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Capital Flows and Macroeconomic Stability: Theoretical and Conceptual Considerations

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I. Introduction

Foreign capital flows are generally desirable as they have played major roles in the development of the industrialised countries (Obadan, 2004) and in the developing countries where domestic resources tend to be in short supply. Capital flows can make significant contributions to the host country's economic growth and development in terms of easing the constraints of low levels of domestic savings and investment (Iyoha, 2004). According to Chatterjee and Turnosky (2005), foreign capital flows in different forms represent an important channel through which wealth is transferred from the rich-developed nations to the poor- underdeveloped nations. The justification for some forms of foreign capital flows were identified in Asher (1966) as rehabilitation and reconstruction of the economies of war-devastated nations, strengthening and subsidising the military defense of the free world, and promotion of economic growth as well as political and economic stability of the underdeveloped countries.

The theoretical foundation for the proposition that capital flows can promote macroeconomic performance and stability of emerging economies was entrenched in the 2-gap model, which posits that development may be hampered by the existence of both the savings and foreign exchange gaps in the developing countries. The savings gap as espoused, arises from the fact that domestic savings tend to be low and as a result fall short of required investment, while foreign exchange gap arises from the fact that most developing countries run import surpluses or balance of payment deficit due to extreme dependence on primary commodity exports, exports instability and internationally transmitted shocks (Iyoha, 2001). Thus, these gaps can be filled by the complementary role of foreign capital flows. However, the practical impact of these flows to augment these gaps in achieving the growth and development of developing countries have not materialised into desired results, thus, questioning the place of capital

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flows in most emerging economies by some scholars. This paper discusses both conceptual and theoretical perspectives of capital flows and their macroeconomic stabilisation strands.

II. Capital Flows: A Review of Concepts, Types and Constraints

Capital Flows refer to the inflow and outflow of capital from one country to another country. It is important to state that capital flows do not relate to movement of goods or payment for exports and imports between countries. It is basically the borrowing and lending between countries (Iyoha, 2004).

II.1 Types of Capital Flows

According to Obadan (2004) and other scholars, the several classifications of capital flows are foreign private investment, official development finance, private and government capital and workers' remittances.

II.1.1 Foreign Private Investment

These are classified into long-term international investment or capital movement. Foreign private investment is a significant aspect of foreign capital flow as it has the ability to stimulate new investment in developing countries (Obadan, 2004). It is basically the transfer of capital, mainly, from the developed countries to the developing countries in the form of portfolio and direct investment to argue the two gap models vis-à-vis: the savings gap and the foreign exchange gap thereby making these countries to achieve their economic potentials (Iyoha, 2004; Obadan, 2004). These flows in the form of portfolio and direct investments can either be inflows or outflows.

a. Foreign Portfolio Investment

This is the acquisition of assets by a foreign national or company in a domestic stock or money market. This is the holding of transferable securities that is either issued or guaranteed by the government of the importing country. These include: equity shares; debentures; bonds; promissory notes and money market instruments issued in a domestic market. The money market instruments include: treasury bills; commercial papers; bankers' acceptances; and negotiable deposits. One prominent feature of foreign portfolio investors is that they seek a share of profits, but do not exercise management control over the companies in which such assets or securities are acquired. The holdings are generally restricted to a small percentage of the total equity so as not to infringe on the management of the enterprise (Obadan 2004). On money and capital market instruments holding, portfolio investors are entitled to only dividends or interest and they can also gain from assets appreciation,

b. Foreign Direct Investment

This is basically a form of lending or finance in the form of equity participation. It is generally the transfer of resources such as capital, technology and management. The International Monetary Fund (IMF) conceptualised foreign direct investment (FDI) as investment that is made to acquire a lasting interest in an enterprise operating in an economy other than that of the investor whose aim is to have an effective voice in the management of the enterprise (Obadan, 2004). For the Organization for Economic Cooperation and Development (OECD), FDI is conceptualised as having at least 10.0 per cent control of the ordinary shares or voting power of an incorporated enterprise or controls less than 10.0 per cent or more of the ordinary shares or voting power of the enterprise, but with an effective voice in the management of the enterprise. FDI could come to the capital importing country as a subsidiary of a foreign firm or as a means of the formation of a company in which a firm in the investing country has equity holdings. It could also be the creation of fixed capital assets in the other country by nationals of the investing country. Basically, it is to exercise *de facto* and *de jure* control over the assets they have created (Obadan, 2004; UNCTAD, 2009).

II.1.2 Official Development Finance

Official Development Finance is basically divided into two aspects, namely: Official Development Assistance (ODA) and Official Development Flows. These two official development finances can be provided on bilateral or multilateral basis. By bilateral flows it implies intergovernmental loans or assistance made on country-to-country basis without involvement of any other country or third party in the negotiation, while multilateral flows come from foreign governments through global institutions and agencies such as the World Bank, International Finance Corporation (IFC), International Monetary Fund (IMF) and their corresponding regional or continental counterparts such as the African Development Bank (AfDB) (Iyoha, 2001; Obadan, 2004; UNCTAD, 2009).

a. Official Development Assistance (ODA)

It refers to public foreign capital on hard or soft terms, in cash or in kind and inter-government grants. Foreign aid may be tied or untied. It may be tied to project and commodities. Untied Aid is a general purpose aid and is known as non-project loan. ODA is defined as those flows originating from official agencies, used to put up infrastructure critical for the development of other sectors of the economy. By characterisation, ODA includes: capital projects; food aid; emergency relief; peace keeping efforts and technical cooperation (Ali, et al., 1999). ODA consists

of official grants or loans with acceptable grant elements from agencies of government or multilateral organisations. A grant, which is also known as a transfer, is an exchange of goods, services or financial instruments that gives nothing in return. However, military assistance or official export credit are excluded from ODA. The grants have no requirement for repayment. They finance net imports without adding to the country's external debt. However, financial flows that are not grants, but qualify as ODA must be concessional and the grant elements must be at least 25 per cent of the flow. It is the grant element that measures the degree of a loan concessionality. The grant element is the difference between the face value of the loan and the sum of the discounted future debt service payments to be made by the borrower expressed as a percentage of the face value of the loan (Iyoha, 2001; Obadan, 2004; Hou et al. 2013).

b. Official Development Flows (ODF)

These are financial flows from official lenders such as government or multilateral agencies which have little or no concessionality and they are geared towards financing development. Official development flows lending is mainly non-commercial, which invariably implies that the providers are not profit maximisers. The main focus is on economic reconstruction and development. Examples are loans from the World Bank or AfDB

II.1.3 Private and Government Capital

Private capital movement means lending or borrowing from abroad by private individuals and institutions. Private capital is generally guaranteed by the government or the central bank of the borrowing country. The profit motive is the principal factor behind such investments. On the other hand, government capital movements imply lending and borrowing between governments. Such capital movements are under the direct control of government. In fact, governments, as important international lenders, make stability loans, loans to finance exports and imports as well as finance particular projects.

II.1.4 Workers' Remittances

Workers' remittances are transfer of money by a foreign worker to his or her home country or simply sending an amount of money from one country to another. They are closely associated with migration. Remittances are playing an increasingly large role in the economies of many countries, contributing to economic growth and to the livelihood of less prosperous people. They have formed significant part of capital flows to developing countries in recent times.

II.2 Limitations and Causes of Capital Inflows and Outflows

The capital flow literature has identified some factors that might affect capital movement among countries. These are:

(i) Interest Rates

The most important factor which affects international capital movement is the difference among current interest rates in various countries. Rates of interest show the rate of return over capital or the user cost of capital. Capital flows from the country in which the interest rates are low to those where interest rates are high.

(ii) Speculation

Speculation relating to expected variations in foreign exchange rates or interest rates affect short-term capital movements. When speculators feel that the domestic interest rates will increase in future, they will invest in short-term foreign securities to earn profit. This will lead to outflow of capital.

(iii) Expectation of Profits

A foreign investor operates with the profit motive at the time of making capital investment in the other country. Where the possibility of earning profit is more, capital flows into that country.

(iv) Bank Rate

A stable bank rate of the central bank of the country also influences capital movements because market interest rates depend on it. If bank rate is low, there will be an outflow of capital and vice versa.

(v) Production Costs

Capital movements depend on production costs in other countries. In countries where labour and raw materials, among others, are cheap and easily available, more private foreign capital flows there. The main reasons of huge capital investments in countries such as South Korea, Singapore, Hong Kong, Malaysia and other developing countries by Multi-national Corporations, (MNCs) is the low production cost.

(vi) Economic Condition

The economic condition of a country, especially size of the market, availability of infrastructural facilities like transportation and communications, power and other resources encourage the inflow of capital.

(vii) Political Stability

Factors such as political stability, security of life and property and friendly relations with other countries, among others, encourage inflow of capital into a country.

(viii) Taxation Policy

The taxation policy of a country also affects the inflow or outflow of capital. To encourage the inflow of capital, progressive taxation policy should be followed such as the giving of tax relief to new industries with foreign collaborations.

(ix) Foreign Capital Policy

The government policy relating to foreign capital affects capital movements. The provision of different facilities relating to transferring profits, dividend, interest, etc to foreign investors will attract foreign capital. Similarly, fiscal and monetary policies of a country also affect capital inflow and outflow.

II.3 Causes of Capital Outflows in Developing Countries

There has been concern recently over illicit capital outflow in most developing countries, particularly Africa. Capital outflow is a key concern to virtually all developing regions of the world. This is because it is not only having destabilising effects on domestic macroeconomic variables, but also results in loss of productive resources to the home country. A number of factors have been identified as responsible for such illicit capital outflow.

(i) Inappropriate Economic Policies

Poor and inappropriate policies have been identified as one of the causes of capital outflows in most developing countries. Such policies include expansionary macroeconomic policies characterised by large budget deficits and accommodating monetary policy, a repressive interest rate regime and overvaluation of the domestic currency. A widening fiscal deficit could trigger capital outflows (Obadan, 2004; Iyoha, 2004).

(ii) Problem of Governance and Weak Institutions

Governance problems reflected in lack of transparency and accountability in the polity are important factors facilitating capital outflows. Other governance issues affecting capital outflows include lack of political will to fight corruption as well as weak institutional frameworks.

(iii) Financial Sector Constraints

Distorted incentives, excess controls of interest rates and other aspects of the financial markets, and weak support systems impose hidden costs, reduce yields and introduce uncertainties as well as risks that tend to encourage capital outflow.

(iv) Financial Sector Distress

Protracted deterioration in bank asset quality and forced closures, which raises fear of capital loss, also encourages capital outflow. Such distress is caused by other adverse domestic or external conditions.

(v) Risk Factors

It has been entrenched that a number of characteristics such as absence of well-established political and institutional arrangements conducive for savings and investments are drivers of capital outflows. Such institutional arrangements include: inadequate institutional and legal arrangements for private property protections; coupled with rampant political instability; improper monitoring and tax collection system, among others.

III. Capital Flows in sub-Saharan Africa: Stylised Facts**III.1 The Trend of Foreign Direct Investment**

The important sources of FDI for Africa in the 1980s and early 1990s were the European Union, Japan and the United States, the so-called "Triad". During the 1982 to 1996 period, France, Germany and the United States accounted for 80.0 per cent of FDI inflows to the continent. Other countries gaining importance thereafter, were Canada, Italy, and the Netherlands. Together with Norway, Portugal, and Spain, these countries helped to reduce the rate of decline of Africa's share of FDI. Between 1988 and 1997, these six countries increased their share in African FDI inflows from 8.0 per cent to more than 22.0 per cent (UNCTAD, 1998).

Over the past decade, a noticeable foreign direct investment has come from the developing countries themselves who are emerging as outward investors – the so called "South-South FDI" UNCTAD (2004) reported that the South-South flows were growing faster than North-South flows. Africa is part of this broad trend, with investors from other developing countries, particularly South-East Asia, having emerged as new sources of FDI. A recent World Bank report indicated a massive increase in investment from China into SSA through the later half of the 1990s. Between 1990 and 1997, Chinese investment into Africa

amounted to about \$20 million, but from 1998 to 2002 that increased six-fold to \$120 million (World Bank, 2004). The report indicates that there were 450 Chinese-owned investment projects in Africa, of which 46.0 per cent were in manufacturing, 40.0 per cent in services and only 9.0 per cent in resource-related industries.

In addition, Taiwan has been a major source of FDI into Africa. Taiwanese investment into South Africa increased substantially during the 1980s, but more recently, in response to the African Growth and Opportunities Act (AGOA), Taiwanese investment has entered several other Southern and Eastern African countries. Currently, as many as 700 Taiwanese investment projects are present throughout sub-Saharan Africa (Gelb, 2005). The third Asian country that is rapidly growing as an important investment source in Africa is India. India is the largest investor in Ghana since 1994 with more than 225 projects (GIPC, 2006). An estimated 35 Indian companies are present in South Africa, but the figure is higher in terms of projects (Gelb, 2005).

Much less investment is coming into Africa from Latin America, although Brazilian firms are now starting to invest in other Lusophone countries in Africa, - i.e. Angola and Mozambique in particular. Other significant investors in the region include Lebanon and Portugal, albeit for select countries. For instance, Lebanese firms in Ghana are responsible for more than 175 projects since 1994 (GIPC, 2006). Some African firms, particularly from South Africa and Nigeria, are becoming MNCs and also investing in other African countries. Since its democracy in 1994, South Africa has claim over 600 projects in the continent. It accounts for more than 50 per cent of all investments to Botswana, Lesotho, Malawi, Swaziland and Democratic Republic of Congo. Nigerian firms, on the other hand, are active in countries within the West African Region.

Based on a recent UNCTAD data, global foreign direct investment indicated a declining trend. From a peak of US\$2 trillion in 2007, it fell to US\$1.8 trillion in 2008 and then US\$1.2 trillion in 2009, followed by a recovery in 2010 and 2011 to US\$1.4 and US\$1.6 trillion, respectively (UNCTAD, 2013). FDI flows to sub-Sahara Africa (SSA) have experienced a significant increase over the past decade, moving from less than US\$7.0 billion in 2000 to about US\$37.0 billion in 2011 (UNCTAD, 2012). Between 2006 and 2008, inward FDI to SSA grew by about 118 per cent, reaching its highest level at US\$37.3 billion. In 2009 and 2010, FDI inflows to SSA declined, owing to the global financial crisis (GFC). Although, African countries have long been seen as attractive because of Africa's vast natural resource endowment, a recent survey conducted by the Economist Intelligence Unit (2012) showed that a number of other factors have also

been significant in enhancing SSA attractiveness to investors over the past few years. The most important are: Africa's emerging middle class and different consumption patterns; its strong economic growth; and high commodity prices. These are followed by several other factors such as increased political stability, favourable demographics, and improved fiscal and monetary policies.

Indeed, while FDI inflows to low income countries experienced increases of 3.0 and 35.0 per cent in 2009 and 2010, respectively, those to middle income countries declined by about 13.0 per cent and 37.0 per cent, respectively, in the same period. Among middle income countries, Nigeria and South Africa were the largest recipients of inward FDI in 2011; Mozambique, Chad, Democratic Republic of Congo, Guinea and Tanzania were the top five low income countries destinations of FDI inflows (Hou et al., 2013). It is noteworthy also that over the last decade, most of the FDI inflows to SSA middle income countries and low income countries were to natural-resource-rich developing countries (see, Hou et al., 2013). However, the increase in FDI flows to non-resource rich countries was greater than in those to natural-resource-rich developing countries. FDI directed to natural-resource-rich developing countries was affected by the global turmoil, experiencing a decline of 15.0 per cent between 2009 and 2010, while that to non-natural-resource-rich developing countries continued to increase. Looking at the countries of origin of FDI, Europe is a key investor in SSA and, FDI inflows to SSA from European Union countries experienced an upward trend up until 2009, before contracting in 2010 and 2011, partly because of the Euro Zone crisis.

The BRICS¹ countries have also become important investors in Africa. Data showed that in 2010, BRICS represented 25.0 per cent of total FDI flows to the continent (Table 1). FDI flows from the EU, which is still the largest investor in Africa, accounted for 41.0 per cent of the region's FDI flows in the same year.

Among the BRICS countries, the major investor in Africa is China, followed by India and South Africa (UNCTAD, 2013). Chinese FDI flows to SSA have grown very rapidly since the mid-2000s, reaching a high of US\$5,416 billion in 2008 (UNCTAD, 2013). After experiencing an 80.0 per cent decline in 2009 after a one-off large investment, they recovered slightly to US\$1,883 billion in 2010 – which is still significantly below the 2008 peak.

¹ Brazil, Russian Federation, India, China, South Africa

Table 1: Africa: estimated FDI inflows, 2010

	Millions of dollars	Share in total
Home region		
Total world	39,540	100
<i>Developed countries</i>	26,730	68
European Union (EU)	16,218	41
North America	9,281	23
<i>Developing economies</i>	12,635	32
Asia	9,332	24
<i>South-East Europe and Commonwealth of</i>	175	0
Memorandum		
BRICS	10,007	25

Source: UNCTAD 2013 & Hou et al. 2013

A key factor in Chinese FDI to SSA was Africa's richness in natural resources (Mlachila and Takebe, 2011). For example, the continent has large reserves of oil (e.g. in Nigeria and Angola) and is also rich in non-fuel minerals (e.g. platinum and gold in South Africa, cobalt in Democratic Republic of Congo, copper in Zambia and diamonds in Angola). Besides this, other macroeconomic and structural factors (e.g. improved investment and business environment, better macroeconomic conditions, and privatisation processes, among others) are also relevant to the increase of Chinese FDI in SSA. Chinese FDI flows to SSA are directed mainly to natural-resource-rich developing countries such as South Africa, Sudan, Nigeria and Zambia (UNCTAD, 2013).

However, there is evidence that Chinese FDI to SSA is becoming increasingly diversified, moving into manufacturing and services sectors (Table 1). This is the case even in resource-rich developing countries (RRDCs) such as Zambia, where Chinese FDI flows have targeted not only the mining sector, but also the financial, telecommunication, tourism, garments, textiles and agro-processing sectors.

The manufacturing and services sectors have attracted the biggest share of Indian FDI flows to Africa, while Brazilian FDI has focused mainly in the natural-resource sector (UNCTAD, 2013; Mlachila and Takebe, 2011). Russian FDI flows to Africa, however, are both resource-seeking and market-seeking (UNCTAD, 2013). It is also worth noting that Indian and Brazilian FDI tend to be concentrated in a limited number of countries in SSA. For example, the bulk of Indian FDIs in Africa is directed to Mauritius, while Brazilian FDI flows are mainly concentrated in Angola and Liberia (UNCTAD, 2013; Mlachila and Takebe, 2011).

III.2 Portfolio Equity Flows

Portfolio equity inflows to SSA have been rather volatile over the last decade. In the mid-2000s, they reached a high of about US\$17.0 billion in 2006 (of which 89.0 per cent went to South Africa). In 2007, however, portfolio equity inflows experienced a significant decline of 40.0 per cent because of the global financial crisis, and in 2008 they even reversed.

This clearly showed that SSA's equity markets were not immune to financial contagion during the crisis. The slowdown and reversal in portfolio equity inflows to SSA countries were, indeed, consistent with the sharp fall of their stock markets. Table 2 shows that stock markets in South Africa, Nigeria, Kenya, Mauritius, and Côte d'Ivoire were hit hard in 2008.

Table 2: Selected SSA countries: Stock Index Change in 2008

Index	% change in 2008
Nigeria All Share Index	-46
Mauritius All Share Indices	-36
Nairobi Stock Exchange 20-Share Index	-34
Johannesburg Stock Exchange All Share Index	-26
BRVM (Regional Securities Exchange) Composite Index	-11

Source: adapted from Hou et al. 2013

In 2009, portfolio equity inflows to SSA started to recover, reaching a new high of about US\$16.0 billion in 2010 (Hou et al., 2013). Although flows declined by about 47.0 per cent when the Euro Zone crisis hit in 2011, there were no outflows as in 2008. Massa et al., (2012) reported that stock markets in countries such as Nigeria and Kenya were largely affected by the Euro Zone crisis, experiencing heavy sell-offs as a result of a global flight to safety of capital. Notwithstanding, the storms of the global financial and euro zone crises, stock markets in SSA have made important progress over the past decade. Nevertheless, a number of serious challenges need to be met to facilitate growth in portfolio equity inflows. First, is the fact that SSA stock markets are still thin and very illiquid. Stock market regionalisation may help to overcome this barrier, and there are already a few initiatives in this direction. Plans to form regional stock exchanges abound across the continent.

III.3 Bond Flows

Bond flows in SSA have also been volatile over the past decade (Hou et al. 2013), and concentrated in the Middle Income Countries. After reaching a peak value of more than US\$ 7 billion in 2007, when Nigeria, Ghana and Gabon issued bonds

internationally for the first time, these flows were strongly hit by the global financial crisis in 2008.

- Nigeria issued a US\$350.0 million private corporate bond in January 2007 and a US\$ 75 million private corporate bond in March 2007;
- Ghana issued a US\$750.0 million Eurobond in September 2007;
- Gabon issued a US\$1.0 billion 10-year Eurobond in December 2007 (Hou et al., 2013). Many bond issuance plans were put on hold. In particular, Ghana cancelled plans for a US\$300 million debt issue, owing to poor global market conditions; Kenya delayed a planned debut of US\$500 million Eurobond; Tanzania postponed plans to issue a debut Eurobond totalling at least US\$ 500 million; and Uganda did not issue a debut Eurobond to fund infrastructure projects (Brambila-Macias and Massa, 2010).

A substantial recovery in bond flows occurred in 2009. In 2010, bond inflows to SSA declined by about 28.0 per cent to US\$1.4 billion, and then increased to US\$6 billion in 2011. This showed that, compared with the 2007–8 global financial crisis level, when several bond issuance plans were put on hold in SSA countries, the Euro Zone crisis has affected bond inflows much less. Indeed, Namibia and Senegal were still able to issue bonds successfully for the first time, notwithstanding the crisis in the euro area (Massa et al., 2012).

There has been a rapid scaling up of bond flows in 2011 and 2012 (judging by recent reports) and more was expected in 2013 (some argue that Africa is set for a sovereign debt rush³), suggesting that bonds flows are likely to be an important source of non-concessionary external finance for a number of African countries, which are gradually graduating out of the poorest economy status.

III.4 External Debt Flows

The total external debt of the SSA economies has been rising slowly in nominal terms since 2006. It was largely constant until 2006, the year after debt cancellation took place for a number of African countries. The level of external debt increased during the global financial crisis. However, the ratio of external debt to exports fell steadily to about 60.0 per cent after the debt cancellation in 2005 (Hou et al., 2013). Since then, it has been almost flat despite a slight upward movement during the recent financial crisis.

III.5 Official Development Assistance (ODA) to Africa

With the main objective of promoting economic development and welfare of the recipient countries, ODA has a long repayment horizon suitable for

infrastructure projects with long gestation periods. ODA flows to Africa declined as part of a broader trend of the decline in total official flows to developing countries in the late 1990s, but remained a significant component of external financial flows to the region. Throughout the past three decades, ODA flows showed a general upward trend, climbing in nominal terms and growing significantly between the mid-1970s and early 1990s and resumed growth again in 2001 due to debt relief (White, 2003).

African countries in the past three decades continued to rely largely on ODA than other regions of the developing world. For instance, while ODA flows to Africa were as much as US\$33 per capita in 1991, the average ODA of other low-income countries was US\$14.0 per capita. Similarly, while ODA flows contributed to 5.3 per cent of African gross national product (GNP) in 1996, the corresponding proportion for other low-income countries was lower at 3.5 per cent (Ali et al., 1999).

Some of the recent boost in ODA flows reflects debt relief granted under the HIPC Initiative and other special purpose grants both directly attributable to the effort of the G-8 countries to put Africa on a sustainable development path. Debt relief grants in 2005 totaled US\$23.0 billion, up more than five-fold of its 2004 figure. Aid to sub-Saharan Africa as percentage of total aid, has for the most part, been more than triple that of other regions, emphasizing the importance of these official flows to the region. The top recipient countries for ODA within Africa have varied although, since the late 1990s, the list has included Democratic Republic of Congo, Tanzania, Mozambique, Uganda, Madagascar, Ghana, Ethiopia and Zambia (Ali et al., 1999). These countries are part of those classified as Heavily Indebted Poor Countries (HIPCs). Most of the aids goes to the social sector of the economy for purposes of improving education, health and infrastructure development.

III.6 Workers' Remittances

The 2005 Global Development Finance Report estimated that remittances reached US\$161.0 billion in 2004 and US\$167.0 billion in 2005. Remittances seem to be unique in that they appear more evenly distributed and less volatile than the rest of the capital flows to developing countries (Table 3). Nevertheless, the report acknowledged the shortcoming of these figures, which take into consideration remittances channeled via official systems. One would argue that for Africa, it is very plausible that an equal or greater amount is channeled via informal means.

Table 3: Workers' Remittances to Developing Countries, 1990- 2004 (US\$ billions)

	1990	1995	2000	2001	2002	2003	2004
Developing Countries	31.3	56.7	76.8	84.6	99.0	116.0	125.8
Lower middle-income	17.5	34.8	41.9	44.1	49.1	54.8	55.6
Upper middle-income	5.7	8.6	13.1	18.8	18.7	24.4	26.8
Low income	8.1	13.3	21.7	23.8	31.2	36.7	43.4
Latin America and the	5.8	13.4	20.2	24.2	28.1	34.1	36.9
South Asia	5.6	10.0	16.0	16.0	22.3	26.7	32.7
East Asia and the Pacific	3.2	9.0	11.2	12.9	16.6	19.5	20.3
Middle East and North	11.7	13.0	13.5	15.2	15.5	16.8	17.0
Europe and Central Asia	3.2	8.1	11.0	11.4	11.5	12.8	12.9
Sub-Saharan Africa	1.9	3.2	4.9	4.9	5.1	6.0	6.1

Source: IMF Balance of Payments Statistics Yearbook 2004 and World Bank estimates cited by Global Development Finance 2005 as adapted from Mhlanga and Christy (2006).

III.7 Capital Outflow in Africa²

While Africa is fast becoming the darling of foreign direct investment (FDI) and economic growth and aid organisation, Oxfam International raised concerns that the continent's development is being held back by a massive and illicit outflow of capital. This was part of discussions held ahead of the World Economic Forum on Africa, which started in Cape Town, bringing together political, corporate and civil society leaders to discuss the opportunities and challenges on the continent. According to Oxfam, *Business Day* reported that, while Africa's oil, gas and mineral exports amounted to US\$333.0 billion in 2010, illicit financial outflows, achieved, for example, through tax evasion and trade mispricing by extractive industries, were estimated at US\$200.0 billion annually, dwarfing development aid inflows to the continent.

Furthermore, a joint report by the African Development Bank and the Global Financial Integrity (2013) showed that Africa lost between US\$1.2-US\$1.4 trillion over the 30-year period, 1980-2009 through illicit financial flows, with illicit outflows from Sub-Saharan Africa outstripping those from North Africa by over two times. In real terms, three African regions - West and Central Africa at US\$494.0 billion (37.0 per cent), North Africa at US\$415.6 billion (31 per cent), and Southern Africa at US\$370.0 billion (27.0 per cent) - accounted for 95.0 per cent of total cumulative illicit outflows from Africa over the 30-year period. Estimates by country in the report showed that the large outflows from: West and Central Africa are driven largely by Nigeria, the Republic of Congo, and Cote d'Ivoire; North Africa are driven by outflows from Egypt, Algeria, and Libya, and Southern

² This is a report extracted from Risk Africa Magazine, October 12, 2013.

Africa are driven mainly by South Africa, Mauritius and Angola. Nigeria, South Africa and Egypt are the three largest exporters of illicit capital from Africa based on volume of outflows. However, the relative severity of the problem of illicit flows among African countries can be assessed using several measures. The study utilises "normalisers" such as GDP, external debt, exports, official development assistance and population to gauge the extent of the problem.

IV. Capital Flows and Macroeconomic Stabilisation

In this section, the ways in which capital flows and policy interact to determine macroeconomic outcomes are outlined. The discussion is classified into the implications of capital inflows and outflows on the macroeconomy.

IV.1 Capital Inflows and the Macro-Economy

Capital flows affect a wide range of economic variables such as exchange rates, interest rates, foreign exchange reserves, domestic monetary conditions and savings and investments. Some commonly observed effects of capital inflows that have been documented in recent studies include: real exchange rate appreciation; stock market and real estate boom; reserves accumulation; monetary expansion and effects on production and consumption. Empirical studies that have begun to appear on the subject assess the impact of capital inflows upon output growth (Gruben and McLeod, 1996), differential macroeconomic effects of portfolio and foreign direct investment (Gunther, Moore and Short, 1996) and effects upon monetary conditions, savings and investment (Kamin and Wood, 1998). Several studies, notably Corbo and Hernandez (1994), Calvo, Leidermann and Reinhart (1994) and Khan and Reinhart (1995), amongst others, have documented these effects for Latin America and East Asia. Some commonly observed effects of capital inflows are exchange rate appreciation, monetary expansion, rise in bank lending if the flows are intermediated through banks and effects upon savings and investment (Kohli, 2001).

a. Exchange Rate Appreciation:

In theory, an inflow of foreign capital will raise the level of domestic expenditure in the economy, raising the demand for non-tradable goods that results in an appreciation of the real exchange rate. The price-adjustment process then leads to a reallocation of resources from tradable to non-tradable goods and a switching of expenditures in favour of non-tradables. The rise in aggregate expenditure also increases the demand for tradables, leading to a rise in imports and a widening of the trade deficit. The transmission channel of the real exchange rate appreciation will, however, depend on the exchange rate regime. With a floating exchange rate and no central bank intervention, the

appreciation will take place through a nominal appreciation, but in a fixed exchange rate regime, the appreciation will work through an expansion in the domestic money supply, aggregate demand and the prices of non-tradeables. The behaviour of the real exchange rate in response to capital inflows has been an important area of concern and has been examined in several recent studies. Calvo, Leiderman and Reinhart (1993) and Edwards (1999) have explored the association between capital inflows and real exchange rates for a set of Latin American countries. They find substantial evidence that capital inflows contributed both to real exchange rate appreciation and reserves' accumulation in these countries.

b. Reserve Accumulation:

Capital inflows can be traced to either international reserves' accumulation or a current account deficit, depending upon the exchange rate regime. If there is no intervention by the central bank, i.e. the exchange rate regime is a pure float, then the net increase in capital assets via capital inflows would be associated with a similar increase in imports and therefore a widening current account deficit. Alternately, if the exchange rate regime is fixed and the central bank intervenes to counter appreciation pressures, then capital inflows would be visible in increase in foreign exchange reserves. Since the two extremes are rarely observed in practice, the choice of intervention, or its size, narrows down to the degree of exchange rate flexibility desirable by the authorities and is, in essence, a policy choice.

c. Impact on Monetary Conditions and Sterilisation:

Capital inflows impact on domestic money supply through accumulation of net foreign currency assets with the central bank. Whether the monetary base is altered or not depends on whether the central bank intervenes to maintain a fixed exchange rate or allows it to float freely with no intervention. If there is intervention, then an accumulation of international reserves represents an increase in the net foreign exchange assets of the central bank and directly affects the monetary base. Inferences based upon mere movements of the monetary variables, however, are in danger of amounting to conjecture, as these are also driven by domestic conditions. The relationship between capital inflows and money supply, therefore, needs to be investigated more carefully, as a monetary expansion implies inflation and if the central bank's monetary growth targets are disrupted, it may be desirable to insulate the impact of capital flows on money supply. This is typically done through sterilisation, which is simply the exchange of domestic assets for foreign assets. Typical sterilisation tools in developing countries are open reserve requirements and to a lesser extent, open market operations. The former has been a common monetary management tool

in Southeast Asia, and also, in some parts of Latin America (Chile, Mexico), use to insulate domestic money supply from the expansionary effects of capital inflows.

Recent econometric evidence shows the impact of capital flows on monetary growth. For instance, Kamin and Wood (1998) uncovered a significant independent effect of capital flows on domestic money demand for Mexico and the Pacific Basin group of countries. Both reserve changes and net capital inflows tended to lower interest rates and raise M_2 , particularly in Mexico. In most developing countries, the securities markets are thin, with the result that central banks typically rely heavily on reserve requirement changes. While it is difficult to collect evidence on the magnitude of sterilisation, it has been conceded elsewhere that a complete offset could not be achieved. Occasionally, other sterilisation instruments like open market operations, swap operations with commercial banks, cuts in central bank credit and rediscounts, increase in the rediscount rate, conversion of commercial bank debt of public institutions and transfer of assets of pension/provident funds, among others, have been used to bring about monetary tightening.

IV.2 Capital Outflow and the Macroeconomic Stabilisation³

Capital Outflow has several consequences both in the short-run and long-run and these include:

First, in the short-run, capital outflow destabilises domestic interest rates, exchange rates and the country's international reserves. The outflow creates a shortage of liquidity in the system, which pushes interest rate higher. In floating exchange rate regime, capital outflow tends to depreciate the domestic currency, but in fixed exchange regime, it results in exchange reserves loss, which constrains the ability of the country to import capital goods necessary for growth. Second, in the long-run, it reduces growth potential resulting from inability to finance domestic investment leading to decline in capital formation. Furthermore, the tax base is eroded as income and wealth generated are held abroad through capital outflow and such tax erosion leads to potential loss of revenue to government and reduction of its ability to service its debt and lastly, by reducing government revenue and diverting savings out of the country, capital outflow increases the need to borrow from abroad thereby increasing the foreign debt burden.

³ For detailed capital outflow consequences (see Obadan, 2004).

V. Capital Flows and Macroeconomic Stabilisation: ⁴Theoretical Arguments on the Benefits and Costs

Considered and discussed below are the arguments in favour of benefits and costs of capital flows across countries as opined by some economists and policy makers:

V.1 The Benefits of Capital Flows

Theoretical arguments supporting international capital flows in ensuring macroeconomic stabilisation from the point of view of its potential benefits are discussed as follows:

1. Consumption Smoothing

Access to international capital flows may allow a country to engage in risk sharing and consumption smoothing behaviours, by making the country to borrow in 'bad' times such as a recession or a sharp deterioration in the country's terms of trade and as well lend in 'good' times. Capital flows have the potential to increase household welfare and this is possible by making them to smoothing their consumption path over time. However, this 'counter-cyclical' role of world capital flows is particularly important if shocks are *temporary* in nature.

2. Domestic Investment and Growth

The possibility to draw from the international pool of resources from world capital market may also influence domestic investment and growth. Most emerging economies are faced with low saving rate resulting from low level of income and as a result domestic saving could not meet up with the desired investment that could put these economies on the path of desired growth and development. Consequently, experts argue in favour of foreign capital flows to augment this short fall in domestic saving, increase levels of physical capital, and facilitate the recipient countries, to increase their rate of economic growth and improve living standards. Foreign Direct Investment (FDI) has received much attention in exerting these potential benefits than other forms of capital flows (MacDougall, 1960; Berthélemy and Démurger, 2000; Borensztein et al. 1998; Grossman and Helpman, 1991).

3. Enhanced Macroeconomic Discipline

It has been argued that by increasing the rewards of good policies and the penalties for bad policies, the capital flows across borders may induce countries to follow sound macroeconomic policies and thus, reduce the incidence of policy mistakes. Burside and Dollar (2000) also opined that good policies are

⁴ For detailed discussion of the theoretical arguments for capital flows (see Agénor, 2001)

responsible for capital flows resulting in better macroeconomic performance of recipient countries and this invariably will produce macroeconomic discipline so as to be able to access more capital flows. Consequently, greater policy discipline translates into greater macroeconomic stability, leading to higher rates of economic growth, and this is entrenched in the recent endogenous growth literature. Similarly, Bartolini and Drazen, (1997) argued that capital flows can act as a 'signal' that a country is willing to adopt 'sound' macroeconomic policies, for instance by reducing budget deficits and forgoing the use of inflationary tax. Against this backdrop, an open capital account may also encourage macroeconomic and financial stability, ensuring a more efficient allocation of resources and higher rates of economic growth.

4. Banking System Efficiency and Financial Stability

An increasingly common argument in favour of capital flows across border is that it may increase the depth and breadth of domestic financial markets and lead to an increase in the degree of efficiency of the financial intermediation process, by lowering costs and 'excessive' profits associated with monopolistic or cartelised markets. Invariably, improved efficiency may lead to lower markup rates in banking, a lower cost of investment and higher growth rates (Baldwin and Forslid, 2000).

V.2 The Costs of Capital Flows

In the past decades, the experience of capital flows across borders has led economists and policymakers to identify that, besides the possibility of its macroeconomic stabilisation; it may also induce instability and greater costs. The following issues were put forward to support this notion:

1. Concentration of Capital Flows and Lack of Access

There is sufficient evidence that periods of 'surge' in cross border capital flows tend to be highly concentrated to a small number of recipient countries. The dramatic increase in capital inflows in the early 1990s, for instance, was directed to only a small number of large, middle-income countries of Latin America and Asia (Fernandez-Arias and Montiel, 1996). However, despite this significant increase, capital flow to sub-Saharan African region, compared with other developing economies is still low. Recent evidence points to the fact that the region is largely marginalised in the area of financial globalisation (Ndikumana and Verick, 2008; Ogunleye, 2009). The share of total private capital flows to low-income countries actually fell during the 1990s whereas the share to the top ten recipients increased significantly (World Bank, 2001). Little foreign capital is directed at sub-Saharan African countries, and most of what flows to the region is limited to a few countries with significant natural resources (Bhattacharya et al.

1997; and Basu and Srinivasan, 2002). Thus, a number of developing countries may simply be 'rationed out' of world capital markets – regardless of how open their capital account is.

2. Domestic Misallocation of Capital Flows

Although the inflows of capital associated with an open capital account may raise domestic capital, their impact on long-run growth may be limited if such inflows are used to finance speculative or low-quality domestic investments (real estate sector). Low-productivity investments in the non-tradable sector may reduce over time the country's ability to export and this may lead to rising external imbalances. The misallocation of capital inflows may in part be the result of pre-existing distortions in the domestic financial system. In countries with weak banking sector and poor supervision of the financial system, the direct or indirect intermediation of large amounts of funds by the banking system may exacerbate the moral hazard problems associated with deposit insurance. That is, lenders may engage in riskier and more concentrated or outright speculative loan operations.

3. Loss of Macroeconomic Stability

Capital inflows induced may have undesirable macroeconomic effects, such as rapid monetary expansion resulting from the difficulty and cost of pursuing sterilisation policies, inflationary pressures due to its influence on domestic spending, real exchange rate appreciation and widening current account deficits resulting from reduced export value. In flexible exchange rate regime, growing external deficits tend to bring about a currency depreciation, which may eventually lead to a realignment of relative prices and induce self-correcting movements in trade flows. By contrast, under a fixed exchange rate system, losses in competitiveness and growing external imbalances can erode confidence in the viability and sustainability of the peg, thereby precipitating a currency crisis and increasing financial instability.

4. Pro-Cyclicality of Short-Term Flows

Small developing economies are often marginalised in the world capital markets. Furthermore, among those countries with a greater potential to access these markets specifically, oil producers, the availability of resources may be *asymmetric*. These countries may indeed be able to borrow only in 'good' times, whereas in 'bad' times they tend to face credit constraints. Access may thus, be pro-cyclical. Clearly, in such conditions, one of the alleged benefits of accessing world capital markets, the ability to borrow to smooth consumption in the face of temporary adverse shocks, is simply a fiction. Pro-cyclicality may, in fact, have a perverse effect and increase macroeconomic instability: favourable shocks may

attract large capital inflows and encourage consumption and spending at levels that are unsustainable in the longer-term, forcing countries to over-adjust when an adverse shock hits (Dadush *et al.*2000). This invariably suggested that overdependence on external capital tend to put such countries on undue macroeconomic crises.

5. Herding, Contagion and Volatility of Capital Flows

A greater degree of financial openness could lead to a high degree of volatility in capital movements. The possibility of large reversals of short-term capital flows raises the risk that borrowers may face costly 'liquidity runs', (Chang and Velasco, 2000). The higher the level of short-term debt is relative to the borrowing country's international reserves, the greater the risk of such runs. High levels of short-term liabilities intermediated by the financial system also create risks of bank-runs and systemic financial crises. In general, the degree of volatility of capital flows is related to both actual and perceived movements in domestic economic fundamentals, as well as external factors, such as movements in world interest rates. More generally, the fact that investors' sentiment (particularly that of highly leveraged, speculative trading institutions, such as hedge funds) is constantly changing in response to new information creates the potential for markets to overshoot on a scale that can generate financial crisis with very large economic and social costs. Short-term portfolio flows, in particular, tend to be very sensitive to herding among investors and contagious factors. Although investor herding is seen by some as evidence of irrationality, some recent literature suggests differently. In any case, rational or irrational, herding behaviour often translates into large movements into and out of certain types of assets and exacerbates fluctuations in asset prices and capital movements. Volatility of capital flows can also result from contagion effects.

VI. Conclusion

The paper, which is basically a review of concepts and theoretical considerations on the relationship between capital flows and the macro-economy, has attempted to review the nature and types of capital flows to Africa as well as their significance in the various recipient countries. The paper, while making effort to identify the other side of capital flows – i.e. the outflows through illicit channels, focused largely on the inflows and their effects on macroeconomic stability. Given that the nature and volume of capital outflows from the continent in recent times has become large and worrisome, there is an urgent need for attention to be re-directed to these illicit financial outflows from Africa, which are reported to be huge and of greater magnitudes than the inflows. If efforts in addressing this issue are sustained, Africa will be better off in obtaining the needed financial resources to promote rapid economic development.

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