of diversification on the continent, but will also improve its economic conditions as the relationship between the financial markets, FDI, and growth has shown in this study.

For the attraction of FDI, Africa needs to focus on the financial variables identified in this study as they showed a positive and significant relationship with FDI. There is evidence as to which financial variables enhance FDI inflows. This information must be used to attract FDI Africa's ability to attract FDI in this way is not enough as it was shown in this study that Africa's share of global FDI is still very low. Benchmarking with other emerging market economies is essential.

The absorption of Africa's FDI to convert it into economic development for reducing poverty also needs attention. The fact that banks receive millions of dollars in the form of FDI and still show a negative relationship with growth is problematic and needs to be investigated.

The potential studies that can be done as a result of this study include:

- The role of African banking in converting FDI into growth.
- Absorption of Africa's markets and banks
- The obstacles in Africa's financial systems.

- The development of African equity markets and regional equity markets in Africa
- The chain of FDI inflows from the original receiver to the worker on the ground

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