

PERCEIVED FINANCIAL RISK AND THE ECONOMIC GROWTH OF SUB-SAHARAN AFRICAN COUNTRIES

1. INTRODUCTION

Many studies have shown that African countries have been lagging behind in various economic performance measures compared to other regions of the world (Collier and Gunning, 1999). Over the past three decades, sub-Saharan African countries in particular have witnessed slower growth, higher poverty, and lower human performance. Such anemic economic growth performances partially occur because sub-Saharan African countries tend to lack access to the international capital markets, owing to the dubious high financial risk often attributed to this part of the world. One way these countries can achieve improved economic performance is to attract domestic and foreign investments into their economies, thereby breaking the vicious cycle of poverty and underperformance. To attain such investments, though, sub-Saharan African countries need to lower the perceived financial risks often associated with them.

Despite Africa's enormous potential (including low-cost labor and vast natural resources), overseas businesses and investors remain wary about investing in Africa. These businesses and investors tend to prefer a more certain business environment than that offered by the sub-Saharan African countries, mostly due to lack of information on borrowers, political instability, poor governance and corruption, among other factors. In analyzing global risk ratings, Haque *et al.* (1999) determine that Africa as a whole is often assigned a higher risk rating than that warranted by these economic factors, thereby creating the perception that Africa is a bad investment region. Such a high-perceived risk of investing in Africa may help account for why capital inflows have not occurred quite as successfully in Africa as elsewhere around the world, most notably in Asia. In addition to this limited flow of external funds, African countries also experience huge capital flight where even Africans tend to invest in other regions of the world rather than in Africa itself, a phenomenon that occurs in Asian countries at a lower level or not at all. Collier and

Gunning (1999), for example, indicate that despite the dire need for capital in the African region, investors from this region choose to invest 39 percent of their portfolio outside of Africa. The financial risks, however, are not the same for all African countries, requiring further inquiry into financial risk and its implications for growth and investment in African countries (Lesova, 2007).

The main objective of this study is to investigate the extent to which the differences in financial risk help explain the divergence in economic growth experienced by African countries from the years 1984 to 2000. In addition, the study explores the effects traditional sources of economic growth might have on the perceived risks associated with sub-Saharan countries, using estimation methods based on simple panel models with fixed effects, random-effects, and the Doornik *et al.* (2002) general method of moments (GMM) estimator.

The random effects and fixed effects model specifications allow us to account for the heterogeneity of African economies and differences in contributions by traditional sources of economic growth to these economies. The Arellano-Bond method permits us to obtain efficient and unbiased estimates of the effects of our variable of interest (financial risk) in the presence of possible autocorrelation in the residuals of the dependent variable (GDP *per capita*) as well as the pre-determined (e.g., schooling) and endogenous (e.g., foreign direct investment) variables of some of the conventional growth factors without using an explicit instrumental variable as an estimation technique. The contribution of our work to the empirical literature is that we provide evidence of the extent to which perceived high financial risk may impede the economic growth of African countries while accounting for the conventional sources of economic growth using standard endogenous growth theory. Our empirical results show that perceived financial risk significantly contributes both to the current level of gross domestic product and the economic growth rate of sub-Saharan African countries. Our findings imply that the short-term and long-term economic growth of African economies could be spurred by a more careful and realistic assessment of investment risk in Africa and thus a subsequent reduction in perceived risk, paving the way for flow of external sources of capital critical for economic growth and development.

The rest of this study is organized as follows. Section 2 presents the analytical framework and the data. Section 3 presents the empirical results and their interpretations. Concluding remarks and some policy guidelines are offered in Section 4.

2. THE ANALYTICAL FRAMEWORK AND DATA

Theoretical studies including Cohen and Sachs (1986), Marcet and Marimon (1992), and Thomas and Worrall (1994) conclude that risk can indeed reduce capital flows from rich to poor nations and significantly retard economic development. Our main goals are to investigate whether perceived financial risk of African countries can impact their economic growth and to determine if its effect is similar along all conditional distributions of growth (i.e., low, middle, and high groups). While this study focuses on the influence of perceived financial risk on economic growth, we also consider in our model the effects of traditional sources of economic growth such as investment in physical and human capital, terms of trade, a measure of an institutional factor represented by the political rights index, foreign direct investment, and official development assistance. We first specify a simple double log-linear Cobb-Douglas production function as:

$$PCI_{it} = \alpha_i + \beta_1 FRK_{it} + \beta_2 FDI_{it} + \beta_3 GCF_{it} + \beta_4 TOT_{it} + \beta_5 AID_{it} + \beta_6 SCH_{it} + \beta_7 PLI_{it} + \varepsilon_{it} \quad (1)$$

PCI_{it} is the natural log of real GDP *per capita* and FRK_{it} is the financial risk index of a country; FDI_{it} is the log of foreign direct investment flows in US\$ as a percent of real GDP; GCF_{it} is the log of gross fixed capital formation as a percent of real GDP used as a proxy for investment in physical capital¹. TOT_{it} is the log of terms of trade for each country under consideration as measured by the ratio of the export to import price indices to capture the impact of trade, or openness of the economy on economic growth; AID_{it} denotes official development assistance and foreign aid in current US\$; SCH_{it} is secondary and tertiary school enrollment used as measure of investment in human capital; and PLI_{it} is political rights. Owen (1987) and Sen (1999) argue that freedom (political, economic, social, transparent, and security) is a necessary condition for economic growth and development. Thus we use the log of political liberty index (PLI_{it}) to capture the effect of this institutional factor.

Gallup *et al.* (1998) indicates that sound overall macroeconomic management lowers risks for investors and increases investment, in turn leading to economic growth. Thus lower financial risk may serve as an impetus for both domestic and foreign investment and then to development.

¹ Our specification in equation (1) is based on previous literature in the new growth theory (Lucas, 1988; Barro, 1990, and Barro and Sala-i-Martin, 1992).

We thus hypothesize a positive relation between investment in physical capital (GCF_{it}), investment in human capital (SCH_{it}), the openness of the economy (TOT_{it}) and *per capita* income levels (PCI_{it}). The volatility of terms of trade has been associated with the poor performance of developing countries dependent on commodity trade. The fluctuation of terms of trade thus impacts foreign exchange earnings, which in turn impacts growth².

Intuitively it makes sense to suspect that foreign direct investment (FDI_{it}) will promote growth in the host country, not just through providing direct capital financing but also by creating positive externalities via the adoption of foreign technology and know-how. The empirical literature, however, finds mixed evidence for the existence of a positive impact of foreign direct investment on host country's economic growth. The conclusions made by related literature range from significantly positive (Ram and Zhang, 2002; Campos and Kinoshita, 2002), to insignificant (Carkovic and Levine, 2002), and to significantly negative (Dutt, 1997; Saltz, 1992). Other macro level studies also suggest that country characteristics are important in determining the contributions of (FDI_{it}) to growth. For example, Borensztein *et al.* (1998) and Xu (2000) point out that (FDI_{it}) leads to positive growth only if certain minimum stock of human capital exists in the host country, whereas Alfaro *et al.* (2004) and Durham (2004) argue that only countries with well developed financial markets realize significant growth rates due to FDI_{it} . Since the effect of foreign direct investment (FDI_{it}) on economic growth has been mixed, the expected relation may be ambiguous (i.e., positive or negative).

The impact of foreign aid (AID_{it}) on economic growth is also controversial. Some studies, including Hansen and Tarp (2000, 2001) and Dalgaard *et al.* (2004), find a positive impact while others, including Mosley (1980) and Shan (1994), identify a negative impact of aid on growth. On the other hand, Fayissa and El-Kaissy (1999) and Burnside and Dollar (2000) conclude that aid has a positive impact on growth in developing countries with good policies and little effect in countries with poor policies. Using an expanded version of the dataset of the latter study, Easterly *et al.* (2004) raise new doubts about the effectiveness of aid even in the case of good policies. Thus the effect of aid (AID_{it}) on economic growth cannot be predicted *a priori*.

² See Ziesemer (1995); Kose and Riezman (1999); Dehn (2000), and Easterly *et al.* (2000).

We estimate the parameters corresponding to the explanatory variables of equation 1 above using panel data of 39 African countries spanning from 1980 to 2004. We employ a panel data estimation methodology (fixed and random effects), an empirical representation of which is provided in equation (2) below:

$$Y_{it} = \delta_i + \Gamma_t + (X_{it})\Phi + \Psi_{it} \quad (2)$$

Y_{it} is the natural logarithm of real GDP *per capita* in country i at year t ; X_{it} is a vector of the explanatory variables (financial risk, investment in physical and human capital, terms of trade, foreign direct investment, political risk, and foreign aid) for country $i = 1, 2, \dots, n$ and at time $t = 1, 2, \dots, T$; Φ is a scalar vector of parameters of $\beta_1 \dots \beta_7$; Ψ_{it} is a classical stochastic disturbance term with $E[\Psi_{it}] = 0$ and $\text{var}[\Psi_{it}] = \sigma_\epsilon^2$; δ_i and Γ_t are country and time specific effects, respectively. Instead of a *a priori* decision on the behavior of $\delta_i + \Gamma_t$, different types of assumptions are separately imposed on the model with the one having robust estimates chosen.

Assuming the country specific effects to be constant across countries and the time specific effects are not present [i.e., $\delta_i = \lambda$ and $\Gamma_t = 0$], model (2) then is estimated by the Ordinary Least Squares (OLS) method, or restricted OLS method. The second estimation technique assumes that the country specific effects are constant, but not equal (i.e., $\delta_i = \lambda_i$ and $\Gamma_t = 0$) which yields a one-way fixed effects model. The third assumption presumes a situation where the country effects are not constants, but rather disturbances; the time effects then are not present [i.e., $\delta_i = \lambda + w_i$ and $\Gamma_t = 0$], where $E[w_i] = 0$ and $\text{var}[w_i] = \sigma_w^2$ and $\text{cov}[\Psi_{it}, w_i] = 0$. In this case, model (2) is estimated by the Generalized Least Squares (GLS) which yields a random-effects model.

We allow that some of the traditional factors explaining growth are either pre-determined, or endogenous, or both and current period growth could depend on its values in the past. Accordingly we specify a dynamic variant of the fixed and random effects model provided in equation (2) above, known as the Arellano-Bond estimation (1991), as follows:

$$\Delta Y_{it} = \alpha \Delta Y_{it-1} + \beta \Delta X_{it-1} + \gamma Z_{it} + v_i + \epsilon_{it} \quad (3)$$

ΔY_{it} is first difference of the natural log of *per capita* income growth in country i during time t ; ΔY_{it-1} is the lagged difference of the dependent variable; ΔX_{it-1} is a vector of lagged level and differenced predetermined and endogenous variables; z_{it} is a vector of exogenous variables, and α , β , and γ are parameters to be estimated. v_i and ϵ_{it} are assumed to be independent over all time periods t in country i . The term v_i represents country specific effects which are

independently and identically distributed over the countries; ε_{it} is a noise stochastic disturbance term, also assumed to be independently distributed. We estimate the coefficients of the variables using the Arellano-Bond (1991) Generalized Method of Moments (GMM) estimator to evaluate the joint effects of financial risk and the other explanatory variables on economic growth in African countries while controlling for the potential bias due to the endogeneity of some of the regressors including the lagged dependent variable.

The data employed by this study incorporate annual panel data from 1984 through 2000. The financial risk index comes from the financial risk ratings of the Political Risk Services (PRS) Group. We average the monthly rating for each year to come up with an annual financial risk rating for each country. The financial risk rating thus is a continuous variable where higher ratings denote lower risk and vice versa. The political rights index comes from the Freedom House's Freedom in the World Country Ratings. The rights index goes from 1 to 7, where 7 denotes the least level of political liberty and 1 the most. The educational enrollment data are taken from the World Bank's EDSTAT database. The rest of the data come from the World Bank Development Indicators (World Bank, 2006, CD Rom). The definitions and descriptive statistics of each variable employed by this study are provided in Table 1.

TABLE 1 - *Variable Description and Summary Statistics*

Variable	Description	Mean	Min	Max
<i>PCI</i>	GDP <i>per capita</i> (constant 2000 US\$)	615.255	74.741	4242.890
<i>FDI</i>	Foreign direct investment, net inflows (% of GDP)	2.136	0.000	40.150
<i>GCF</i>	Gross capital formation (% of GDP)	20.085	1.763	66.381
<i>TOT</i>	Net barter terms of trade (2000 = 100)	109.701	39.200	312.308
<i>AID</i>	Official development assistance and official aid (current US\$)	488214651	30700000	5430000000
<i>FRK</i>	Average annual financial risk rating (higher number denotes less risk)	26.908	12.000	45.125
<i>SCH</i>	Total school enrollment, secondary + tertiary (% gross)	31.554	0.890	116.439
<i>PLI</i>	Political Right index (higher numbers denotes less rights)	5.105	1	7

3. EMPIRICAL RESULTS AND INTERPRETATIONS

The estimation results of the random effects and fixed effects models are presented in Table 2. The estimation results for the Arellano Bond dynamic model are presented in Table 3.

TABLE 2 - *Fixed Effects and Random Effects Estimates*

Variables	Description	Random-effects coefficients	Fixed-effects coefficients
<i>Constant</i>		5.030 *** (0.446)	5.031 *** (0.452)
<i>FRK</i>	Average annual financial risk rating (higher number denotes less risk)	0.092 ** (0.043)	0.091 ** (0.040)
<i>TOT</i>	Net barter terms of trade (2000 = 100)	0.121 *** (0.035)	0.122 *** (0.035)
<i>FDI</i>	Foreign direct investment, net inflows (% of GDP)	0.001 (0.004)	0.001 (0.004)
<i>AID</i>	Official development assistance and official aid (current US\$)	-0.031 ** (0.016)	-0.027 ** (0.016)
<i>PLI</i>	Political Right index (higher numbers denotes less rights)	-0.021 (0.017)	-0.021 (0.018)
<i>SCH</i>	Total school enrollment, secondary + tertiary (% gross)	0.128 *** (0.035)	0.100 *** (0.032)
<i>GCF</i>	Gross capital formation (% of GDP)	0.129 *** (0.038)	0.120 *** (0.036)
Observations		430	430
Number of countries		35	35
R-Squared		0.689	0.675
Wald		62.31 ***	49.97 ***

Notes: Standard errors in parentheses; *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$. All variables are log transformed. Standard errors are based on 500 bootstrap re-sampling estimates.

Overall the results of both the fixed-effects and random-effects models are consistent with our theoretical hypotheses. In both models the variables representing the sources of growth (including the terms of trade, human, and physical capital formation) have the expected signs. Because we estimated a double-logarithmic model, all the coefficients represent elasticities. Both models indicate a significant positive relationship between higher country rating with respect to financial risk (i.e., lower financial risk) and growth. The impact of

the financial risk rating is similar in both the fixed and random-effects models. However, comparing the consistent fixed-effects model with the efficient random-effects model using the Hausman specification test allows us to reject the random effects in favor of the fixed-effects estimates.

The result from the fixed-effects model (our model of choice) indicates that a better country rating (or lower financial risk, *FRK*) has a positive and statistically significant effect on the GDP *per capita* (at $p < 0.05$) of African countries. We find that a 10 percent decrease in the financial risk of a typical African economy would result in a 0.91 percent increase in the average *per capita* income. Similarly, a 10 percent increase in investment in human capital (*SCH*) through increases in secondary and tertiary levels of school enrollment will increase GDP *per capita* by 1 percent. Consistent with the findings of Barro (1990), we also find that investment in physical capital (*GCF*) as measured by the gross fixed capital formation as a percent of GDP as well as terms of trade (*TOT*) both have a positive and statistically significant impact on the real GDP *per capita* of a sample African economies. Foreign direct investment (*FDI*) has a positive, but not statistically significant impact on the real GDP *per capita* growth rate. On the other hand, foreign aid is shown to have a statistically significant negative impact on economic growth consistent with the findings of Heller (1975) and Boone (1994). The institutional variable (*PLI*) used to capture the effect of political freedom shows a negative, but not statistically significant impact on growth for the time frame considered.

While the results based on the fixed and random-effects models in which we simultaneously account for the heterogeneity and time to time fluctuations in the economic performance of African economies are appealing, we note that some of the explanatory variables of growth are endogenous, thus confounding the results. For example, while *FDI* and investment in human capital (*SCH*) have often been credited for their role in the economic growth, there are also several studies including Hansen and Rand (2006) and de Mello (1999) that indicate the level of GDP and its growth rate have feedback effects on the amount of *FDI*³ a country receives and the rate of investment in human capital formation. Since our main interest lies in investigating the effect of financial risk on African economic growth

³ Foreign investment decisions are profit driven and thus foreign investors seek to invest in countries with low risk and high profit potential. Thus higher growth countries may attract more investment than lower growth countries.

while accounting for the traditional growth explanatory factors that are either pre-determined (e.g., schooling, *SCH*) or endogenous (e.g., *FDI*) or both, we employ the one-step Arellano-Bond dynamic panel General Method of Moments (GMM) estimator to obtain robust estimates by including one period lags as instruments for the endogenous variables. The Arellano-Bond dynamic GMM estimates with one year lag of the dependent variable (growth in GDP *per capita*) are reported in Table 3.

The Sargan test fails to reject the null hypothesis that the over-identifying restrictions are valid while the Arellano-Bond test rejects the null hypothesis of no-first autocorrelation in the differenced residuals AR(1). Consequently, the estimated coefficients reflect the true (efficient and unbiased) relationship between the traditional growth variables, our variable of interest (financial risk), and the growth in income of African countries.

From Table 3, we find that foreign direct investment (*FDI*), foreign aid (*AID*), human capital (*SCH*), and the institutional variable proxied by the political liberty index (*PLI*) were not significant. Yet, we also find that investment in physical (*GCF*), the terms of trade (*TOT*), and the lagged values of GDP *per capita* (*PCI*) have significant growth enhancing roles.

In the case of our variable of interest, financial risk (*FRK*), we find that lower perceived financial risks (a better country rating) have a significant and positive impact on the growth rate of *per capita* income as a result of access to the external capital sources. We find that a 10 percent better country rating (i.e, decrease in the perceived financial risk) would lead to a 0.47 percent growth in the GDP *per capita* of African economies.

4. CONCLUSION

The main goal of this study is to investigate the effect of the perceived financial risk on the economic growth and development of sub-Saharan African countries. The results show that having low financial risk generally positively impacts the economic growth of African countries.

The results lead to an important policy implication: African countries can improve the performance of their economies not only by investing in the traditional sources of growth, but also by strategically focusing on developing a positive domestic policy environment. They should clear the dark clouds and, perhaps, wrong apprehensions of foreign businesses that investment in Africa is financially risky.

TABLE 3 - *Arellano-Bond Dynamic Panel-Data Estimation Results*

Variables	Coefficient estimates (One-Step and One-Year Lag)
Constant	1.437 (0.347)
<i>PCI</i> (LD)	0.719 *** (0.045)
<i>SCH</i> [D(1)]	-0.007 (0.013)
<i>SCH</i> (LD)	0.007 (0.029)
<i>FDI</i> [D(1)]	0.002 (0.003)
<i>FDI</i> (LD)	0.002 (0.003)
<i>FRK</i> [D(1)]	0.047 ** (0.021)
<i>TOT</i> [D(1)]	0.032 * (0.018)
<i>AID</i> [D(1)]	-0.006 (0.008)
<i>PLI</i> [D(1)]	-0.013 (0.013)
<i>GCF</i> [D(1)]	-0.030 ** (0.013)
Number of Observations	316
Number of Countries	31
Wald Chi-Square	372.430 ***
Arellano-Bond Test of the null of No AR(1) Residual Errors	-2.953 ***
Arellano-Bond test of the null of No AR(2) Residual Errors	-0.655
Sargan Test of the Validity of the null of over-identifying Restrictions	24.650

Standard errors in parenthesis; ***, **, and * indicate significance at $p < 0.01$, $p < 0.05$, and $p < 0.1$ levels, respectively. While the suffix D(1) after each variable denotes the number of times the specific variable was differenced, LD denotes the lagged difference. The variable SCH is treated as predetermined, while FDI is treated as an endogenous variable.

This may entail strengthening property rights, enhancing investor protections, easing tax burdens, and encouraging the development of the financial sector to reduce the unwarrantedly high financial risk attributed to Africa.

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ABSTRACT

Since the 1970's, countries of the sub-Saharan African region have experienced slow economic growth and development in comparison to other regions of the world. This paper studies the role of perceived financial risk in explaining the anemic economic growth among sub-Saharan African countries by employing regression techniques on panel data for the period of 1984 to 2000. Our findings suggest that higher ratings of a country's investment environment (used as a proxy for reduced perceived financial risk) tend to make the flow of external funds more accessible to African countries and spur their economic growth.

Keywords: Economic Growth, Financial Risk, Foreign Direct Investment, Human Capital, Physical Capital, Political Rights, Openness, Panel Data

JEL Classification: C33, F20, G32, O40, O50

RIASSUNTO

*Rischio finanziario percepito e divergenza nella crescita economica
dei paesi dell'Africa sub-sahariana*

Negli anni '70 la crescita economica e lo sviluppo dei paesi dell'area sub-sahariana sono stati inferiori rispetto al resto del mondo. Tramite applicazioni di regressioni *panel data* per il periodo 1984-2000, questo studio analizza il ruolo che il rischio finanziario percepito può aver giocato ai fini della divergenza della crescita economica dei paesi dell'Africa sub-sahariana. I risultati suggeriscono che *rating* più alti attribuiti all'*investment environment* (utilizzati come indicatori di un minor rischio finanziario percepito) tendono a rendere più accessibili i finanziamenti stranieri ai paesi africani in questione, stimolandone la crescita economica.