Leveraging Corporate Governance For Economic Development:

Imperatives for Regulators in Sub Saharan Africa

By Lucy Newman

Specific corporate governance-related reforms could make countries more attractive investment destinations, and emerging market investors believe that better firm-level governance can sometimes make up for country weaknesses.

Foreign investments are known to facilitate economic growth. However, effective monitoring mechanisms must be emplaced to mitigate potential risks to host countries and facilitate required growth in strategic sectors. In view of this need for optimal balance, countries often face the dilemma of attracting non-volatile FDIs, while keeping reins on volatile portfolio investments with potentials for economic disequilibrium. Financial institutions, especially banks and insurance companies are preferred channels for investment inflows. Therefore, that unique role could be leveraged to encourage related entities and organisations to embrace effective corporate governance practices, which can ultimately provide sufficient reassurance to investors.

This article explores theoretical and empirical insights and proffers practical ways that regulators in jurisdictions within Sub Saharan Africa [SSA] can consider in attracting investments for economic growth, through their financial systems. Presented in two parts, the first section is a synopsis, which provides general introduction with some relevant literature on the subject, while the second section is an inference, which discusses the theoretical and conceptual issues in corporate governance, with some recommendations to industry regulators within financial systems in SSA.

Synopsis

The increasing focus on Africa as a preferred destination for global commerce and investment is steeped in the continent's potential for economic transformation and growth, which to a large extent is still unexplored. The World Bank, in the latest edition of its *Africa's Pulse* alludes to this, while confirming that Sub-Saharan Africa (excluding South Africa) grew in 2012 at 5.8 percent as against developing country average growth rate of 4.9 percent. The Bank went on to project that economic growth in SSA should significantly outpace the global average over the next three years, as a result of resilient domestic demand, high commodity prices and other opportunities including mineral wealth, elevated food prices, rapid urbanisation and a demographic dividend in the region. The Bank also identified a major challenge to realising this growth as infrastructure constraint. (*Africa's Pulse Volume 7*, Chuhan-Pole, 2013).

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The quest for growth and development has always been a central focus in economic debates. Economists have been unanimous in their position that countries aspiring for economic growth must have a minimum level of savings to channel into investments, before they can experience economic growth (*Foreign Capital Flows and External Debt: Perspectives on Nigeria and the LDCs' Group*. Obadan, 2004). This was also a central assumption in the *Harrod-Domar growth models*, and the subsequent *neoclassical growth model* derived by Robert Solow and T. W. Swan. The preponderance of empirical evidences to support this position has led to the quest by sovereigns to encourage a savings culture amongst their citizenry towards ensuring they have enough resources to acquire necessary capital for economic growth.

Developing economies also recognise the importance of savings and accumulating necessary resources. However, they appear constrained by the structural deficiencies in their respective economies, which tend towards entrenching a vicious cycle of poverty. The alternative for them therefore, is to attract resources from external sources, via overseas development assistance (ODA) to governments, private capital through domestic multinational banks, foreign investments, etc. (*Determinants of Capital Flows in Nigeria and Challenges for Macroeconomic Stability*, Englama et al, 2009). Most developing countries tend to prefer grants because grants are usually without the burden of repayment. However, the trend now is to discourage giving of grants and instead, encourage economies to become more fiscally disciplined to be able to save, encourage investments and facilitate economic growth.

From economic literature, there are two components of foreign investments – portfolio investment and foreign direct investment (FDI). Portfolio investment consists of bonds and equities, offering reduced risk to investors. However, portfolio investments are a usual cause of worry for host countries, because they are mainly short-term, and they are often used for arbitrage opportunities and capital gains. Also because they can easily be recalled at the slightest provocation, they are usually referred to as “volatile” funds. Empirical examples include the East Asian crisis of 1997 and the recent Nigerian capital market meltdown of 2008. FDIs on the other hand tend to offer higher “risks to investors” because foreign investors cannot easily recall their investments when the need arises. Therefore, FDIs tend to be more desirable to host countries, because they do not seem to portend serious macroeconomic instability to their economies.

The challenge for countries, especially developing economies, is how to attract the desirable FDIs into their economies, while closely monitoring and, where

possible, minimising the not-too-desirable volatile portfolio investments. Most countries employ different strategies and offer incentives to attract FDIs. These include tax exemptions, low cost of production, infrastructure availability, etc. Unfortunately, most developing countries are unable to compete for FDI effectively, because of their structural deficiencies, observable high incidences of corruption and protracted vicious cycle of poverty.

The central premise here is that demonstrated effective corporate governance practices tend to provide some level of reassurance and comfort to investors. By emplacing corporate governance as a corporate cultural norm, Sub-Sahara African countries can in view of projected medium to long-term economic growth, offer a strategic edge and, therefore, be in a good position to attract desired FDIs for necessary capital accumulation and growth. The seeming developments in variety and sophistication in financial services and resources in SSA, actually offer a unique opportunity for regulators of the industry to require that their financial institutions demand compliance with specified minimum level of corporate governance practices amongst their major corporate customers and service providers. I believe that this theoretical postulation is practicable and, if properly pursued as a strategic regulatory thrust, can within the medium to long-term, start a revolutionary change in the way businesses carry out their activities in Nigeria and SSA, and may in turn, positively impact FDI inflows.

Inference

All economists believe in the equality of savings and investment, even though they often disagree on how this equality is brought about. While classical economists believe that full employment can be achieved through the mechanism of the interest rate, the Keynesian economists believe that it is brought about by changes in income level. More importantly, they all consent that savings are indispensable for economic growth; and where there is a deficiency of savings, one has to source foreign savings to bridge the savings-investment gap. ("*Capital Flows and Financial Crises: Policy Issues and Challenges in Nigeria*". CBN Economic and Financial Review. Obiechina, 2010).

Unfortunately, most developing countries, including those within SSA are characterised by low levels of domestic savings, which seem to have prevented them from being able to make the crucial investment in capital accumulation for economic development. To exit this conundrum, they will need to leverage their competence to become competitive and be able to attract foreign investment. Needless to say that having an abundance of natural resources does not necessarily guarantee economic growth (Barro and Sala-i-Martin, 2002; Collier and Gunning, 1999; Sachs and Warner, 1977: cited in Mahmud, 2009).

In their empirical work, Arora and Vamvakidis (2005) opined that openness facilitate economic growth in a domestic economy that trades with relatively better economies. However, they failed to specify the necessary conditions that will ensure that the weaker economy gains from such a relationship. Their study was contradicted by Yauri (2009) whose study of the impact of foreign direct investment in Nigeria revealed that FDIs are not export-seeking, neither do they contribute to the overall capacity of developing economies to manufacture goods for export. Instead they are attracted by certain other economic fundamentals like market size, availability of natural resources, level of real income, availability of skilled labour, infrastructures, favourable trade policies, political and macroeconomic stability. The critical questions, therefore, are: Can corporate governance provide the missing safety valve to protect weaker economies that have aspirations of opening their economies to trade with their stronger counterparts? And can corporate governance actually be leveraged to provide a competitive advantage that will attract and sustain foreign capital flows to developing economies?

"Corporate governance defines the rules and institutions for coordinating collective activity and the process for deriving these ... and involves a host of private actors in setting agendas, creating rules and monitoring and enforcing compliance" (*Strategies, Markets and Governance*. Cambridge, Cambridge Press, Boscheck, 2008: 8). This definition highlights certain crucial aspects of governance framework: Rules, institutions, setting agendas, monitoring and enforcing compliance. These show that corporate governance actually provides the essential ingredients that foreign investors require for them to be comfortable in investing their funds. »

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According to a study by Khanna and Zyla (2010), corporate governance is a major factor that foreign investors consider when they make decisions on where to invest. The study reveals that specific corporate governance-related reforms could make countries more attractive investment destinations, and emerging market investors believe that better firm-level governance can make up for some country weaknesses. Corporate governance is also a critical factor in emerging market investment decisions and investors are observed to be willing to pay a premium for better-governed emerging market firms. Lack of transparency is a red flag for emerging market investors, and they often do not invest in emerging market companies with observable poor governance practices.

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The World Economic Forum's 2013 Africa Competitiveness Index indicates despite various initiatives taken by most countries in SSA, there are still immense opportunities for improvement. Could it be that moral suasion from industry regulators in financial services sectors of respective jurisdictions, requiring financial institutions to not only internalise principles of corporate governance themselves, but also require same from their major corporate customers and suppliers place us on the path to enhanced competitiveness to attract foreign direct investments and overtime, improve domestic savings?

End Note:

FITC has been advocating for and delivering bank director continued education series from 1984 to date. FITC has also collaborated with the Central Bank of Nigeria in delivering Bank Director Training from 2006 to date, and has been collaborating with the Mortgage Bankers' Association of Nigeria [MBAN] in delivering continued education series for directors of Mortgage Institutions from 2007 to date. In March 2011, the Global Corporate Governance Forum of the International Finance Corporation [IFC] nominated FITC to be the Corporate Governance Centre for Banks in Sub Saharan Africa. In furtherance of FITC's advocacy for effective corporate governance practices beyond the private sector as a demonstration of what has been advocated in this article, FITC will in Collaboration with the Nigeria Institute of Directors Corporate Governance Institute, be delivering a one-day Corporate Governance workshop for Public Sector policy and strategic decision makers in Lagos, on October 24, 2013.

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