

EFFECT OF FINANCIAL RISK ON REGIONAL FINANCIAL INTEGRATION IN AFRICA

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ABSTRACT

The study examined the effects of financial risk on African regional financial integration covering 2008–2024. The study used panel regression analysis to assess the effect of loan default, delayed payments, losses from currency control, and expropriation of private investment on net capital inflow in South Africa and Nigeria. Loan default, payment delay, and expropriation of private investment all intensely reduce net capital inflow by -2.97%, -2.98%, and -2.02%, respectively, according to the research. Nevertheless, net capital inflow is positively affected, albeit somewhat, by losses from exchange control. The study established that there is a correlation between financial risk and the amount of investment flowing into Africa. More investment in Africa can only be encouraged if profit repatriation regulations are relaxed and loans are repaid on time.

Keywords: financial risk, loan default, exchange control, expropriation of private investment, capital inflow.

1. INTRODUCTION

The primary objectives of financial integration at the regional and global levels are to facilitate trade within and between member states, increase the flow of FDI, and boost economic growth and development. To achieve monetary union in any area or on the global market, reliable macroeconomic stability is essential. However, macroeconomic stability is attainable when the financial system is made to be predictable, stable, and transparent (Sildar, 2010). The country risk premium, which is the default spread on a country's bond, is determined by multiplying the equity risk premium by the volatility of the country's equity relative to the US equity market. A melded premium, which accounts for the higher volatility of the equity market, is then added to this formula (Damodaran, 2015). Like other industries, the construction industry faces intense competition, uncertainty, and risk on a global scale, both from competitors and customers. These worries affect the bottom lines of multinational contractors. The most notable risk factors that can be identified for global construction firms include exchange rate risk, inflation, cultural differences, language barrier, expropriation, tax discrimination, corruption and bribery, societal conflicts, force majeure, and law and regulation (Aydogan & Köksal, 2014). It has been particularly evident that political activity correlates with foreign investment during economic or financial crises. Tools that provide more precise and refined assessments might be built with the use of financial risk analysis (Sottilotta, 2013).

Because global hazards are interrelated and have a systematic effect on risk management, it is crucial to identify, assess, and predict the interdependencies among risks using normal risk

management techniques with specific ideas developed for uncertain contexts. If these risks are not adequately addressed, they might cause significant social, economic, and political problems. The World Economic Forum (2022) stated that in order to strengthen the global economy and society, public and private sectors must collaborate on a global scale. In its 2022 Global Risks Report, the Global Risks Perception Survey (GRPS) identified economic, social, environmental, and technological tensions as the primary risk drivers. The worldwide survey study indicated that social and environmental concerns will pose the greatest threat in the next years. Uneven economic recovery poses a threat to cooperation on global issues, according to predictions that the world economy would contract 5.9% in 2021, 4.9% in 2022, and 2.3% in 2024. Another consequence of the COVID-19 pandemic is the 13% increase in worldwide government debt, which will reach 97% of GDP in 2020. The results of the study indicate that improved global governance and more efficient global risk mitigation methods are necessary in light of the pandemic, which highlighted the shortcomings of international collaboration (IMF, 2024).

All countries now recognize the growing significance of regional financial integration. Much like other regions, the Southern African Development Community (SADC) has always worked to strengthen regional integration among its member nations. This goal has been in place since the group's inception. Business, energy, finance and investment, transportation, and communication were among the many different issues covered by the 26 protocols that the regional bloc had put into effect by 2015 (SADC, 2015). The 2016 Africa Regional Integration Index survey ranked the Economic Community of West African States (ECOWAS) as the most economically linked area in all of Africa. Financial integration is a key component of the ECOWAS Monetary Cooperation Programme. Article 53 pushed for the creation of suitable frameworks to promote investments in businesses situated within other member states' territory via the international trading of stocks, shares, and other securities. The quick and unfettered flow of cash across the community can only be achieved by removing restrictions on capital mobility among member states. Increased capital mobility within the ECOWAS area is believed to boost investment and direct funds to areas with the greatest potential to affect productivity, which is why this goal has been set (Adeyele & Ouedraogo, 2019). Additionally, investors across the continent get higher returns. Micro, small, and medium-sized businesses, as well as new ventures, will reap the rewards of more efficient financial institutions and lower transaction costs. According to Banyen and Biekpe (2020), the three main determinants of successful financial integration are the speed and breadth of reforms, the commitment of member states, and the influence on the efficiency and effectiveness of financial intermediaries are.

Although, financial integration has numerous benefits, it does come at a cost: the loss of control over one's own currency and monetary policies. When the economy is under a major shock, a unified monetary policy throughout the union would be disastrous. Economic integration does undoubtedly rob member states of their monopoly power over monetary policy instruments and exchange rates, which can be vital for dealing with national-specific macroeconomic shocks (ECA, 2012). Also, capital flight may hinder economic development if institutions are weak, which can happen when a country liberalizes its capital account (Edison et al., 2002). According to Agénor (2003), there are a number of drawbacks to monetary coordination, including less macroeconomic stability, more cyclical fluctuations in temporary streams, domestic capital being misallocated, capital flows being concentrated geographically, and smaller nations having less access.

Consequently, most African countries have failed to fully benefit from regional financial integration. International investors may be discouraged from setting up subsidiaries in African states due to unfavorable official business practices, such as payment delays, capital repatriation limitations, and loan repayment concerns. In light of the above, it is critical to investigate the impact of financial risk on African regional financial integration.

2.0 LITERATURE REVIEW

2.1 The Concept of Financial Risk

Financial risk is considered as a situation where nation's debt levels get too high as a result of borrowing too much money and it can't pay its foreign debts when they come due. Financial risk is more likely to arise when debt levels rise since the threat of repayment rises in tandem with them. Any nation that is in grave financial jeopardy is sure to have an abrupt financial catastrophe. This country poses too much financial danger for risk-averse foreign investors; they would be better off looking for another country less financial risk. Chronic current account deficits increase a country's financial risk since they make its foreign debt worse (Hayakawa, Kimura, & Lee, 2012). Rene (2008) opined that financial risk is the chance of losing fund because of changes in the competitive landscape or how quickly things change in the environment.

Buyers of various financial instruments are subject to different degrees of default risk, according to Mendez-Carbajo (2020). Default occurs when planned interest payments on securities are not made in a timely manner. A measure of financial risk might be an index or the spread between the returns on various financial assets. A risk spread is the difference in yields across assets with different risk profiles; it changes as the projected default risk of each investment changes. Factors such as the security's price, interest rate, and maturity date determine its yield. Price fluctuations, investor apprehension, and signs of default are all parts of the present market conditions that make up financial risk, as measured by an index (Mendez-Carbajo, 2020). But the point made by Mendez-Carbajo (2020) is for private investors.

In addition, Timurlenk and Kaptan (2012) defined financial risk as the ability of a country to pay its debts and participate in market trade. This is in accordance with Howell (2013), who opined that financial risk rating determined whether or not a nation could meet its financial obligations. By assigning risk points to various components of financial risk allows us to measure this risk. Foreign debt as a percentage of GDP, international liquidity, government repudiation of contracts, loan defaults, delayed payments, expropriation of private investments, and expropriation of private assets are all components of financial risk. So is foreign debt service as a proportion of exports of goods and services.

According to the ICRG approach, high point indicates a lower risk. Howell Llewellyn (2013) and Timurlenk and Kaptan (2012) both agreed that a 50-point scale is the most appropriate for establishing a financial risk index. In developed countries, the financial risk metric outperformed other risk metrics in identifying high- and low-return portfolios (Erb et al., 1996).

2.1.2 Financial Integration

According to Harris (2008), financial market integration occurs when securities with similar maturities in separate markets are able to have their risk-adjusted rates converged. Money and financial intermediaries move freely across borders as a result of financial integration (Banyen, 2021). Public sector efforts like economic policy harmonization are examples of regional integration, although economic integration is more often associated with improvements in cross-border activities (Ogun & Adenikinju, 1992). The term "regional financial integration" (RFI) describes a system wherein neighboring nations open capital accounts and financial institutions within that system are allowed more freedom to transact across borders. Both political institutionalization, which involves using the same payment systems aligning regulations, and market pressures, which include the entrance of multinational banks, are driving this twin process. Regional integration is beneficial since it leads to the adoption of changes on several levels. By instituting national reforms before integration, local markets are able to be better controlled and managed, leading to increased efficiency as a result of increased competition.

Added advantages result from regional integration of markets, infrastructures, and financial institutions. According to Tomlinson (2007), there can be no assurance of the advantages of regional financial integration until there are changes at the national level. The advantages grow as a group of nations works toward full integration, such a financial services market. Adeyele and Ouedraogo (2019) argued that the benefits will not accrue linearly but rather as a result of a critical mass of policy changes being put into place, after which the most substantial benefits will become apparent. The first adjustments will bring about institutional efficiency.

2.2 Theoretical Framework

Relevant theories to this study include financial development hypothesis, the efficient market hypothesis, the Hecksher-Ohlin theory of trade, the absolute cost advantage, the neo-classical growth framework, international risk diversification theory and so on. However, the theoretical framework for this study is the international risk diversification theory. The theory is based on the notion that most investors are risk averse, this is the premise upon which Harry Markowitz built his famous portfolio theory in 1952. It seems that most investors are willing to take on a certain amount of risk, but they may not want to take much more than that. If an investor wants to reduce their overall risk, they could want to look at investing in several markets. Two points are presented in support of variety on a global scale. There are pros and cons to owning assets abroad, with the cons being heightened foreign currency risk and decreased risk. To maximize anticipated returns within a certain level of risk, asset allocation in a portfolio should follow the mathematical framework of normative mean-variance theory, which Markowitz (1952) linked. Investors gain from international diversification, according to Basu, Oomen, and Stremme (2006), since foreign stock markets have low correlations, which reduces risk. Unfortunately, it is difficult to internalize portfolio investing due to additional risks such as currency risk and portfolio (beta) risk. As Sullivan and Sheffrin (2003) put it, the ideas revolve on the diversification effect. Each asset's risk may be reduced by capital allocation. A wide variety of assets are funded, which reduces volatility. There will be less variation in the diversified portfolio's value than in the weighted average value

of its individual assets if asset values do not fluctuate symmetrically. Compared to the component with the lowest volatility, this one should be less volatile.

2.3 Empirical Literature

Empirical studies on regional financial integration are not new to the literature, though there are scanty studies that specifically address this topic in the literature. For instance, Ajayi, Osasona and Oluyide (2025) examined the effect of economic risk on regional financial integration in Africa from 2006 to 2022. The study aimed at how debt service, inflation rate, foreign trade and parallel foreign exchange affected net capital inflow. The study used the panel regression to analysis the data. Results revealed that all the variables except inflation rate positively influence net capital inflow. The study concluded that stable macroeconomic policies will increase net capital inflows into African economies. With the aid of OLS, and ARDL, Ajayi, Oluyide & Oluwaleye (2025) looked at the relationship between social risk and regional financial integration in Africa between 2006 and 2022. The study focused on how religion, ethnic tension, socioeconomic conditions and law and order affect net capital inflow as a proportion of GDP. The outcome of the research showed that socioeconomic conditions significantly affect net capital inflow, while religion revealed mixed effects through the countries. The study therefore established that the major social risk factor that impedes regional financial integration in Africa is socioeconomic conditions.

Furthermore, Oyetade and Muzindutsi (2023) examined the effect of country risk on the soundness of African banks' finances using dynamic panel models. Data covering 2000 to 2021 was gathered from ten African nations. Result from the study showed that Africa has a high level of national risk exposure. National risk has a substantial and detrimental impact on the stability of banks in Africa. Yasmin and Jung (2023) studied the roles of financial integration and regional integration on economic development.

The study specifically looked at the effect of banking and financial market in enhancing financial integration within the European regions. The study highlighted the roles of banking and capital market, mechanism as well as challenges of regional connectivity. Also, Iwegbu et al., (2022) adopted panel and quantile regression as the estimation technique in studying the effect of financial development and regional financial integration on industrial sector of ECOWAS. Results from the research work showed that expanding regional financial integration will increase industrial output of ECOWAS countries with sound institutional structure. The study concluded that credit to private sector CPS has no impact on industrial performance.

Using data from three separate time periods, Selvarajan and Ab-Rahim (2020) examined the correlation between growth and financial resources from 1980 to 1995, 1998 to 2015, and the whole research period from 1980 to 2015. There was a robust correlation between growth and finance before to the crisis, according to the study's results; however, this correlation gradually diminished after the disaster. The results helped policymakers comprehend the unique characteristics of each country and determine the level of financial integration that should be comparable to that of European countries. Lastly, Makoto (2020) examined the immediate and future impacts of partial international financial integration on the instability of macroeconomic indicators. The study utilized ARDL Model for the data analysis. The findings showed that

Notes: The *, **, ***, denotes significance at the 10%, 5%, 1% levels respectively.

Table 4.1 presents evidence about the impact of financial risk on regional financial integration across African nations, using pooled OLS effects. It is important to highlight that 34 observations have been documented for the estimate. Previously, four explanatory variables - loan default (LD), delayed payment (DP), losses from exchange control (LEC), and expropriation of private investment (EPI) - were used to assess financial risk, whereas net capital inflow indicated regional financial integration. The R² of the estimator indicated a coefficient percentage of 53% for net capital inflow, suggesting that the variables used in the research contribute over 50% to the dependent variables, with the remaining 47% attributed to factors outside the regression model. Therefore, the model is appropriate.

Loan default (LD) and EPI have a negative and substantial impact on net capital inflow at the 5% significance level. Furthermore, whereas DP was significant at the 10% level, LEC remained negligible.

Consequently, LD and EPI would adversely and severely impact NCI over the examined time by 2.93% and 2.27%, respectively. Furthermore, DP and LEC with identical signs would provide significant and unimportant values of 2.31% and 0.05%, respectively.

Table 4.2 Fixed effect result on the effect of financial risk and regional financial integration in Africa

NCI	Fixed Effects
LD	-0.032822**
DP	-0.045302**
LEC	-0.021609**
EPI	0.010049
Obs	34
R ²	0.621115
Prob.>F	0.000812

Source: Author's computation (2026), E-view 11

Notes: The *, **, ***, denotes significance at the 10%, 5%, 1% levels respectively.

Table 4.2 presents evidence about the impact of financial risk on regional financial integration within African nations. The table specifically presented an overview of results derived from the fixed effect model, using 34 data for the estimator. To date, the R² of the estimator indicates a coefficient percentage of 62% for net capital inflow, suggesting that the variables used in the research contribute over 60% to the dependent variable, with the remaining 38% attributed to factors outside the regression model. The model is substantial.

Specifically, LD, DP, and LEC exhibited a negative and significant impact on net capital inflow, indicating that a 1% increase in LD, DP, and LEC correspondingly resulted in a decrease in NCI by 3.28%, 4.53%, and 2.16%, respectively. Conversely, EPI demonstrated a positive but insignificant effect on NCI, contributing 1.00%.

Table 4.3 Random effect result of the effect of financial risk on regional financial integration

NCI	Random Effects
LD	-0.029781**
DP	-0.029817**
LEC	0.003745
EPI	-0.020287**
Obs	34
R ²	0.551392
Prob.>F	0.000081

Source: Author's computation (2026), E-view 11

*Notes: The *, **, ***, denotes significance at the 10%, 5%, 1% levels respectively.*

At the random effects level, Table 4.3 shows how financial risk affects regional financial integration among African states. The table summarized the findings from a random effect study that included 34 variables. The coefficient percentage of 55% for net capital inflow was shown by the R² of the random estimator, which means that the research variables account for more than half of the dependent variables. The remaining 45% is thought to be due to components that were not included in the regression model. Assuming the models pass Hausman's test, they may be employed since the model is substantial.

NCI is significantly and negatively affected by LD (2.97%), DP (2.98%), and EPI (2.20%). On the other hand, LEC has a small but positive effect on NCI, leading to an increase of 0.03%. The findings show that LD, DP, and EPI have a significant impact on net capital input.

4.4 Result of Hausman Test

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

Table 4.4 Hausman Test

Test Summary	Chi-Sq. d.f.	Chi-Sq. Statistic	Prob.
Period random	4	3.063004	0.5473

Source: Author's computation (2026), E-view 11

According to the Hausman test findings shown in Table 4.4, the chi-square statistic coefficient was 3.06 and the probability was 0.54. The random effects estimate is the best choice out of the three since the p-value is greater than 5%. At the 5% level of significance, an increase of 1% in LD, DP, and EPI would have a negative impact of -2.97%, -2.98%, and -2.02% on NCI, respectively. In contrast, LEC would have a positive but insignificant effect of 0.37% on NCI. As a result, the selected African states' regional financial integration is thought to be significantly and negatively affected by financial risk.

4.5 Discussion of Findings

The study aimed to investigate how financial risk affect regional financial integration in Africa from 2006–2022. The study evaluated financial risk with loan defaults, delayed payments, losses from currency restrictions, expropriation of private investments, and net capital inflow as a fraction of gross domestic product for regional financial integration. To find out how particular African countries' regional financial integration and financial risk are related, the study employed panel regression and the Hausman test. Net capital inflow is negatively and severely affected by -2.97%, -2.98%, and -2.02% by loan default, delayed payment, and expropriation of private investment, respectively, according to the research. However, there is a positive association between losses from exchange control and net capital inflow, albeit the effect is minimal. Massive foreign debt overhangs caused by excessive borrowing and missed repayment deadlines put a country's finances in jeopardy. A country faces more financial risk and a higher probability of repayment issues as its debt grows. According to the findings, policies that discourage foreign investment, such as loan default, payment delays, and the seizure of private capital, convey the wrong message to potential backers. This makes investing in that nation more difficult for risk-averse foreigners, so they go elsewhere for safer investments. Particularly in developing nations, payment delays, contract expropriation, and corruption greatly impede the inflow of foreign capital. Less money would flow into a country whose financial risk is rising.

Findings of this study is consistent with the empirical results of Balan (2019) and Kirikkaleli (2020), the results showed that there is a significant but weakening relationship between financial risk and investment. It follows that foreign investors will be interested in the studied nations' financial risk and whether or not their governments take steps to repay loans quickly and avoid taking private investments.

5.0 CONCLUSION

This study looked at the effect on net capital inflow relative to GDP of loan default, payment delays, losses from currency control, and expropriation of private investment. According to the research, African countries' net capital inflow is negatively and significantly affected by financial risks such as loan default, delayed payments, and expropriation of private enterprises. The research found that these results support the idea that financial risk can reduce the amount of money that Africa receives. For this reason, "investor-friendly" policies, such as loosening regulations on the repatriation of profits and prompt loan repayment, are crucial if the continent is to see a rise in capital inflows.

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