Effect of Economic Risk on Regional Financial Integration in Africa

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Abstract

The study investigated the effect of economic risk on regional financial integration in African from 2006 to 2022. Nigeria and South Africa were selected to represent two African regions (West and Southern regions). Economic risk was proxied by inflation rate, debt service, parallel foreign exchange rate and foreign trade, while net capital inflow was used to proxy regional financial integration. The estimation technique used in the study was panel regression analysis. Findings from the study revealed that foreign trade, parallel foreign exchange rate and debt service, exhibited a significant positive effect on net capital inflow. The study therefore concluded that implementation of stable macroeconomic and "investor friendly" policies will dramatically increase net capital inflows into African economies.

Keywords: *foreign trade, debt service, parallel foreign exchange rate, macroeconomic policy, net capital inflow, investor friendly.*

JEL Classification codes: *F2, F32.*

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Introduction

Africa continent has gone to great lengths to promote harmonious relationship and intra-regional trade via the establishment of institutions coupled with regional bodies. For instance, in 1964 marks the introduction of African Development Bank (AFDB), in 1975, the Economic Community of West African States (ECOWAS) was initiated, Similarly, 1980 marks the introduction of Southern African Development Community (SADC), the East African Community (EAC) was initiated in 1999, in 1983, the Economic Community of Central African States (ECCAS) was founded, the Common Market for Eastern and Southern Africa (COMESA) in 1994, the African Union in 2002 among others (Ajayi, 2024). In an attempt to foster economic recovery coupled with stable development witness the establishment of the African Continental Free Trade Area (AfCFTA) in

2018. However, all these initiatives were meant to further strengthen financial integration among countries in Africa (Ajayi, 2024; Ekpo & Chuku, 2017). Due to banks' monopoly, markets typically lack other financial institutions, while the remaining financial institutions may be too small to profit from economies of scale. Microfinance, insurance, pension, and finance firms are NBFIs that are usually overlooked (West African Monetary Agency 2016). In addition, most African nations face insecurity, coups d'état, political instability, ethnic strife, kidnappings and bandits, religious crises, corruption, high inflation, poor infrastructure, and unfriendly and ineffective policies. Regional financial integration is hampered by economic risk and other considerations. Investment and trade affect a nation's economy. When inadequate economic policies damage the quality of management, the fundamental issue that follows is: how much will financial integration ever actively assist development? Because of their interconnection, excellent governance and financial integration are two sides of the same coin (Ajayi, 2024). Rather, the regional entity's commissions and member countries' institutions are what are needed to implement the financial integration agenda. When these institutions provide inadequate finances, difficulties develop and progress may be impeded (Kose, Prasad & Ashley, 2011).

On the other hand, economic risks include a sharp decline in the country's trade balance, spikes in the cost of production and energy, mismanagement of foreign capital, and irresponsible lending by international financial institutions (Nagy, 1988). Economic risk is largely measured by: GDP growth rate, inflation rate, loan default rate, servicing of foreign debt, balanced budget, late payments among others (Athari, 2022). These risk variables may hinder investment risk-return attributes or capital input. Foreign investors worry about personnel and installation safety, and interruption of business (Juttner, 1995; Hoti & McAleer, 2004). Economic risk arises from government policies to strengthen a country by benefiting or disassociating itself from other nations, such as currency rate and trade policies for commercial transactions and wealth development. While studies exist on country risk and economic growth, financial integration, investment, and economic growth (Friedrich et al., 2010; Frey & Volz, 2011; Hayakawa et al., 2012; Olaniyi, 2013). However, studies to address economic risk in relation to regional financial integration in Africa is scarce, creating vacuum to be filled.

Literature Review

Many theoretical frameworks promote financial integration. They examine local and global market exchange laws and nations' interconnectivity. For instance, the neo-classical growth framework by Robert Solow and Trevor Swan in 1956 explains how financial integration increases local and international investment. Samuelson's 1948 capital arbitrage theory supported FDI by stating that multinational businesses seek higher profits regardless of local conditions. According to Lucas (1988), the neoclassical paradigm predicts that capital would migrate from industrialized countries to less developed ones due to their greater marginal product of capital, lower wages, and lower marginal labour productivity. In addition, Absolute Cost Advantage theory by Adam Smith (1776) was to eliminate barriers and increase commerce among nations. This theory addressed the inadequacies of the mercantilist theory of international trade. To boost an economy, this approach promotes labour division and free trade across borders.

Empirically, Tinta et al (2018) used global value chains to study how regional integration in ECOWAS states from 1995 to 2012 may promote economic development and food security. The study examined whether nations should prioritise regional commerce over international trade. Two models were estimated using panel fixed effects. Although openness and growth are not correlated, intracommunity trade and per capita domestic value-added tend to affect economic development. According to the study, regional integration must be expanded and promoted to help each nation transition from uneven to sustainable development. Even if regional trade connected to value

chains among member nations may generate prosperity, the concluded that international business is not the solution for ECOWAS but governments should prioritize regional integration above international trade. Likewise, Ehigiamusoe and Hooi (2018) evaluated empirical studies on economic integration and development in developed and developing nations. We also examined financial integration and economic development. This research employed content analysis to establish how economic integration impacts growth, although two sets of writers discovered negative and substantial effects across all approaches. These include capital accumulation, productivity boosts, commerce, and financial integration.

Furthermore, Kouki and Rezgui (2017) examined Maghreb economies and financial integration. Financial integration has been studied theoretically and empirically to increase growth and quality of life. The research investigated the economic growth of Sudan, Algeria, and Morocco from 1981 to 2014 using the ARDL cointegration testing technique. Projections showed that financial integration favours Maghreb economies. Ikue-John, Amabuike, Ajaba, Sodipo, and Enegesi examined WAMZ financial and trade indicators' effects on economic growth in 2020. Three variables and control measures were used to examine six WAMZ countries from 2001 to 2018. Integrating data analysis required a microstructure, therefore models were created in static and dynamic panel frameworks. This was needed since the investigation used various data. The models were evaluated using statistical and economic methods. The study found that WAMZ governments often have permissive import laws, even though imported trade involves more items and partners than export trade, which focusses on fewer commodities. WAMZ indexes for economic development, finance, and commerce showed susceptibility. Using the dynamic panel approach with system generalised linear modelling, Adeyele and Ouedraogo (2019) studied how regional governance and financial integration affected West African economic development from 2001 to 2016. The African Regional Integration indicator (ARII) quantifies regional financial integration by combining financial integration and macroeconomic policy. An indicator that analyses political and economic aspects that firms encounter in a country may measure governance quality. Financial integration was negatively correlated with governance quality and ECOWAS's economic potential. Governance and regional financial integration somewhat but positively affect economic development.

Saliba, Farmanesh, and Athari (2023) explored how country risk influences the credit risk of banking sectors in emerging and BRICS countries. These nations include South Africa, India, Brazil, and Russia. Panel data covering 2004–2020 was examined using a quantile estimation approach. National risk significantly increases banking sector credit risk, particularly in countries with large non-performing loans. Economic, political, and financial instability in developing countries increase credit risk for the banking sector, and banks in nations with significant non-performing loans benefit most from political risk. Also, Muthoga, Obere, Mburu, and Mukwate-Muchai (2013) examined how EAC financial integration affects economic development. The system's generalised approach of moments showed that regional financial integration considerably increased EAC economic development. Similarly, Chiwira and Tadu (2012) reviewed the literature to determine whether Africa's financial integration affects financial contagion. A content analysis-based empirical investigation found that most areas have accepted EU strategy. Africa requires a comprehensive economic growth and integration plan to reduce contagion and boost financial integration.

Materials and Methods

This section discusses estimation techniques, model specification, and data sources.

Estimation Techniques

The study used panel regression analysis through Pooled OLS, Fixed and Random Effects. Likewise, Hausman test was used to determine the most appropriate regression among them.

Economic risk data was sourced from International Country Risk Guide (ICRG) while other data were obtained from World Bank database.

Model Specification

The model specified in this study was based on the study of Saliba, Farmanesh, and Athari (2023) which is on country-specific risks (economic, financial, and political risks) on BRICS countries non-performing loans. Saliba, Farmanesh, and Athari (2023) model is stated as:

$$NPL = f(FR, ER, PR) \quad (1)$$

Where:

NPL = Non performing loans; FR = Financial risk; ER = Economic risk; and PR = Political risk

This model is modified by the removal of NPL which was replaced with NCI (ratio of Net capital inflow to GDP), FR and PR were removed which is in line with this study's objective.

$$NCI = f\ (Economic\ Risk) \quad (2)$$

Where:

NCI = Ratio of Net capital inflow to GDP; Economic Risk = INF, DS, FT and PFE

Therefore,

$$\mathrm{NCI} = \mathrm{f}\ (\mathrm{INF}, \mathrm{DS}, \mathrm{FT}, \mathrm{PFE}) \quad (3)$$

Where:

NCI = Ratio of Net capital inflow to GDP; INF = Inflation; DS = Debt Service; FT = Foreign Trade; PFE = Parallel Foreign Exchange Rate; f = functional notation

Results and Discussions

Result of Pool OLS

Table 1 The result contained evidence from pooled OLS estimator.

Table 1. Economic Risk and Regional Financial Integration in African Countries Through Pool OLS

NCI	**Pool OLS**
Obs	34
R^2	0.460623
Prob.>F	0.009504
INF	-0.007267
DS	-0.024896**

FT	0.003461
PFE	0.024824*

Source: E-view 11

Table 4.1 depicted the pooled OLS outcome of the model. It showed that 1% increase in INF led to -0.07% insignificant effect on NCI, similarly with the same sign, DS negatively but significantly affect NCI by 2.48%, FT has a positive and insignificant effect on NCI to the tune of 0.03% and lastly, PFE contributed to NCI by 2.48% increase. Hitherto, DS and PFE contributed negatively and positively with significant effect to NCI. Furthermore, the R^2 showed that when all the factors of economic risk are pool together, the variables jointly affect NCI by 46.06%. Though, the variation is low but its F-probability significant level at 0.05% cannot be swept under the carpet.

Result of Fixed Effect

Table 2. The result contained evidence from fixed effect estimator.

Table 2. Economic Risk and Regional Financial Integration in African Countries Through Fixed Effect

NCI	**Fixed Effects**
Obs	34
R^2	0.652779
Prob.>F	0.000011
INF	-0.001989
DS	0.028812**
FT	0.025456**
PFE	0.029894**

Source: E-view 11

Note: The *, **, *** denote significance levels at 10% 5%, and 1%, respectively.

Result in Table 4.2 showed a more robust result compared to Pooled effect. The result indicated that inflation rate cannot be used as a determining factor on NCI based on its negative and insignificant effect, therefore, a percent increase in inflation rate will further reduce the level of NCI in African region by 0.01%. On the other hand, DS, FT and PFE contributed positively and significantly at 5% level of significant to NCI. As such, the variables affect NCI by 2.88%, 2.54% and 2.98% respectively. The changes in variation of R^2 connoted a percentage of 65.27% which is relatively accepted couple with its F-probability level of $0.00 < 0.05$.

Result of Random Effect

Table 3 The result contained evidence from random effect estimator.

Table 3. Economic Risk and Regional Financial Integration in African Countries Through Random Effect

NCI	**Random Effects**
Obs	34
R^2	0.660971
Prob.>F	0.000037
INF	-0.007312
DS	0.024948**
FT	0.046153**

PFE	0.047985***

Source: E-view 11

Note: The *, **, *** denote significance levels at 10% 5%, and 1%, respectively.

Result in Table 4.3 which is random effect is similar to result in 4.2. However, the R^2 showed an increase percentage with 66.09%. this connoted that the contributive effect of the explanatory parameters jointly affects and account for the presence of NCI by 66.09%, the significant value of 0.00 suggested that the result of the model is accepted. Individually, inflation rate produced a negative and insignificant effect to NCI, that is, any effort to further increase inflation rate would produce a detrimental effect of -0.07%. Moreso, DS, FT and PFE contributed positively and significantly to NCI by 2.49%, 4.61% and 4.79% respectively.

Generally, the outcome of fixed and random look similar when evaluating the signs and magnitudes of the coefficients from the used observations. However, random effect provides the most significant outcome while the result of pooled OLS estimated provided a slightly different.

Result of Hausman Test

Hausman test to determine the most appropriate result to select from the three estimates.

Table 4. Hausman Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Period random	8.501897	4	0.0748

Source: Author's computation (2024), E-view 11

The outcome of Hausman test is reported in Table 4.4. The chi-square statistic stood at 8.50 while its probability value of 0.07 is not significant. This implies that between fixed and random effects, random provided the most suitable result for interpretation. As such, outcome obtained from the random effect is employed in the implication and discussion of findings.

Discussion and Implications of Findings

The study aimed to investigate how economic risk impacts regional financial integration in African countries. To measure economic risk, four metrics were employed: inflation, debt service, international trade, and parallel foreign exchange rate. The findings unequivocally demonstrated that whereas international commerce, debt repayment, and the parallel foreign exchange rate all had significant and favourable impacts on net capital inflow—by 2.49%, 4.61%, and 4.79%, respectively—inflation had a small and adverse effect. This indicated that African cross-regional financial transactions are hindered by economic policies connected to inflation. As a consequence, the inflation rate sent a bad message to foreign investors. The parallel foreign exchange rate, international trade, and debt servicing all have a positive and negative influence on economic risk indices, which in turn affect regional financial stability.

Evidently, having debt is not illegal; what matters most is how sparingly it was utilised. It wouldn't have a detrimental effect on the economy if a nation, like Nigeria, had borrowed money from South Africa, for example, and utilised it for its primary objective without political selfishness, such as repaying debt or providing services. However, the outcome would be adverse if the goal was not achieved.

International commerce occurs between nations. According to Adam Smith (1776), a nation's success depends on its absolute cost advantage, which was based on international free trade and the division of labour. Free trade allows a country to provide its people a vast array of commodities through specialisation. This provides evidence that nation should concentrate on areas she can enjoy better absolute advantages.

Economic risk often results from government policies that either strengthen a nation or distance it from other nations. These policies include those pertaining to the exchange rate and commerce with other nations in order to do business and build wealth. The findings showed that governments are making the most of economic risk in order to draw in investments on a local, regional, and global scale. Mutually beneficial economic measures need to be enacted. This is due to the fact that severe economic policies or witch hunts implemented by a nation's government may have detrimental effects on its citizens, businesses, and even international partners. Therefore, efforts should be directed towards measures that may increase foreign direct investment. The research matched the findings of Athari et al. (2023) that claimed that significant influence subsists between economic risk and financial activities among regions in Africa.

Governments of economically and politically divided countries, which are experiencing high levels of inflation, high exchange rates, high debt servicing, and other problems, must provide solution to these problems and try to reduce their impact on the implementation of economic policies. For example, the high inflation rate recorded in Nigeria is due to the high exchange rate and the government`s policy of removing fuel subsidies. Although the policies of unifying the exchange rate and removing fuel subsidies were intended to put the country`s economy on the path of development, they have made life more difficult for the people of the country in recent months. For instance, Nigeria, which was ranked by the International Monetary Fund (IMF) as Africa`s largest economy in 2020-2022, now ranks fourth in Africa after Algeria. The new ranking placed South Africa on the first position as the biggest economy in Africa (IMF, 2024).

Conclusion

The study assessed the effect of economic risk on regional financial integration in Africa. Economic risk was proxy by inflation, foreign trade, debt service, and parallel foreign exchange rate while ratio of net capital inflow to GDP was employed in measuring regional financial integration. Findings from the panel results clearly showed that inflation is insignificant and inversely induces ratio of net capital inflow to GDP while debt service, parallel foreign exchange and foreign trade showed a significant and directly impact on net capital. It was recorded that economic risk has positive and significant effect on net capital inflow among countries in Africa. Based on this conclusion, government of African countries can dramatically increase capital inflows into Africa and implementing sound macroeconomic policies with mutual benefits. Likewise, "investor friendly" environment that will attract foreign investors into the region should be promoted.

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