Journal of Applied Economics. Vol XVII, No. 1 (May 2014), 63-88

DETERMINANTS OF FOREIGN CAPITAL FLOWS: THE EXPERIENCE OF SELECTED SUB-SAHARAN AFRICAN COUNTRIES

William Gabriel Brafu-Insaidoo and Nicholas Biekpe*
University of Cape Town

Submitted October 2011; accepted May 2013

This study investigates the major determinants of international capital flows in selected countries in Sub-Saharan Africa. Both theory and the empirical literature suggest that financial liberalization and regionalism lead to higher levels of capital inflows. By using a dynamic panel data analysis, this research tests these hypotheses. The impact of financial liberalization depends on the type of liberalization implemented. Liberalization of the domestic financial system and the domestic equity market has a positive and significant impact on international capital flows. Aggregate capital account liberalization is not significant, but the elimination of multiple exchange rates significantly affects international capital flows, while other components have a more limited impact: the liberalization of inward FDI directly increases foreign direct investments, whilst the deregulation of offshore borrowing directly causes an increase in foreign debt inflows. Regionalism causes an increase in foreign direct investment inflows but does not affect other forms of capital inflows.

JEL classification codes: F2, F21, F3, F34, F4, F40, F41, F43
Key words: international capital flows, financial liberalization.

I. Introduction

A number of countries across the world have taken steps to encourage cross-border investment flows, based on the notion that increased capital flows bring benefits in the form of increased efficiency in the allocation of global resources

* Nicholas Biekpe (corresponding author): Graduate School of Business, University of Cape Town, Republic of South Africa; tel: +27 21 914 6778; email: nicholas.biekpe@gsb.uct.ac.za. William Gabriel Brafu-Insaidoo: Graduate School of Business, University of Cape Town, Republic of South Africa; email: winsaidoo@yahoo.com

(Kose et al. 2005). This initiative has led to a surge in international investment flows over the past two decades (Agenor 2003; Lane and Milesi-Ferretti 2003; Morrison and White 2004; and Vo 2005). Sub-Saharan Africa has, however, received a comparatively smaller share of the increased global flows.[1] This raises an important issue and policy challenge for the region, namely, how to increase incentives to attract a greater share of the increased global flows.

Kaminsky and Schmukler (2003), Prasad et al. (2003), Campion and Neumann (2004) and Caprio et al. (2001) suggest that countries can increase incentives to attract more international capital flows by de-regulating activities in their domestic financial markets, and liberalizing their capital account transactions and equity markets. They further explain that these policies can cause an increase in international capital inflows by reducing transaction costs and quantitative limits of ownership and investments, and by increasing returns on assets. Another body of literature, including Baldwin (1997), Wakeman-Linn and Wagh (2008), and Garcia-Herrero and Wooldridge (2007), suggests that countries that are active members of regional blocs or signatories to regional free trade and investment agreements tend to attract more foreign investment flows. They further argue that this regional initiative can attract more foreign investments by producing benefits in terms of exploiting wide-ranging scale economies, expanded trade links and enhanced financial development within the regions concerned.

Given their arguments, we can hypothesise therefore that countries that deregulate their domestic financial markets, and liberalise their capital account transactions and equity markets attract greater inflow of international capital. We can also postulate that regionalism causes greater inflows of international capital. Despite the seemingly conventional wisdom in the hypotheses, the empirical literature, including studies on Africa by Delechat et al. (2009), Asiedu and Lien (2004) and the International Monetary Fund (2008), fail to provide any conclusive evidence on the relationship between external financial liberalization and international capital flows. The lack of consensus could stem from the use of aggregated indices or a binary dummy as proxy measures for external financial liberalization, which comprises the liberalization of capital account transactions

[1] Total foreign private capital inflow and official aid inflow to sub-Saharan Africa amounted to 126 billion United States Dollars, accounting for merely 2 percent of total global capital inflows in 2007.