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Regulatory Choices for Low-Income Countries in a World of Increasing Financial Integration

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In recent months, participants in private capital markets have expressed enthusiasm regarding the economic situation in many African nations. An increase in rates of economic growth, coupled with continued liquidity in global capital markets, has led many investors to consider the "emerging" or "frontier" markets of Africa as their next investment destination. And financial sector problems in the developed world may be prompting a "flight to quality" (ironically) from the United States to many developing nations. This new interest in shorter-term investment in Africa has been coupled with decisions by some African nations to liberalize their investment laws and to encourage foreign participation in sectors like telecommunications and banking.

For African governments, private capital inflows appear to offer promise: in much of the developing world, the magnitude of private investment far outstrips that of official development assistance. And private flows do not suffer from many of the qualities associated with official assistance, such as the cyclical nature of official development assistance flows; the tying of funds to particular programmatic activities (i.e. spending on HIV/AIDs efforts, rather than on health care generally); and the directing of funds on the basis of political alliances and interests (rather than on the basis of economic need).[1] Offering a welcome reception to private capital flows also is consistent with much of the advice from international financial institutions, which – despite financial crises and contagion of the mid- and late 1990s -- continue to view financial market liberalization as central to growth and development. On both sides, then, private capital flows appear to be a winning strategy.

This enthusiasm for financial integration, however, should be met with some deal of caution. It is not that capital market integration is usually detrimental to economic growth in the developing world. Indeed, under many circumstances, there is a positive and significant association between financial integration and economic development. But, at the same time, the effects of financial

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[1] For a review of recent literature on the linkages between official development assistance and political considerations, see Carey 2007. In her empirical analyses, Carey finds that a nation's level of democracy, but not its human rights record, influences its receipt of foreign aid from European donors.

integration on national economies are very contingent; they are contingent on both the type of capital inflows (broadly, short-term and speculative vs. long-term), as well as on the level of regulatory development in the host country. Where governments have developed appropriate political and regulatory infrastructures, private capital tends to have positive consequences. But, where governments lack regulatory capacity, a rush to capital account liberalization can be associated with negligible, or even negative, effects on economic growth. The issue for African governments, then, is not *whether* to encourage foreign capital inflows and to pursue financial liberalization; it is *how* to pursue foreign capital and *when* to encourage inward investment.

This paper focuses on the regulatory challenges associated with capital account openness in African nations. While short-term capital flows offer a range of benefits to low- and middle-income nations, they also present a variety of risks, particularly when regulatory capacity lags behind the arrival of investment. In order to capture more fully the benefits of – and avoid the potential negative consequences of – private capital flows, African governments should transition gradually to greater capital account openness. During this transition phase, governments should focus on developing the technical capacity to monitor private capital flows, to implement prudential regulations for banks and other financial institutions, and to recognize the warning signs of potential financial crises. The donor community can assist in this transition by helping to adapt international "best regulatory practices" to the specific circumstances of African nations, and by supporting a gradual, but focused, move toward greater capital account openness.

I begin with a brief empirical analysis of capital account openness in Africa. I present recent data on both the legal extent of capital account openness, as well as information on actual flows, with a focus on shorter-term (i.e. equity and bond) investments. I also note that, in many cases, central banks appear to lack accurate data regarding capital flows, a further indication of the need for improved technical capacity. Next, I briefly discuss some of the perils associated with rapid capital

account liberalization. I point to the causes of recent capital market crises in other regions of the world, and I suggest that – given the importance of "push factors" to many private investors -- African nations run the risk of rapid reversals of capital flows, even when they pursue prudent public policies. Most importantly, I consider the current state of financial sector regulation in various African nations. I employ various cross-national measures of institutional capacity and quality to draw comparisons between African nations, on the one hand, and a geographically diverse set of emerging market economies, on the other. I also summarize various ROSC reports undertaken for African nations (often undertaken as part of broader Financial System Stability Assessments), many of which highlight challenges in terms of applying global standards regarding banking supervision, securities regulation, and data dissemination. This evidence suggests that, in order to increase the likelihood that capital account liberalization will provide benefits (rather than costs), governments of low income nations need to make sustained efforts at improving their regulatory and technical capacities. I conclude with policy recommendation, for governments of African nations as well as for the international community.

I. Capital Flows and Capital Account Openness in Africa

Recent years have been marked by high rates of economic growth in the developing world: not only did China and India continue to display impressive gains, but the countries of sub-Saharan Africa achieved average growth rates greater than five percent for 2004, 2005 and 2006 (World Bank 2007). These outcomes can be attributed to domestic demand, as well as to export growth; the World Bank estimates that these growth rates will remain above five percent through 2009. At the same time, private capital flows to developing countries have expanded, far exceeding official flows in most regions of the world. The composition of these capital flows has shifted away from debt and toward portfolio equity and foreign direct investment. As a result of the increased pool of capital, as

well as improvements in sovereign creditworthiness, spreads on developing country debt have declined markedly, facilitating lower-cost public sector borrowing. The rise in private capital flows coincides with a decline in net official lending to developing nations; excluding debt relief funds, disbursements of official development assistance (ODA) were static in 2006 (World Bank 2007). This decline partly reflects governments' repayment (in some cases, early) of loans to IFIs and Paris Club creditors.

These overall trends also are evident in Africa: in 2006, net private capital flows exceeded bilateral aid grants – for the first time since 1999 (World Bank 2007). Several African nations (i.e. Kenya, Nigeria and Zambia) have expanded their local bond markets by attracting foreign participation. Several Africa-specific investment funds have been launched in recent months, including New Star's Heart of Africa Fund (November 2007) and Aureos Capital's Africa Fund (February 2008). And foreign direct investment in sub-Saharan Africa (excluding South Africa) increased by 43.5 percent in 2006, with the largest increases directed at extractive sectors in oil-exporting nations.[2]

At the same time, though, official flows to the region have not kept pace with donors' commitments. The World Bank (2007) reports that, while net ODA increased to $13.2 billion in 2005 (from $7.7 billion in 2002), it fell again in 2006. The OECD (2008) notes an increase in Africa's share of total programmable aid (which includes debt relief), from approximately $23 billion in 2002 to $41 billion in 2006. This amount, though, still falls significantly short of the G-8's 2007 promise to double (from 2004 levels) aid to Africa by 2010.[3] Private capital flows, then, may offer opportunities to African nations: they can substitute for ODA flows, at a time when foreign

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[2] Nearly ninety percent of these flows, however, were concentrated in the ten largest recipient nations.

[3] The OECD also notes that slow progress has been made in the untying (from obligations to purchase donor country exports, for instance) of foreign aid. DAC members, which account for approximately 90 percent of foreign aid flows, reported 53 percent of their aid as untied in 2006, compared with 42.5 percent in 2002 (OECD 2008).

assistance programs remain relatively small. They also may allow – if they are more stable and less cyclical – governments to "smooth" some of the volatility associated with ODA flows, providing a (perhaps) more reliable source of budgetary finance.

Like African governments and publics, private investors also stand to gain from increased investment flows to Africa: Africa holds the pattern of high recent growth rates, the possibility of undervalued assets, and the promise of financial market movements that are largely disconnected from those in advanced countries (and those in traditional emerging markets). Some investors cite high rates of growth and investment opportunities in natural resources, telecommunications and banking as the primary motivations for their investment (while also acknowledging problems of domestic political uncertainty and corruption, i.e. Lesova 2007). Others note that movements in African markets are largely uncorrelated with movements in other capital markets, providing an opportunity for diversification (Chung 2007).

To what extent is the recent overall increase in private capital flows to Africa borne out by capital flows data for specific nations? Assessments of financial liberalization tend to rely on two different measures, one of legal openness, and another on actual openness. The former, *de jure* measure may be inaccurate when there is a high degree of evasion; and – given the way in which most *de jure* measures are compiled (summing a set of binary measures of restrictions) – it may obscure significant variation across asset types. The latter, on the other hand, may be plagued with statistical inaccuracies, particularly for countries with underdeveloped statistical systems.[4] Given that neither is without flaws, I report summary information based on each.

A common *de jure* measure of openness (Chinn and Ito 2006) is based on the binary coding of restrictions in the IMF's *Annual Report on Exchange Arrangements and Exchange Restrictions*. The Chinn-Ito index focuses on four dimensions of restrictions: the existence of multiple exchange rates,

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[4] See Edwards (2008) and Kose et al (2006) for a discussion of various de facto and de jure measures of capital account openness, including the Chinn-Ito index.

restrictions on the current and capital accounts (where the latter are measured as the proportion of the last five years without controls), and requirements to surrender export proceeds.[5] The index has a mean of zero and ranges from -2.66 (full capital controls) to 2.66 (complete liberalization). In 1990, the mean index level for sub-Saharan Africa nations was -0.84 (with data available for 44 countries). Only Botswana and Seychelles received scores above zero. That same year, countries in Latin America and the Caribbean averaged an openness score of -0.65. By 2005, legal capital market openness in Africa had increased marginally, to a regional average of -0.51; eight nations (Botswana, Gambia, Liberia, Kenya, Mauritius, Sudan, Uganda and Zambia) received scores above zero. In Latin America, however, average legal openness was much greater, with an average score of 0.83.

Figures 1a and 1b summarize trends in *de jure* openness, presenting the annual average Chinn-Ito score for 1990 to 2004. In terms of averages across country income categories (Figure 1a), we see a general trend toward capital account liberalization (higher scores on the index), but also marked differences across categories. Low income countries, in particular – the category into which most African nations fall – continue to display extensive capital account restrictions in the early part of this decade. In terms of variation by geographic region, Figure 1b suggests that African nations remain the least open, at least legally, to global capital flows, while European nations are the most open. (The decline in the European average represents the entry into the sample, in the mid-1990s, of former Soviet bloc nations).

Insert Figures 1a and 1b here.

In terms of actual investment flows, several African nations have created stock exchanges in recent years; the African Securities Exchanges Association currently includes eighteen national stock exchanges, plus the eight-member West African stock exchange (BVRM). Many of these national exchanges are small: in 2006, Uganda's exchange listed eight companies, while Tanzania's listed ten

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[5] For a detailed description of this measure, see Chinn and Ito 2006.

and Mozambique's included thirteen. Nigeria, on the other hand, listed 202 companies that year, while South Africa listed 401. In terms of the exchange's capitalization relative to gross domestic product, this also varies significantly, from 28 percent of GDP in Botswana and Nigeria to 69.4 percent of GDP in Kenya. Perhaps most notably, stock market turnover ratios – which capture market liquidity relative to market size – also varied markedly, from 0.25 percent in Uganda, 0.43 percent in Zambia, and 1.76 percent in Botswana; to 14.7 percent in Nigeria and 42.1 percent in South Africa.[6] By comparison, in high income nations, it is not uncommon for turnover ratios to exceed 100 percent. Investors' recent enthusiasm for African investments, then, is sometimes tempered by concerns about low liquidity and diversity (as well as about political instability, corruption, and transparency, in some cases). The stock exchange of Cote d'Ivoire is dominated by a single telecommunications stock and other African exchanges, save South Africa and Egypt, are comprised largely (between forty and ninety percent) of financial sector firms (Lesova 2007).

On the debt side, several African nations have issued bonds in international markets in recent years. In September 2007, Ghana brought to market a $750 million bond issue, which was more than four times oversubscribed. A few months later, Gabon issued a $1 billion bond, the proceeds of which were used to repay debt to Paris Club members (Wakeman-Linn and Nagy 2008). And in February 2008, the European Investment Bank (the EU's lending arm) sold a two-year bond denominated in *kwacha,* the currency of Zambia. And in several African countries (including Botswana, Ghana, Kenya, Nigeria, Tanzania, Uganda and Zambia), foreign investors hold a significant portion of domestically-issued government debt securities (Le Manchec 2008, World Bank 2007).[7] Additionally, seventeen countries now have sovereign ratings (for local as well as foreign currency issues) from Fitch Ratings. While South Africa (1994), Tunisia (1995) and Egypt

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[6] Data in this paragraph are for 2006, from the African Stock Exchanges Association; http://www.africansea.org/ASEA/Statistics.aspx (accessed January 12, 2008).
[7] This mirrors a trend in some emerging markets, like Brazil, which has witnessed a pronounced increase in international investors' purchases of domestic government debt.

(1997) have had such ratings for more than a decade, all other governments have acquired them more recently –for example, Cameroon in 2003, Mali in 2004, Namibia in 2005, and Nigeria in 2006.[8] Ratings often allow institutional investors to include governments' bonds in their portfolios, providing another source of capital for African governments.

In terms of more systematic measures of these trends, is difficult to assemble timely data on capital inflows and outflows for many African nations, reflecting either the challenges associated with meeting international standards for the computation of balance of payments statistics, or difficulties in measuring actual investment flows (Schneider 2001). For instance, in the IMF's *International Financial Statistics* database, data for 2006 on portfolio assets and liabilities are unavailable for thirty-five out of forty-seven sub-Saharan African nations. For another seven countries (six, in the case of liabilities), portfolio investment is reported as equal to zero.[9] Similarly, in a study of capital flows in seven African and Latin American low income countries, Martin (2004) finds that internationally-reported data substantial underestimate the scope of inflows and outflows. Based on surveys and a variety of statistical data from 2000 and 2001, Martin reports flows that are much higher than extant statistics indicate, approaching the magnitude (relative to GDP) of flows in emerging market and Asian economies.

In an effort to overcome some of these data limitations, Lane and Milesi-Ferretti (2006) employ national estimates of international investment position, along with data from international sources, to construct a dataset measuring countries' foreign assets and liabilities, for the 1970 to 2004 period. Their measures of *de facto* openness, which are available for 145 years, allow us to gauge international financial integration using a measure of foreign assets plus foreign liabilities, scaled to GDP – the analogy to measuring trade openness as the ratio of imports plus exports to GDP. Lane

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8 See http://www.fitchratings.com/web_content/ratings/sovereign_ratings_history.pdf. A similar pattern holds for Standard and Poor's, which assigns sovereign ratings to 15 African governments.
9 The *International Financial Statistics* database was accessed January 15, 2008. Portfolio assets refers to category 79ACDZF…; portfolio liabilities refers to category 79LCDZF…

and Milesi-Feretti present summary data indicating that, by this *de facto* measure, global financial integration has increased markedly over the last three decades.

These data provide a mixed picture on financial integration in Africa, perhaps ending prior to the most recent surge in private capital flows. Figure 2 plots the average of net assets and liabilities/GDP for two sets of countries: all African nations, and all nations (41, in total)[10] listed in JP Morgan's Emerging Markets Bond Index-Global.[11] On average, the figures indicate, the emerging market economies (here, EMBI-G nations) were slightly more integrated in 1990 than were African nations (an average of 1.61, compared with 1.13). By 1995, in the wake of the Mexican peso crisis perhaps, African nations were on average *more* integrated – 1.68 percent of GDP, versus 1.5 percent. But by the beginning of this decade, emerging market economies again were more financially integrated, while African economies were moving in the opposite direction. This trend persists through 2004: by the last year for which data are available, African nations average 1.28, compared with 2.05 for EMBI-G nations.

Insert Figure 2 here.

A similar pattern obtains if we split the data according to income category or according to geographic region. High-income OECD countries have an average assets and liabilities ratio of 1.54 in 1990; this expands over the next fifteen years, reaching an average of 4.7 by 2004. Low- and lower-middle income countries start with relatively low levels of integration in 1990 (1.31 and 1.03, respectively); by 2004, integration in low income countries has fallen to 1.18 percent of GDP and, in lower-middle income nations, has risen to 1.27 percent of GDP. Upper middle income countries also experience an increase in integration, but only to a 2004 average level of 1.75 percent of GDP –

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[10] Six African nations presently are included in the EMBI-G: Algeria, Cote d'Ivoire, Egypt, Morocco, Nigeria and South Africa. In calculating group averages, they are included in the EMBI-G mean (rather than in the Africa category).

[11] To be included in the index, debt instruments must have a minimum outstanding face value no less than $500 million; the EMBI-G requires less liquidity in secondary market trading than do some of the other J.P. Morgan indices (e.g. EMBI +).

far less than that of the high-income (OECD or non-OECD) nations. In terms of regional averages, African nations are less financial integrated than all regions other than South Asia in 1990. Following an increase in integration during the first half of that decade, integration declines in the late 1990s; by 2004, the average level of integration in Africa is only marginally greater (1.25 percent, versus 1.16 percent) than it was in 1990.

Data on the size of national financial sectors (from Beck et al 2000) offer a similar picture: while financial sector development in Africa has expanded in recent years, it still lags noticeably behind that observed in emerging market economies. Figure 3a plots the average level of bank deposits in national economies, again scaled to GDP. For African nations, this level expands gradually over time; but even in 2005, the mean level of bank deposits in Africa does not equal the level in emerging markets in the early 1990s. Similarly, stock market capitalization (Figure 3b) increases markedly in African economies during the last fifteen years; but – not surprisingly – Africa's stock markets remain much smaller than those in middle-income emerging markets. Indeed, the trend is toward greater market capitalization (and toward higher turnover ratios); but African countries remain quite on the "frontier" in terms of these indicators.

Insert Figures 3a and 3b here.

II. Development through Capital Markets?

Nearly a decade ago, in the wake of the East Asian financial crises, many academics and policymakers noted the dangers associated with rapid capital account liberalization. Some of these accounts focused on the general perils of capital account openness, in terms of the volatility of shorter-term investment; the preference of international investors and the International Monetary Fund for one-size-fits-all economic reforms (i.e. Stiglitz 2002); and the propensity for contagion,

given the information-gathering tendencies of institutional investors (i.e. Calvo and Mendoza 2000). Other analyses focused specifically on the dangers of premature capital account liberalization.[12]

These studies relate to a wider literature which investigates the benefits, mostly in terms of economic growth, of capital account openness. The main focus of this literature has been to establish whether, or under what conditions, financial liberalization enhances economic growth, by ensuring the efficient global allocation of capital. Recent reviews of this literature note mixed findings: under some conditions, certain types of capital flows are associated with increased rates of economic growth (Kose et al 2006).[13] One explanation for the mixed findings on this issue is empirical: some studies rely on *de facto* measures of capital account liberalization, while others employ *de jure* measures. The latter tend to find more positive effects. The country and year coverage of studies also varies significantly, perhaps explaining sometimes inconsistent results.

Another explanation relates to the type of financial flow under consideration: foreign direct investment flows tend to be more stable than portfolio capital flows, leading to more positive effects on growth, and perhaps to the transfer of technology and expertise (see Jensen 2006 for a review of much of this literature). Similarly, other studies posit that equity flows – because they also are believed to be more stable than debt flows – are more likely to have positive and sustained effects on economic growth (Kose et al 2006). And, within the fixed income market, borrowing at shorter maturities or in foreign currencies may result in lower financing costs for governments; but such patterns also expose governments to exchange rate and rollover risk.

The preference for longer-term flows also reflects a concern that investors in shorter-term assets may be more inclined to exit national markets – or to sharply increase risk premiums – in response to concerns about political or economic instability. Moreover, shorter-term investors may

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[12] See Edwards 2008, Schneider 2001 for reviews of this literature.

[13] Kose et al (2006) summarize approximately twenty-five recent studies on the linkage between financial openness and growth. See their Table 4A.

be driven as much by external, "pull" factors (i.e. global capital market liquidity, developments in U.S. capital markets) as by internal, country-specific factors (Mosley 2003). While high returns in emerging markets may tempt investors during periods of global market liquidity and pronounced risk appetite, these same investors may rush toward the safety of developed markets when liquidity contracts, or when a prominent borrower defaults. The worry, then, is that developing country governments may come to depend on global capital markets for financing a significant portion of public (and perhaps private) consumption, but that the price and volume of these capital inflows may be volatile – and that, in some cases, even governments that pursue appropriate economic and regulatory policies may fall victim to sudden stops and reversals of capital flows.

The most important explanation for variation in the effects of capital mobility on growth, particularly with respect to contemporary African nations, relates to thresholds: the positive effects of financial openness appear to be contingent on the existence of a certain set of conditions. Nations that have liberalized trade and that have solid macroeconomic fundamentals often benefit from capital account liberalization (Edwards 2008, Schneider 2001), in contrast to countries with significant trade policy distortions and macroeconomic imbalances (Eichengreen 2003).[14] Weak and weakly-regulated financial sectors may lack the capacity to absorb, and to benefit from, capital inflows (Prasad et al 2007). As several East Asian countries demonstrated in the late 1990s, weakly-regulated domestic banks may be more able to engage in risky behavior in an environment of financial openness, as they may borrow excessively from abroad (and then lend imprudently at home); borrow at short maturities; or borrow in foreign currencies (thereby exposing themselves to currency risk). Opening the capital account in the absence of stable macro-economies and strong financial sectors – that is, without regard to sequencing issues -- can delay or prevent the realization

[14] Edwards (2008) reports a significant, albeit small, relationship between capital account liberalization and contractions in capital flows. More importantly, the effect of capital mobility on the probability of investment contractions is magnified by current account deficits, fixed exchange rates, and a bias in investment toward shorter-term capital (that is, when the share of FDI in the economy is small).

of gains from liberalization; premature opening also may make reversals of capital flows more likely (Kose et al 2006). This logic may help to account for the fact that, while many low and lower middle income countries have experienced impressive rates of economic growth over the last few decades, these growth accelerations tend to fizzle out, often the result of external shocks (Rodrik 2006). Such shocks can include swings in commodity prices (Wibbels 2006), but they also likely encompass reversals in (official or private) financial flows.

Three main caveats, then, follow from this literature: first, capital account liberalization may be desirable for countries, all else equal; but the precise form of liberalization that is effective – in terms of which asset markets are liberalized first, for instance – depends on country context. Second, for many countries, the capacity to regulate adequately the domestic financial sector is essential to realizing the benefits of capital account liberalization. Without appropriate reform sequencing – allowing domestic banks to borrow from foreign banks without appropriate regulatory and supervisory practices in place, for example – countries may not reap the benefits of capital account openness (Eichengreen 1999). Rather, they may fall victim to financial crises, which can serve to erase many of the initial gains. Third, even with appropriate regulatory practices in place, volatility in financial flows remains a possibility; just then, as investors may want to diversify their investments in order to lower total risk, governments and local firms may find it desirable to avoid pronounced reliance on any one type of capital inflow.

In terms of the first caveat, in its 2005 *Learning from Reform* report, the World Bank acknowledges that a single broad reform objective – such as macroeconomic stability or the opening of domestic markets – could be reached through multiple paths (Rodrik 2006). The most effective reform path for a given country, then, could be highly dependent on national context – economic as well, perhaps, as political. Such a claim draws from the broader literature on economic growth, which finds few hard-and-fast relationships between specific institutions and growth; the impact of

institutions often is interactive and contingent, rather than independent. Applying this lesson to financial liberalization in developing countries, then, we might expect that the governance of, and incentives for, foreign direct investment will differ between countries with large natural resource endowments and those whose productive advantages stem from an abundant labor force. Or we might expect that nations with deeper and more diversified domestic banking systems will be more able, at the outset, to benefit from inflows of foreign bank and portfolio capital.

The second caveat suggests a more direct temporal linkage between national institutional structures and capital account liberalization – that certain institutional mechanisms, which allow for the governance of capital inflows (as well as a stable macroeconomic environment), should be in place *prior* to full capital account liberalization. Or, as Kose et al (2006) suggest, "the benefits-to-costs calculus [for financial globalization] is much more compelling for countries with robust institutions and macroeconomic policies" (p. 9). These regulatory issues may be most pronounced in low and lower-middle income countries, particularly those that are in the midst of, or recently have experienced, transitions to democracy. In their study of the link between FDI and economic growth in developing nations (and covering the period 1970-1995), Hermes and Lesnick (2003) find that a baseline level of financial sector development is a prerequisite for realizing the positive effects of direct investment. While many countries in Latin America and Asia meet this baseline level, almost every country in Africa falls below the threshold.

The third caveat – the potential for reversals in capital flows, even absent policy mistakes – is particularly relevant for nations with high dependence on commodity exports. At present, high global commodity prices facilitate enthusiasm about, and consumption booms in, many sub-Saharan African nations. But, were the predictions of the "natural resource curse" to hold, these booms might not translate into longer-term growth, causing investors to reconsider their earlier optimism. Moreover, downturns in commodity prices would reduce revenues to local (and foreign) exporters.

If financial system deposits from these exporters – today's petrodollars – decline, banks will have less capital to lend, generating a contraction in the financial system, as well as the potential for problems with non-performing loans. More generally, then, the exposure of national economies to factors beyond their control – global market sentiment, financial sector problems in developed markets, or commodity price swings – suggests a cautious response to the current enthusiasm for investment in Africa, and continued attention to the management and sustainability of public debt (i.e. Le Manchec 2008).

III. Regulatory Issues in African Nations

Challenges associated with regulation and governance are by no means unique to African nations, or to developing nations more generally. Mirroring a general trend in global economic governance, international and transnational efforts at financial regulation have increased dramatically in recent years (Armijo 2002, Drezner 2007). These efforts involve public sector actors (international financial institutions, national governments), private market participants (investors' representatives, national accountants' associations), and public-private partnerships (i.e. the Financial Stability Forum; also see Slaughter 2004). International standards seek, among other goals, to encourage the provision of higher quality information (Mosley 2003); to set common accounting standards (Crouzet and Véron 2002); to resolve economic crises via orderly workouts for sovereign debt (Conceição 2003, Eichengreen 1999); and to encourage prudential bank behavior (Singer 2007).

Whether rules have their origins in domestic political systems or in the global realm, they raise issues of compliance and capacity (Mitchell 1994, Simmons 2000). A government's public commitment to a given standard introduces a reputational angle, but it by no means ensures implementation of the standard. The structure of domestic interest groups, as well as the nature of national political institutions and political competition, may give governments incentives to delay or

avoid implementing certain standards. Political will, then, often is essential to compliance and implementation. Moreover, capacity also plays a role: compliance may be particularly problematic when rules, and the subjects they govern, are highly technical. This is often true of rules related to finance: the staff of regulatory agencies may lack the technical expertise necessary to supervise private actors adequately. And, even when supervisory capacity is high, private market participants may find means of circumventing regulations – following the letter, but not the spirit, of the law.

For African nations, both the will *and* the capacity to enact and implement regulatory measures are central to realizing many of the benefits associated with financial openness. What does recent evidence suggest about the extent of regulatory capacity in African nations, both in general terms and in comparison with the set of contemporary emerging market economies? I consider two forms of evidence: broad indicators of governance and of financial regulation, looking at average levels of performance across types of countries; and several recent assessments of financial sectors in Africa, undertaken as part of the IMF/World Bank's Reports on the Observations of Standards and Codes (ROSCs) and Financial Sector Assessment Programs (FSAPs).

Comparisons with Emerging Market Economies. Recent attention to the role of "good governance" in economic development has focused on areas including political accountability, control of corruption, rule of law and regulatory quality. Many of these items also are identified as among – or closely related to – the domestic institutions and practices that allow countries to reap the benefits of global capital flows. We can look to quantitative data on various governance indicators, both as a means of identifying trends over time in African nations, and as a useful comparison between African and emerging market economies. This comparison is not meant, by any means, to suggest that emerging market economies have solved the main problems associated with governance; rather, if African nations have made significantly less progress in governance than

their middle-income counterparts, we might wonder about how prepared such countries are for the rigors of financial market openness.

As part of a broader research project on governance, Kaufman et al (2007) measure six dimensions of governance, using over 30 different indicators. They assess these indicators on a biannual basis, from 1996 to 2000, and annually from 2002 to 2006. The three most relevant dimensions are regulatory quality, rule of law and control of corruption. They do so using a wide arrange of quantitative indicators; they report both point estimates and confidence intervals (standard errors, based on variation among sources) for each observation. While the calculation and implications of Kaufman et al's measures is not without controversy (i.e. Kurtz and Schrank 2007), they point to the differences across countries in terms of domestic institutional and regulatory outcomes.

The figures in this section focus on three groups of countries: the eight African nations that recently have seen expanded foreign participation in their public debt markets (Botswana, Gabon, Ghana, Kenya, Nigeria, Tanzania, Uganda and Zambia); all other African nations; and the EMBI-Global nations (35 in total, excluding the six African EMBI-G countries). Figures 4a, 4b and 4c present averages within each of these groups, using data from 1996 to 2006. Figure 4a points to pronounced differences in regulatory quality across groups of countries; within Africa, we see that the eight nations with recent international activity in their bond markets have significantly better regulatory outcomes than the continent as a whole. But we also see a slight decline in regulatory outcomes for this set of countries. In emerging markets, regulatory quality is consistently higher than in the developing world generally; for 2006, for instance, the average regulatory quality score for all low and middle income nations was -0.49, while the average score for EMBI-G nations was 0.22.

Overall, the rule of law measure (Figure 4b) takes a similar form: emerging market nations have outcomes that are consistently higher, on average, than those in Africa (although in this case,

there's been little improvement in emerging market average scores on over time). Again, the "African bond market" subset has a noticeably higher level of respect for rule of law than others on the continent, with a slight trend toward improvements over time. With respect to control of corruption, emerging market nations have witnessed little overall change during the last decade; they rank substantially higher than African nations. But, while the subset of African countries with recent bond market activity is improving in its control of corruption, the opposite is true for the overall trend in the remainder of African nations.

Insert Figures 4a, 4b and 4c here.

As a final illustration of the difference across country groups in governance indicators, Figure 5 employs data on regulatory quality for the most recent year (2006), again sorted into three groups. This figure, though, also illustrates the variation within each category, indicating the 25th and 75th percentiles. While there is (again) a pronounced difference between the general groups of African and emerging market nations, there is less of a difference between the eight African countries that have recently increased their engagement with international bond investors. Indeed, emerging market countries that fall below the 25th percentile in regulatory quality have worse outcomes than the mean "African bond market" country. Perhaps, then, some of the African nations that have recently increased their involvement with global capital markets *do* have some of the regulatory and institutional preconditions necessary to take advantage of such inflows. The challenge, then, may be to expand the group of African nations for which regulatory quality, rule of law and control of corruption approach the level of that in emerging market nations.

Insert Figure 5 here.

Turning to governments' participation in international codes and standards, we might consider the extent to which African nations' involvement in such activities indicates their more general preparedness to manage private capital inflows. One relevant code in this respect is the

IMF's Special Data Dissemination Standard (SDDS); this code requires governments to meet certain guidelines governing the coverage, comparability and timely release of economic and financial statistics. According to the IMF, the SDDS is aimed at countries that have or seek access to global capital markets; once a country subscribes to the SDDS, the IMF assesses its compliance with the data standard. The notion is that better data practices will allow private investors to make more informed investment decisions, rendering sudden swings in capital flows (in light of new or revised information) less likely (see Bhinda and Martin 2005, Mosley 2004, Schneider 2005). The counterpart to the SDDS is the General Data Dissemination Standard (GDDS), a less stringent set of statistical best practices that are intended to apply to all IMF members.

The pattern of current subscribers to the SDDS and GDDS demonstrates that the SDDS remains focused on high and middle-income countries. Table 1 divides subscriber countries according to income categories, as well as by region. What is most noticeable is that only one sub-Saharan African nation – South Africa – subscribes to the SDDS. Egypt, Morocco and Tunisia also are SDDS subscribers. And, among low income countries, only three governments – India, the Kyrgyz Republic, and Moldova – participate in the SDDS. That participation in this standard is concentrated among middle and higher income nations is not surprising; but it is perhaps indicative that, lacking many of the regulatory prerequisites necessary to take full advantage of capital account liberalization, African governments ought to proceed with caution.

For a broader assessment of governments' compliance with key international standards and codes – covering banking, insurance, payments systems, accounting and the like – we also can turn to data provided by EstandardsForum.[15] Estandards is a private sector-based effort to monitor country compliance with twelve international standards and to provide cross-national summary data

[15] All data are from www.estandardsforum.com; accessed March 14, 2008.

Table 1: Participation in IMF-Sponsored Data Standards[16]

	SDDS Subscribers	GDDS Subscribers	Total Countries
Income Category			
Low	3	42	56
Lower Middle	16	23	52
Upper Middle	17	16	36
High OECD	22	0	23
High non-OECD	4	4	15
Region			
Europe & C. Asia	36	6	48
M. East & N. Africa	4	7	18
E. Asia and Pacific	8	8	23
South Asia	1	5	8
Latin America & Caribbean	10	20	34
Sub-Saharan Africa	1	41	47

to market participants. Estandards provides monthly compliance scores for each standard; their data begin in January 2003. Each rated country receives a score ranging from 0 to 100, with lower scores indicating no or little compliance, intermediate scores indicated standards that have been enacted but not fully implemented, and high scores denoting full compliance. These assessments draw from the ROSCs, as well as from data collected from other sources. For each year, I use the July 1 observation as the annual score.

It is perhaps telling that, of the approximately sixty countries rated by Estandards, only six are in sub-Saharan Africa – Cameroon, Ghana, Kenya, Nigeria, South Africa and Tanzania. Given that Estandards focuses on providing information to private investors, we would expect this small subset of countries to have better regulatory outcomes than their neighbors in the region. Despite this, these six African nations consistently display average scores (for 2007) that are substantially below those for other regions. In some cases, the difference is striking: the average corporate

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[16] Data are participation are taken from the SDDS home page, http://dsbb.imf.org/Applications/web/sddshome/, accessed March 29, 2008.

governance score is 59 in East Asia (n=10), 52.5 in Europe and Central Asia (n=16), but 30 in sub-Saharan Africa (and an even more dismal 26.9 in Latin America). Sub-Saharan African countries average a score of 16.7 for securities regulation, compared with 43.8 in Europe, 52 in East Asia, 18.5 in Latin America and the Caribbean, and 19.1 in the Middle East and North Africa. Here, again, there is a dual problem – a general lack of information about the African region, relative to developing countries in other regions; and a frequently low level of compliance with internationally-developed standards.

Recent Assessments of Financial Sectors in Africa. For a more detailed assessment of regulatory capacity and outcomes in African nations, we can turn to data generated by the IMF and World Bank's ROSC program. The ROSC are intended to investigate the extent to which countries follow globally-recognized standards and codes – the same codes evaluated by Estandards forum. The codes cover areas including auditing; banking supervision; data dissemination and insurance supervision. ROSCs are prepared at the request of the government, and are intended to contribute to discussions between IFIs and governments and to aid private sector actors in evaluating economic and financial risk.[17]

Since its inception in 1999, the ROSC program has generated 646 individual reports, comprising both initial assessments and updates.[18] Some of these are completed in the context of FSAP programs, which generate multiple ROSCs (one per standard). As the IMF and World Bank (2005) pointed out in their recent review of the initiative, the majority of assessments have focused on developed and emerging market (rather than lower-income developing nations). On a regional level, fifteen percent of ROSCs (100 total) have involved African nations. On an annual basis,

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[17] The IMF takes primary responsibility for preparing ROSCs related to data dissemination and fiscal transparency; the World Bank assumes leadership for reports on corporate governance, accounting, auditing and insolvency. Assessments of the financial sector (including banking supervision and securities regulation) generally are done as part of the IMF-World Bank Financial Sector Assessment Program (FSAP).

[18] Data on ROSCs are based on the IMF's ROSCs site, http://www.imf.org/external/np/rosc/rosc.asp; accessed March 13, 2008. Counts for African nations include both North Africa and sub-Saharan Africa.

African countries' participation has ranged from 33 percent of ROSCs in 1999 to 7.6 percent of ROSCs in 2006. In 2007, the year with the fewest ROSCs completed, only four of thirty two Reports focused on African countries. This slowdown may reflect, to an extent, the fact that many governments now have had an initial assessment ROSC completed; it also may belie the fact that many governments do not actively seek out ROSC studies, even though they might benefit from considering the implementation of and compliance with key standards and codes.

Turning to the substance of ROSCs in African nations, the most frequently-assessed areas to date are data dissemination and fiscal transparency, followed by banking supervision. Table 2 summarizes completed ROSCs by issue area; it notes the total number of ROSCs for a given code, as well as the total number of countries assessed (accounting for the fact that some nations have received two or three assessments). Note that twenty-eight African nations have participated in the ROSCs program; the most frequent participants are Tunisia (13 ROSCs covering six areas), Uganda (10 ROSCs, 6 areas) and Mozambique (9 ROSCs, 5 areas).

Table 2: ROSC Assessments, African Nations

Area	Number of ROSCs (Number of Countries)	Most Recent ROSC
Anti-Money Laundering/CFT	5 (5)	Madagascar (2006)
Banking Supervision	17 (13)	Namibia (2007)
Data Dissemination	27 (19)	Chad, Botswana (2007)
Fiscal Transparency	22 (17)	Kenya (2008)
Insurance Supervision	5 (5)	Morocco (2003)
Monetary and Financial Policy Transparency	13 (10)	Rwanda, Namibia (2005)
Payments Systems	5 (5)	Mozambique (2004)
Securities Regulation	6 (5)	Uganda, Morocco, Ghana (2003)
Total	100 (28)	

I use a sample of these ROSCs to highlight some of the issues associated with regulation in African nations, and to consider the challenges facing governments as they attempt to cope – or consider opening their markets to – private capital inflows. These ROSCs were selected on the basis of two criteria – being relatively recent; and relating to some of the regulatory areas that may be most important as preconditions for financial liberalization (i.e. banking and data dissemination). I draw on a set of six FSAPs (Uganda 2003, Tanzania 2003, Ghana 2003, Mozambique 2004, Madagascar 2006 and Namibia 2007), each of which include ROSCs in multiple areas, plus ROSCs for Botswana (2007, on data quality) and Kenya (2008, fiscal transparency).

Many of these ROSCs point to positive features of financial systems in Africa, noting marked progress. For instance, Tanzania's banking system displays a high capital adequacy ratio (in excess of 20 percent), and its supervision is generally consistent with the Basel Core Principles. Similarly, Madagascar is characterized by a sound banking system, in which credit is diversified across sectors (especially in comparison to other African nations). Namibia's financial system is even more developed, with a profitable and well-capitalized banking sector, as well as a well developed set of non-bank financial institutions (NBFIs), account for 58 percent of the assets in Namibia's financial system. In regulatory terms, Ghana's ROSCs points to its recent improvements in securities regulation, while Mozambique's Report details its progress in strengthening bank oversight.

These points notwithstanding, though, this set of ROSCs also points to a variety of challenges and shortcomings facing African governments and regulators. Table 3 summarizes many of these issues; the first column categorizes these in broad terms, while the second column offers details of issues identified in specific ROSCs. The basic pattern that emerges is that – not surprisingly – sub-Saharan African nations face many challenges related to developing their banking sectors and capital markets; managing public debt; and regulating and supervising financial institutions. If we take financial sector development as an important precondition for liberalization

Table 3: Issues Identified by Recent ROSCs

Broad Category	Specific Issues
Banking sector development	Limited role for banking sector in the economy (Ghana, Tanzania, Uganda)
	Access to financial services very limited (Ghana, Madagascar)
	Highly concentrated banking system; finances only 10% of new loans (Mozambique)
	Weak competition in banking sector, but public concerns about foreign participation (Ghana)
	Tendency toward short-term bank loans (Uganda)
Banking sector weaknesses	High level of past due loans (Ghana)
	Banks tend to invest in short-term government securities (Ghana)
	High ratio of non-performing loans (Madagascar, Mozambique)
	Lack of diversity in bank holdings; holding a large proportion of government securities, therefore exposed to interest rate risk (Uganda)
Capital market development	Credit to private sector is very small, short-term (Tanzania)
	Limited investment opportunities in domestic financial markets, perhaps suggesting a need for asset securitization (Namibia)
	Lack of liquidity in domestic stock market (Uganda, Tanzania, Mozambique)
	Financial system provides little long-term financing to the economy (Madagascar)
	Public pension fund heavily invested in government securities (Tanzania); in short-term bank deposits and treasury bills (Uganda); or in assets abroad (Namibia)
	Underdeveloped payments systems (Madagascar, Uganda)
Debt Management	Very underdeveloped markets for medium and long term debt; little market for treasury bills with maturities greater than 91 days (Ghana)
	Lack well-developed market for longer-term bond issues, or for secondary trading in government debt (Tanzania, Uganda)
	Small interbank lending market; scarcity of credible counterparties (Tanzania, Uganda)
	Need to develop a strong government securities market (Mozambique)
Monetary and fiscal policy management	Need a sterilization plan to deal with effects of foreign capital inflows (Tanzania)
Financial sector regulation and supervision	Political independence of bank regulator sometimes questionable; some scope for intervention from Minister of Finance (Tanzania, Uganda).
	Financial regulator lacks technical resources and skilled staff (Madagascar, Namibia, Tanzania, Mozambique)
	Weak enforcement of prudential regulations (Ghana)
	Lack of regulatory capacity in NBFI sector (Namibia); or in pensions and insurance (Madagascar, Mozambique)
	Loan classification regulations do not meet international standards (Mozambique)

Broad Category	Specific Issues
	Banks require greater guidance on prudential requirements (Uganda)
Legal system and corporate governance	Weak corporate governance procedures (Ghana, Mozambique)
	Local firms' financial reporting practices need improvement (Ghana, Madagascar, Mozambique)
	Efficiency of legal system, contract enforcement (Tanzania)
	Need stronger minority shareholder protections (Uganda)
National statistics and accounting systems	Moving toward, but not in, conformity with international fiscal transparency standards (Kenya)
	Timeliness and periodicity of economic data (Botswana)
	IAS not yet implemented, and may not be appropriate for smaller firms (Mozambique)

(see Schneider 2001), we might conclude that many of the assessed countries are not ready for full capital account liberalization. We might expect that, given the voluntary nature of ROSCs and FSAPs, countries that enter the program are in *better* regulatory shape than non-participants: the ROSC program may provide reform-minded governments with detailed information regarding the policy challenges they face, providing a road map – and perhaps a more binding commitment – to regulatory reform. If this "selection" process is at work, African countries that have not participated in the ROSC program may face even greater challenges.

In some cases, addressing these challenges could be facilitated by further engaging global capital markets. For instance, foreign investment could aide in the deepening of government securities markets and national stock markets. Participation by experienced foreign banks could promote the growth of a deeper and more efficient interbank market (see Kose et al 2006, Schneider 2001). But in many cases, the shortcomings likely need to be addressed *prior* to further capital market liberalization, so as to allow countries to take fuller advantage of global financial markets and to avoid many of the risks generated by financial openness. For instance, increased inflows into the banking sector might motivate banks to expand their activities further into the economies, and increasing limits on foreign portfolio participation would provide more liquidity to the financial

system. But, as the authors of Ghana's ROSC stress, "the pursuance of this latter option is conditional on Ghana making further progress in improving macroeconomic fundamentals and in creating a strong and well-supervised financial sector" (IMF 2003a,p. 18). For instance, the expansion of domestic banking capital would generate new demands on the financial regulator, in terms of playing closer attention to banks' risk management practice. The ROSC for Tanzania acknowledges this need for future, as well as current regulatory capacity, in pointing out that continued capital account liberalization will generate a need for additional safeguards (IMF 2003b).

The issues summarized in Table 3 also raise the issue of time horizons: some of the proposed reforms, such as adopting international account standards – and, more specifically, training regulators in these standards, instructing local accountants regarding these standards, and assisting local firms in the transition to these procedures – will require time, as well as resources. The sequencing argument suggests that governments forego the potential short-term benefits of capital market liberalization, instead electing to solve regulatory problems prior to liberalization. But the international community and governments alike needs to consider the length of the "medium" or "long term?" What is a sufficient time frame for governments to address regulatory issues? How long should governments and firms forego capital inflows, particularly in a time of declining official flows? And to what extent might those interest groups that stand to lose economically from liberalization (i.e. locally-owned banks, which would face increased competition) use calls for regulatory improvements as a political justification for continued closure? Of course, the length of the time to reform depends in part on the participation of international actors: increased technical and training assistance – as has been provided to Madagascar's Banking and Financial Supervision Commission (CSBF) by the Banque de France, World Bank, and the Financial Stability Institute – can speed the reform process.

Furthermore, the issues identified in Table 3 raise a larger issue regarding recent efforts at global financial standards (see Drezner 2007) and the role of African nations within that effort. To what extent are the "key codes and standards" promulgated by IFIs and developed country economic official appropriate for African nations? Note that many of these codes were written by developed country authorities, or by private sector actors, with little consultation from emerging market and low income stakeholders (see Mosley 2008). Given the locus of political power in the global financial system, this is not surprising. But it does suggest that such codes may be far less suited to African countries' development level and economic situations. For instance, adopting international accounting standards would be prohibitively expensive for many small and medium-sized firms in Mozambique; it may make more sense for such firms to continue to follow the national standards, which are less complex and easier to implement (IMF 2004).

To take another example, international rules for banking regulation and supervision may not fit the situations on the ground. Where banks have high levels of non-performing loans (i.e. Ghana, Madagascar and Mozambique), the capital adequacy requirements of Basel I may not be large enough. Additionally, governments may lack the capacity to implement the newer Basel II accords. In October 2005, Namibia announced in that they would move to implement Basel II. But given that their financial institutions are not yet in full compliance with the Basel Core Principles, such an effort seems premature. Namibia's recent ROSC points out that Pillar 1 of Basel II, with its provisions for either standardized or individual (using banks' internal risk assessments) rules for capital adequacy, is likely beyond the capacity of Namibia's banks and financial regulator. It should focus, instead, on the more relevant functions of supervision (Pillar 2) (IMF 2007, p. 22). To what extent, then, should we expect such countries to have the technical capacity – or even the political will – to implement codes that were originally designed (as in the case of the Basel principles on bank capital adequacy, for instance; see Singer 2007) for wealthy, democratic nations? And might a

focus on codes that are "too advanced" lead to a lack of attention to other, more fundamental regulatory issues?

IV. Recommendations and Conclusions

What does this review suggest regarding policy choices for sub-Saharan African nations? While there are many policy issues related to financial liberalization, sovereign finance and regulatory efforts, three are central:

- First, national governments and financial regulators should develop a more accurate picture regarding the actual extent, maturity and composition of capital inflows (and outflows).

This should include an assessment of the extent to which legal restrictions on capital account activities are effective, in practice. Such initiatives could draw on recent efforts on data dissemination, as well as capacity building assistance from the donor community. In order to allow countries to meet international best practices for the collection of data, significant technical assistance will be necessary (see Bhinda and Martin 2005).

- Second, governments ought to maintain an awareness of the potential volatility associated with international capital flows, especially those of a shorter-term nature.

While such flows facilitate consumption smoothing and debt financing, they also can be prone to sudden reversals. Such reversals may reflect policy problems in recipient nations; but they also may stem from global market factors ("pull conditions"). The potential for reversals highlights the centrality of sophisticated and forward-looking debt management. Many African governments need to devote effort and resources to the establishment of debt management offices (Wakeman-Linn and Nagy 2008). While debt management offices are common in advanced countries, they are rarer in low and middle income countries; Nigeria's Debt Management Office is one of the few in the

region, and it has contributed to the development of local debt markets, as well as to Nigeria's exit from Paris and London Club arrangements (Gatz 2008).

More specifically, governments – or their debt management offices -- should manage their debt with an eye toward sustainable levels of borrowing, and with an awareness of maturity and currency structures (to avoid rollover risk). Debt management officials also should consider the tradeoff between issuing multiple debt instruments (perhaps facilitating the development of a longer yield curve) and offering few instruments, but with greater liquidity for each. Again, international assistance could be used to create debt management offices, adapting successful practices from other emerging market and advanced nations to the African context. Governments also should focus on how to attract investors with longer time horizons – both in direct investment and in portfolio capital markets. In many locations, these efforts may touch on property rights, judicial system and corporate governance reforms.

- Third, national authorities and international financial institutions should take seriously the sequencing argument. Given the evidence – anecdotal as well as statistical – that the positive benefits of capital flows are contingent upon a set of regulatory and political preconditions, achieving such pre-conditions should be a central goal for political officials.

Some of these preconditions, such as data collection, may be reasonably easy to effect. Others, such as well-developed regulation and supervision of financial institutions, may require a longer timetable; here, there is a possibility that sophisticated international standards – such as the Basel II Accords – may be difficult to implement or even inappropriate, at present, for some African nations. One implication here is that the transition phase to capital account openness may best be a long one, despite its potential benefits.

Each of thee prescriptions offers a role for the international community, both in terms of the specific policy advice it offers (rapid liberalization versus sequenced reform and gradual opening) and in terms of the sorts of technical and capacity-building assistance it might provide. The

challenge presented by capital account liberalization is that, as extant literature suggests, there is no "one size fits all" means of assessing countries' preparedness to take advantage of the global capital market. Many summary indicators of regulatory efforts and outcomes are crude and, even in the presence of such indicators, it is unclear whether what constitutions readiness for one country would constitute readiness for another. As Kose and colleagues conclude, there is "unlikely to be a uniform approach to opening the capital account that will work well for all countries" (pp. 35-36). The caveat, then, is to recognize the interactions among regulatory institutions, economic conditions, political institutions and global capital markets, with an eye toward appreciating the contingent nature of the macro-level effects of globalization.

International financial institutions certainly have paid attention to some of these issues. For instance, they have helped bring regulatory challenges to light through their ROSCs and FSAPs, and they have led the development of an international standard for the provision of national economic and financial data. More recently, both the IMF and the World Bank have drawn attention to the issue of debt sustainability (through their Debt Sustainability Framework; see Le Manchec 2008). At the same time, however, challenges beyond debt sustainability and data transparency often are central, and these may deserve greater – and earlier – attention than capital account liberalization.

The evidence above also reveals a fundamental tension facing policymakers as they consider the proper sequencing of liberalization and regulation. In a situation where local capital markets are difficult to develop, or locally-owned financial institutions are politically entrenched and difficult to regulate effectively, how ought governments to proceed? One possibility is that financial openness may serve as an impetus for the development and improvement of national capital markets and regulatory institutions, suggesting that liberalization itself can be used to strengthen domestic governance (see Kose 2006, Mishkin 2006). But, on the other hand, opening prior to regulatory improvements may serve to increase countries' vulnerability to sudden reversals of financial flows,

or to financial system crises. The result is a chicken and egg problem: openness may increase the efficiency and efficacy of domestic financial systems, but it also raises the specter of financial crises. How, then, to balance between the desire to use liberalization as a fillip to reform, and the interest – as a sequencing framework suggests – in ensuring that national economies are able to withstand the pressures generated by financial openness? Just as there is unlikely to be a single menu of regulatory choices that will work best for every low-income nation, it is unlikely that the same mix of cautious closure and global engagement is appropriate for each country.

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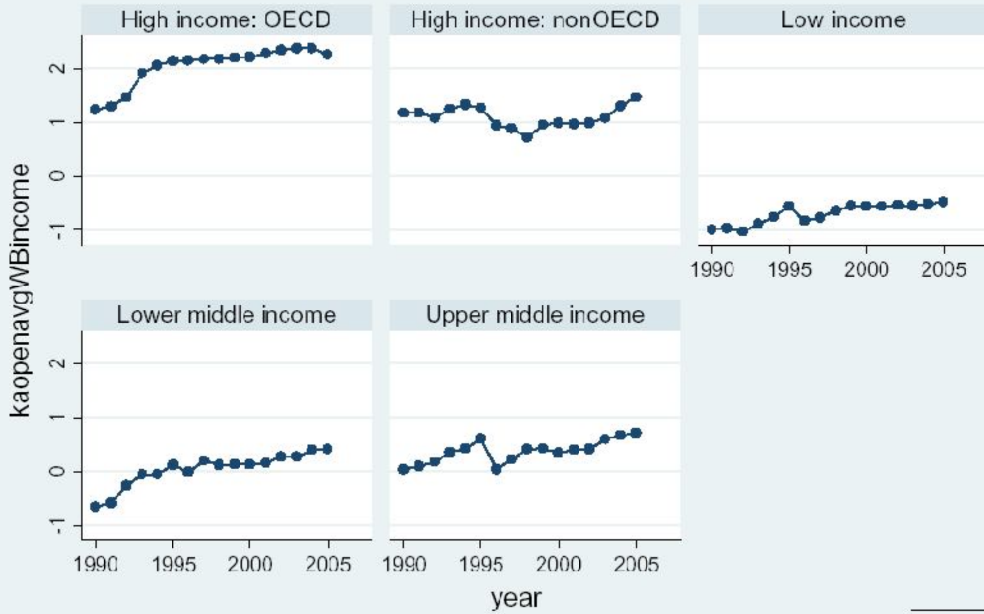
Figure 1a: Average Capital Account Openness
sorted by income category
High income: OECD
High income: nonOECD
Low income
Lower middle income
Upper middle income
kaopenavgWBincome
-1
0
1
2
1990
1995
2000
2005
year
STATA™

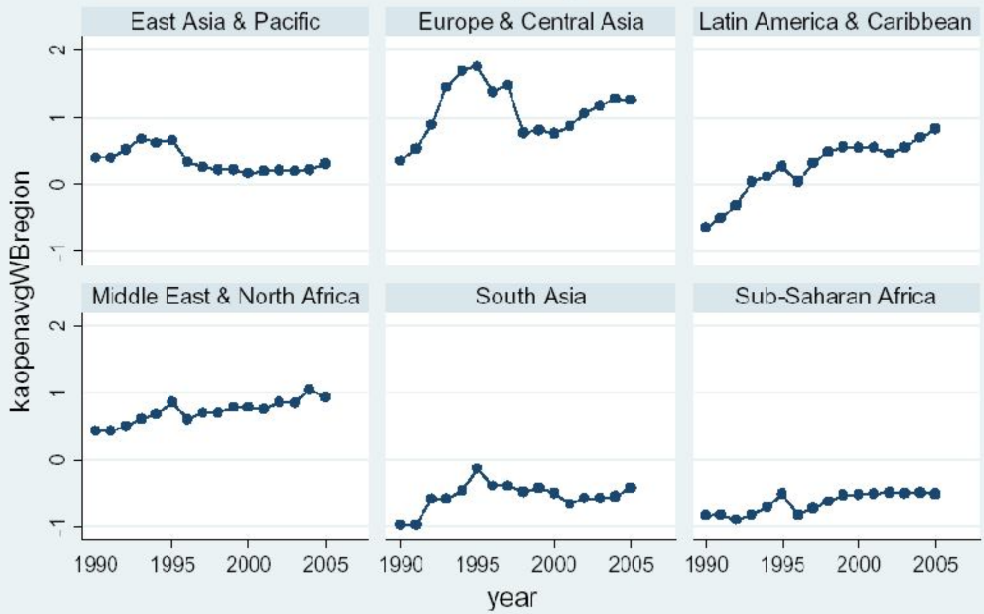
Figure 1b: Average Capital Account Openness
sorted by region
East Asia & Pacific
Europe & Central Asia
Latin America & Caribbean
Middle East & North Africa
South Asia
Sub-Saharan Africa
kaopenavgWBregion
-1
0
1
2
1990
1995
2000
2005
year
STATA™

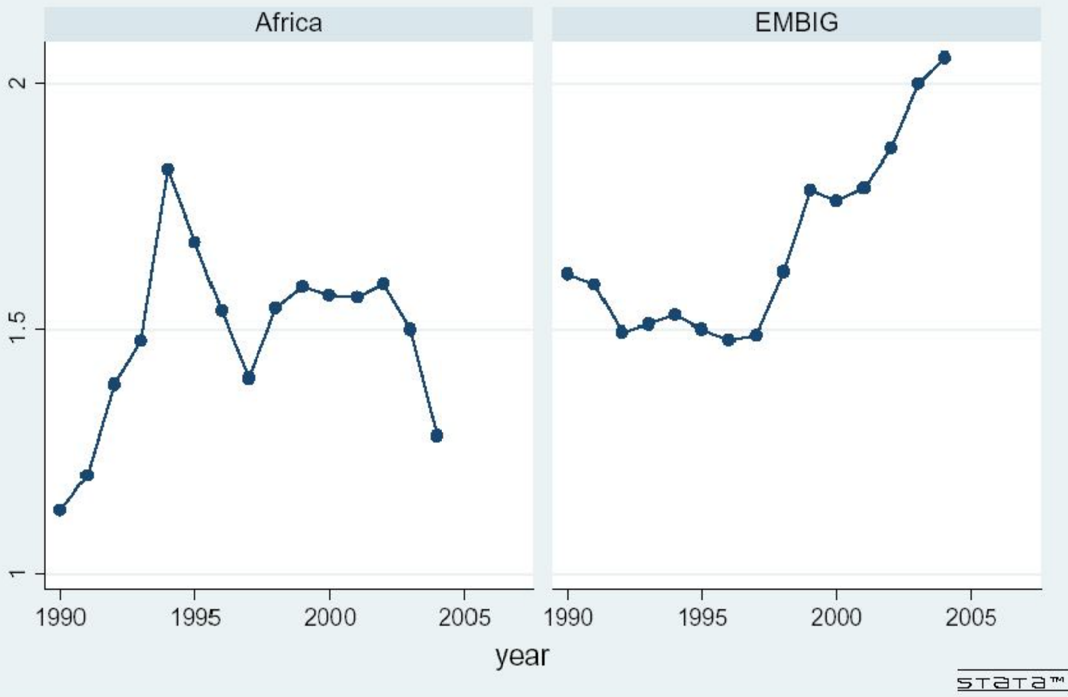
Figure 2: Assets and Liabilities
as a percentage of GDP
Africa
EMBIG
2
1.5
1
1990
1995
2000
2005
year
stata™

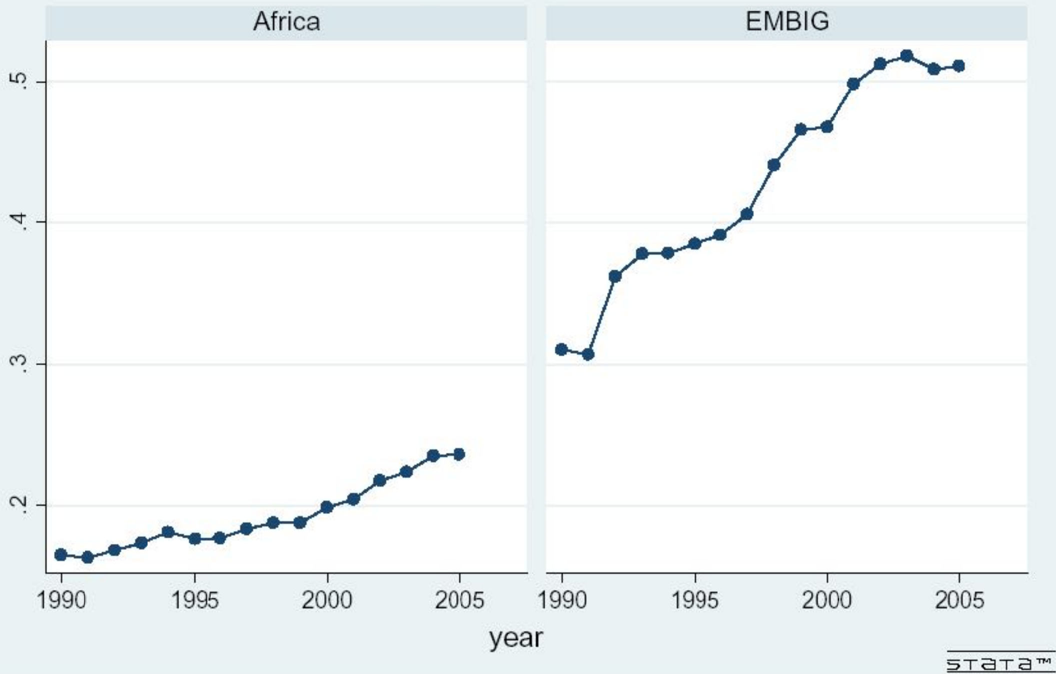
Figure 3a: Bank Deposits
as a percentage of GDP
Africa
EMBIG
.5
.4
.3
.2
1990
1995
2000
2005
year
stata™

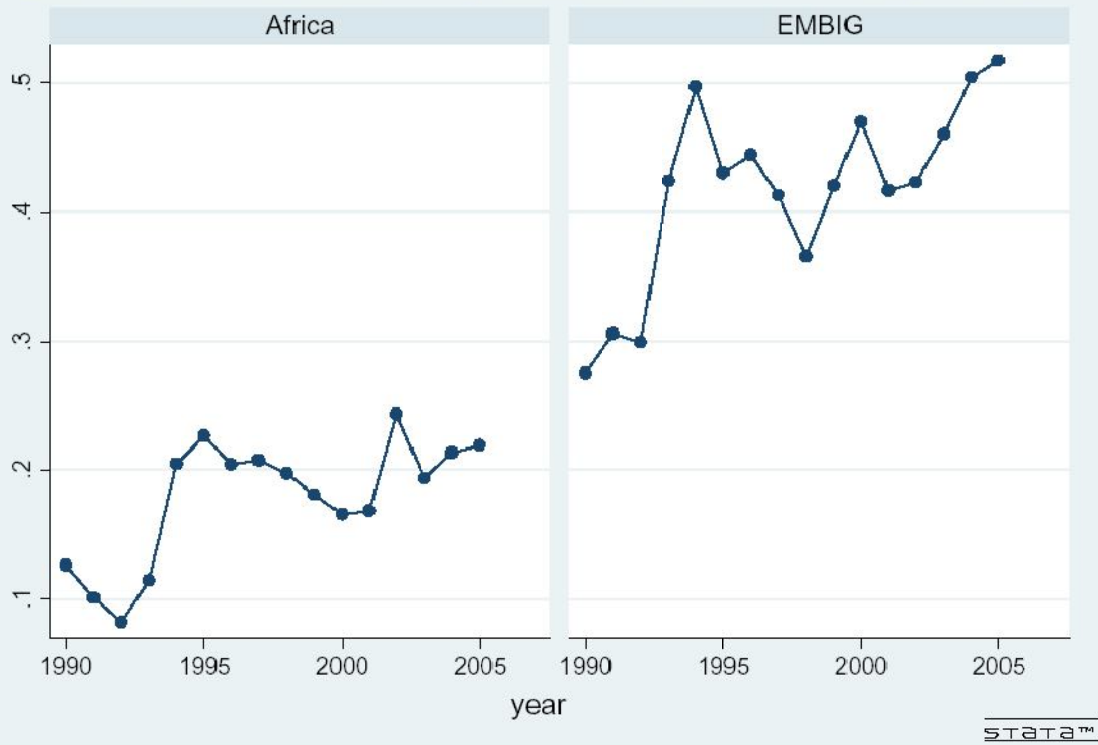

Figure 3b: Stock Market Capitalization as Percentage of GDP
Africa
EMBIG
.1
.2
.3
.4
.5
1990
1995
2000
2005
year
stata™

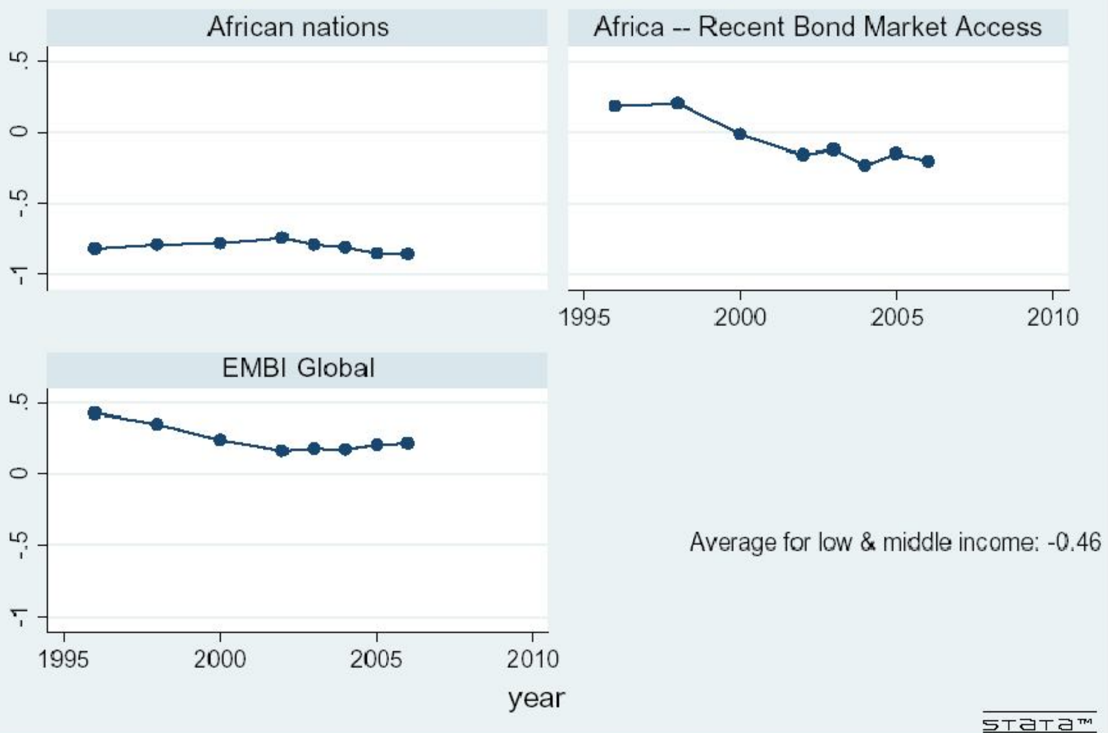

Figure 4a: Average Regulatory Quality
African nations
Africa -- Recent Bond Market Access
EMBI Global
-1
-.5
0
.5
1995
2000
2005
2010
year
Average for low & middle income: -0.46
stata™

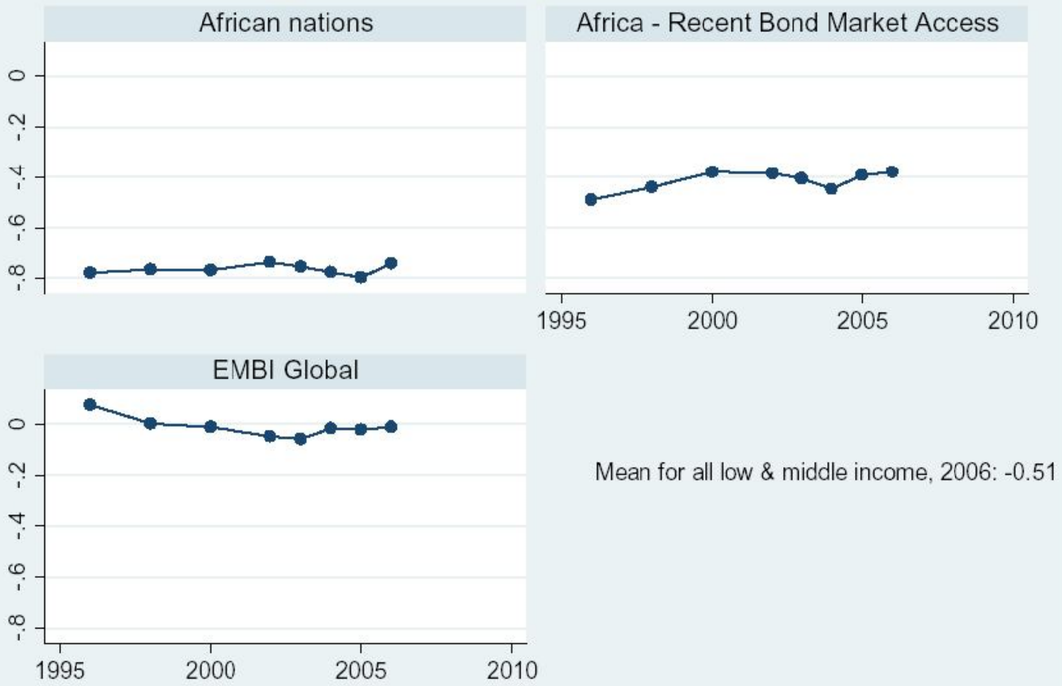
Figure 4b: Average Rule of Law
African nations
Africa - Recent Bond Market Access
EMBI Global
0
-.2
-.4
-.6
-.8
1995
2000
2005
2010
Mean for all low & middle income, 2006: -0.51

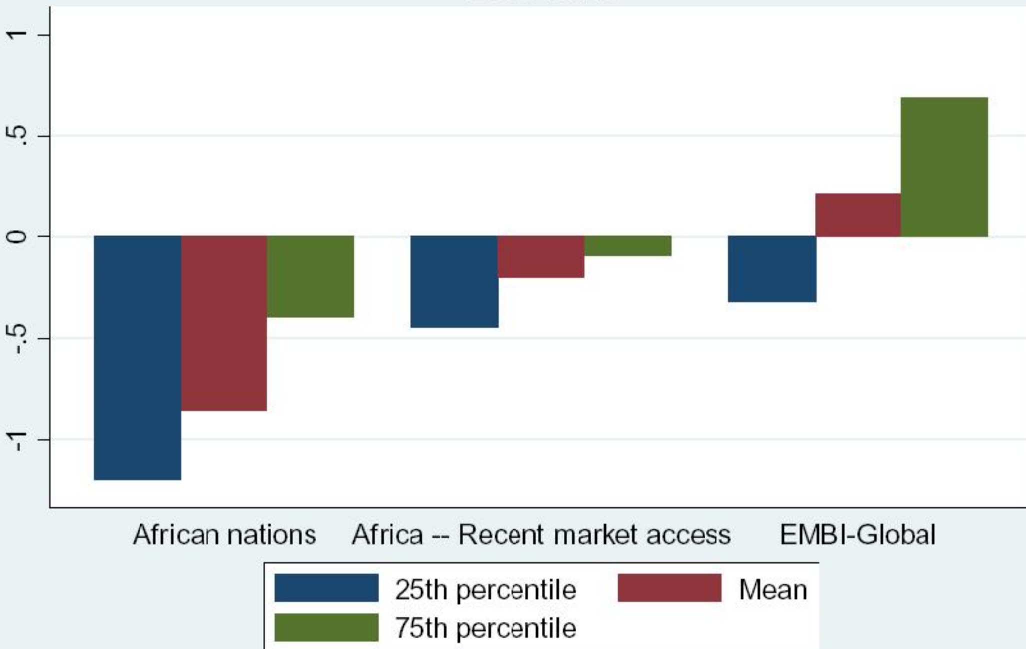
Figure 5: Regulatory Quality
2006 Data
1
.5
0
-.5
-1
African nations
Africa -- Recent market access
EMBI-Global
25th percentile
Mean
75th percentile