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THE INFLUENCE OF ECONOMIC REFORMS AND PRIVATE SECTOR DEVELOPMENT INITIATIVES ON FINANCIAL FOREIGN DIRECT INVESTMENT INFLOWS INTO SUB-SAHARAN AFRICA: INSIGHTS FROM GHANA

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ABSTRACT

African governments have undertaken several economic reforms in order to liberalise their financial sector. Our main purpose is to investigate how financial sector reforms and private sector development initiatives have influenced financial FDI inflows into sub-Saharan Africa and present strategic ingenuities to address these issues. A case study method was adopted to examine the reasons that caused financial MNCs to choose Ghana as an investment destination and to measure which factors affect their current operations. The study employed in-depth interviews to identify how the environmental factors are affecting or supporting their business operations in Africa. The focus of the study has an inevitable bias towards respondents in various regulatory agencies, government institutions and managers of financial MNCs who are directly involved in making investment decisions that affect financial FDI inflows into Ghana. Despite the far reaching reforms, the study finds that there are several structural constraints and deficiencies placed on financial MNCs which affect the size of business they can conduct and their future investment decisions. The findings of these studies have ranged from organisational to environmental factors. Overall, the financial sector reforms in Africa did not deal sufficiently with the structural and institutional problems confronting the financial system as they focused primarily on policy matters. One of the major issues prior to the reforms was fragmentation of the system and the reform was not designed to remedy that; hence the low financial FDI inflows to Ghana in particular and Africa in general.

Keywords: Foreign direct investment (FDI), reforms, multinational Corporations (MNCs), environmental factors, institutional factors,

INTRODUCTION

The attraction of FDI is generally seen as an important source of capital which supports emerging economies in achieving economic development (Rugman and Collinson, 2006). Throughout the last two decades, the operations of MNCs have been growing, becoming an essential variable in achieving and sustaining macro-economic objectives. Wezel (2004) indicates that most emerging economies have, through liberalisation, significantly increased their share of the inflows of financial MNCs in their efforts to achieve and sustain growth. As a result, several African countries have responded by undertaking institutional reforms that are geared towards the attraction of FDI. These reforms notwithstanding, SSA falls short in



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establishing and maintaining the required encouraging environment for these investments to thrive.

This paper, therefore, investigates how financial sector reforms and private sector development initiatives have influenced financial FDI inflows into Africa and also presents strategic initiatives that seek to address these issues. Moreover, this paper will pay particular attention to the institutional factors in Ghana, and this is done by assessing the motives of financial MNCs and FDI inflows into the Sub-Saharan African countries using Ghana as a case in point. The justification for choosing to use the institutional factors as the model for this study is because institutional philosophies are said to be very suitable in explaining the strategies of companies in emerging economies. Moreover, there is evidence that institutional influence on the SSACs is very strong in determining financial FDI inflows (Suchman, 1995:574).

LITERATURE REVIEW

According to Ezeoha and Cattaneo (2011) and Ncube (2007), financial sector development could influence financial FDI inflows. As Kostova and Zaheer (1999:64) argue, the degree of legitimacy of regulatory institutions could support or affect financial FDI inflows into the SSACs. In this regard, financial FDI inflows require a number of important institutional developments including financial market liberalisation and development, efficient regulation and supervision. Other theories focus on the degree of financial sector development as an influence in increasing financial FDI inflows (Mmieh and Owusu-Frimpong, 2004 and 2009 and Goldberg, 2005). Part of Ghana's institutional modifications included financial sector liberalisation. Reforms to the financial sector can affect FDI inflows.

The degree to which the sector is developed and efficiently organised may be considered to be a motivation for financial FDI inflows. This is because the financial sector serves as an allocative channel and reduces transaction costs. In this regard, Ncube (2007) remarks that a liberalised financial services sector reduces risk. Usually, a financial sector is adjudged liberalised if it makes it easier for individuals and entities in need of external funds to gain access at relatively cheaper costs (Guiso *et al.*, 2004). Moreover, a liberalised financial services sector induces economic efficiency because of its capacity for easing information flow, contract enforcement, reducing transaction costs and ability to direct credit to the private sector for development (Hermes and Lensink, 2003; Levine, 1997).

A liberalised financial sector reduces information costs, enhances markets and facilitates trade and other services to investors and stimulates competition which increases the welfare gain of consumers (Mmieh and Owusu-Frimpong, 2004 and Bartel *et al.*, 2009). In view of the above, it is worth mentioning that Arestis and Caner (2005:6) argue that the financial liberalisation literature encountered increasing scepticism over the years as the World Bank and IMF had to revise their philosophy on several occasions when events following the implementation of financial liberalisation prescriptions did not conform to their theoretical premises.



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The authors of this study present an overview as well some of the factors influencing the Ghanaian banking sector.

Overview of The Ghanaian Banking Sector

Prior to 1983, Ghana operated a tightly regulated financial system and the impact on economic growth was found to be dismal (Mmieh and OwusuFrimpong, 2004; Gockelet *al.*, 1998). When Ghana turned to the IMF for assistance to reshape the macro-economic structure, one of the policy packages which were part of the entire reform agenda was to reform the economy's financial sector. There is some evidence, however, that whilst there have been significant gains following the reforms, there are several structural factors that affect FDI inflows and need to be addressed (Debrah and Toroitich (2005); Aryeeteyet *al.*, 2000). In addition, Steel (1997) argues that financial intermediation has been persistently limited, remains inefficient, and the formal financial services sector has been unable to make deposit and credit facilities widely available to support the growth of the private sector development initiatives in Ghana. What is more, the shifts in the financial services sector regime in Ghana have also been propelled by a domestic dissatisfaction with the performance and efficiency of the system. According to Asante (2000) and Cobbina-Asirifi (1999), the dissatisfaction with Ghana's financial services sector has often coincided with the shifts in political regime, often a move from a civilian to military regime or the reverse.

Liberalisation has stimulated a greater search for competitiveness that is revolutionizing the financial services sector (especially in the banking industry) in Ghana. These include the new entry of financial MNCs with more efficient technology and resources. The removal of interest rates, controls, and credit ceilings has allowed banks greater flexibility to compete for customers. One of the most useful innovations is the establishment of the unit rural banks which further supports the activities of the formal institutions. The rural banks numbered about 130 in 2010 (GIPC, 2010). At the end of 2011, there were 29 banking institutions operating in Ghana; foreign investors hold a majority of the shares in about 12 of these major banks in Ghana; there are 42 NBFIs; 7 major supporting institutions and 22 insurance companies (GIPC, 2010).

RESEARCH METHODOLOGY

The study adopted a qualitative approach because Eisenhardt and Graebner (2007) and Yin (2003) argue that when there is inadequate knowledge about a phenomenon, it is considered the most suitable method of data collection. In this regard, the researchers adopted the case study method to examine the factors which influenced financial MNCs in their decisions to choose Ghana as an investment destination and to assess which factors affect their current operations. The study employed interviews to identify how infrastructure, degree of political interference, competition and other institutional factors affect their activities. Eisenhardt and Graebner (2007); Yin (2003) and Saunders and Thornhill, (2007) further argue that when little is known about a phenomenon, adopting case studies will enable cross-case and content analysis. Moreover, it will help explain how the actors react to their environment. To this



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end, two case financial MNCs were selected to study how each of them assessed the regulatory requirements in the financial sector following the reforms, business facilitation systems and other FDI incentives provided by the government to attract financial FDI.

The second aspect of the data collection focused on the key stakeholders within the financial sector whose activities and policies, to some extent, influence or affect financial FDI inflows. Hence, regulatory bodies, government departments and economic policy analysts responsible for financial sector development were interviewed to gain understanding of the external environment. These interviews primarily focused on the regulators of the financial sector – the Bank of Ghana, government institutions in charge of policy formulation (MOFEP, MOTI), and government institutions in charge of policy implementation (Ghana Stock Exchange, NIC, GIPC, PEF, ARP and IDEG). Industry specialist and non-governmental organisations were included in the frame to gain insight into both sides of the coin whereby understanding is gained about how MNCs perceive the institutional systems as much as how regulatory bodies perceive the MNCs.

Case Studies

Alpha Bank (Bank A)

Alpha Bank, which was established in the 1990s, is from a neighbouring West African country. As of 2007, it was the largest company in its home country and the rest of West Africa with total assets of US\$21 billion. In addition to numerous branches in its home country, the bank has branches in Ghana, Gambia, Sierra Leone, South Africa and the UK. In Ghana, bank A was incorporated in the mid-2000s (under the Ghana Banking Act 2004) as a private limited company and commenced universal banking operations in the same period. Bank A has won several awards including *Bank of the Year* within its first year of operations (*Financial Times*, London); *African Bank of the Year* in late 2000s (*African Investor*); *Best Bank* in its home country in 2008 (*Euromoney*); and *Best Global Bank* in 2008 (*African Investor*). In an industry with an average of non-performing loans ratio of 14.9%, bank A had only 6.3% in 2009.

Currently, Alpha Bank operates in 22 branches and agencies in Ghana and has an objective of making banking easier and better than anything customers have so far experienced using latest technology. Bank A has played a major role in the transformation of the banking industry into an intensely competitive, customer-orientated, more efficient and technologically inclined industry. Prior to commencing their operations in Ghana, relationship banking was novel, e-banking was restricted to ATMs, banking was limited to a few hours in the day and weekend banking was almost non-existent. In view of these initiatives, it can be argued that bank A has to some extent helped redefine standards in the financial services sector in Ghana through the introduction of mobile banking, electronic payment systems, and visa payment systems as well as many other products and programmes that provide customers with greater speed, accuracy and options. In spite of all this, bank A still lacks specialist banking staff and stakeholders are sometimes hesitant to commit to



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undertaking larger investments due to a certain degree of political interference during and after the 2008 elections in Ghana.

Delta Bank (Bank B)

Delta Bank is one of Africa's largest banking groups with operations across the continent of Africa and other parts of the world. Bank B was established several years ago in its home country. Bank B became the first foreign bank to open a branch in a mining town in the southern part of Africa to provide banking and other financial services to the businesses in the area. Bank B was subsequently listed on the stock exchange in its home country in the early 1970s and in the late 1980s. Besides this, bank B divested their operations by selling almost 40% of its shares to existing shareholders to increase its market capitalisation in the 1990s. A year after that, Bank B began to establish links with several countries within Sub-Saharan Africa.

Delta Bank appears to be committed to undertaking financial investments in developing countries. Currently, Bank B operates in 17 Sub-Saharan African nations and has a presence in several emerging economies including Russia, Brazil, Argentina and Turkey. Recently, Bank B has acquired operations of a major financial institution in the UK. In addition, bank B acquired a public sector financial institution in Ghana to increase its asset base. The acquired financial institution made losses when it was run as a wholly domestic bank. This signifies the role that financial MNCs can play in transforming state-owned financial institutions (that are financial loss-makers) into profitable ventures. It could be argued that the acquisition of this bank is supporting the effective delivery of financial services to businesses and individuals in Ghana.

Having set out the background information on financial MNCs in Ghana, this paper moves on to examine the institutional and administrative factors that affect their operations in Africa (in general) and Ghana (in particular). By undertaking these two major assessments, as discussed in the literature, this paper moves us closer to understanding the causes of the institutional and administrative weaknesses in Africa.

Financial Sector Reforms and FDI Inflows into Ghana

The primary objective of Africa's financial sector reforms was to improve financial service delivery and facilitate the development of a monetary policy aimed at supporting the growth of the private sector (which is seen as the engine of growth for developing economies). For that reason, since 1987, Ghana's financial services sector has been progressively liberalised which has included the removal of controls on interest and sectoral composition of bank lending, reforms to prudential regulation, and the introduction of market-based financial instruments in order to attract FDI inflows.

Financial MNCs A and B are new entrants into the sector following the financial sector reforms and have been licensed to undertake universal banking activities through privatisation of state owned banks. Firm B however, have been operating in the Ghanaian



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environment for many years. Evidence from the fieldwork undertaken in Ghana revealed that, currently, all the case financial MNCs perform a substantial role by introducing a full range of corporate banking services such as insurance, investments and other international transactions mostly required by foreign investors operating in different sectors. Furthermore, the presence of these financial MNCs has encouraged the entry of other foreign companies in various sectors (sometimes as a result of *follow-the-client*) in ways that is beyond just providing international financial services.

Financial MNCs A and B have been serving as an important point of call for foreign investors in other sectors in terms of information and facilitation, business advisory and consultancy services, informing prospective investors of available incentives, purchase of accommodation and transfer of assets. In addition, case financial MNCs have improved the services available to domestic customers by offering a variety of product mixes tied with a good customer service which had previously been perceived as a luxury by many Ghanaians. The empirical research also revealed that Firms A and B have introduced a-zero-based accounts, online banking and telephone banking which prompted other domestic and foreign banks to improve their services. In addition, the financial services sector in Ghana is undergoing a rapid change which is driven partly by technological changes and the growth of competing non-banking financial institutions. Most financial MNCs do not think that the non-bank financial sector is a threat to their activities. There are also high spreads between lending rates and deposit rates.

In spite of the progress following the reforms, most financial MNCs are faced with several constraints in trying to undertake their activities in Ghana. An assessment of Ghana's financial reforms has been analysed in this paper, in terms of how they have supported the provision of credit to the private sector, effectiveness of the incentives provided by the government, ease of profit repatriation, degree of competition in the sector and the processes of settling commercial matters, as well as discovering if the objectives of the reforms have been achieved; and if not then what explanations might account for this.

Institutional Limitations of The Private Sector

One of the main objectives of Ghana's reforms was to efficiently mobilise and allocate resources to the private sector. Interviewees from financial MNCs A and B argue that the reforms lacked *proper planning and implementation* and that has affected the size of the FDI inflows and lending to the private sector. In addition, the regulators have failed to create *supporting institutions* aimed at meeting the changing and emerging needs of a sector that is constantly changing due to internal and external forces, some of which are global. The study also found that Ghana's financial sector reforms did not take into account the methods for formalising the informal sector in order for them to gain access to credit. In this vein, an officer at the Global Markets department of Firm B argues:

...I think that the objective of the liberalisation was good but poor implementation affected FDI inflows into Ghana due to lack of resources. In addition, the restructuring was not done holistically. For example, there is no system to check the



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credit score of our customers and there is no system set up for the banks to be able to communicate with each other. Due to competition, banks hide their activities from each other. There is no synergy between the banks. If the authorities expect us to give credit to the private sector, we need to be able to conduct a credit reference for customers to reduce our risk.

As a respondent from the private enterprise foundation asserted below, lack of credit is rampant among Ghanaian businesses, part of which is due to the formal nature and processes of the banks.

I would say that access to credit is one of the most frequently mentioned challenges facing Ghanaian businesses. ...If you ask them to rank the challenges facing your company or your business, most likely, access to credit would be number one. They are greatly worried because they are unable to get credit. They complain that the banks are difficult in giving out credit. We have done a lot about it. The banks too have issues with the borrowers, the borrowers too have issues with the banks and we have to find a way of solving it and we've done a number of seminars in an attempt to solve the problem.

In addition, interest rates were partially liberalised in 1987 with the removal of maximum and minimum lending rates to enable banks to provide credit at rates more affordable by the SMEs. Alpha and Delta banks indicate, however, that volumes of their credit to the private sector are given to businesses that are already doing well in order to avoid risks associated with the informal sector. Fry (1997) and McKinnon (1988) argued that liberalising interest rates would enhance the achievement of allocative efficiency. In this instance, there is clear evidence of misallocation of resources. Moreover, prior to the financial sector reforms, there were great disparities in interest rates and this seems to still exist. In other words, although stakeholders of the financial sector have responded positively to interest rate liberalisation, interbank rates are far different and the regulators have no means of managing it. In response to this issue, an economic researcher at the Bank of Ghana argues that:

All through the reform years deposit rates were negative because high rates of inflation during the reform, together with a re-imposition of interest rate ceilings, brought about the negative deposit rates and the situation has led to a poor savings culture. As you know, availability of cash within the banking system affects the cost of borrowing money.

There has also been a re-emergence of non-performing assets, limited credit facilities to the private sector, and a high rate of investment in government securities (designed to hedge against risk) compared to loans to the private sector, a low rate of savings and poor credit information. This implies that more financial MNCs would rather invest in Treasury bills and other short-term financial instruments rather than providing credit to the private sector because of the risk involved. A manager of Agricultural Sector Lending at Firm B indicates:



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Last year, we had to write off huge sums of our loans to the private sector as bad debt because we focused on lending to the informal sector and that has increased the size of our non-performing assets. We had one of the largest non-performing assets in the industry for this financial year. Moreover, the financial sector reforms need to be reviewed to take into account current challenges faced by both the financial institutions as well as the private sector when it comes to the issue of credit.

Similarly, a senior official at the Ministry of Trade supported the view that there is a need to review the policy to support financial institutions and the private sector.

When you start a reform, the eagerness is there, people are ready...but now it seems we have come to a standstill so other countries have taken over. An example is Rwanda; after the war they have reformed their economy. Now in Rwanda, one can register a company in a day with all the necessary steps to get credit and consultancy support from the banks to formalise their activities. When we started the financial sector reforms in Ghana, initially all stakeholders were keen on its implementation and progress was very fast but now progress is very slow. Currently, we are trying to identify why we haven't made much progress in terms of attracting huge investments in the sector (at least to provide funding for the booming oil industry) so that we can address those issues.

In much the same vein, a senior economic consultant at the Ministry of Finance indicates that:

Due to the slow progress with the registration and formalisation of companies, we have advised the Registrar General to open up Regional Offices all over the country, so that people don't have to troop all the way to Accra to get one signature on their forms which could be done online. Through the private sector strategy with the Ministry of Trade we are able to link up now with the Registrar General and the Tax Office so the moment you register a company, the Tax Office gives you a Tax Identification Number and also introduces the business to banks that specialise in providing support to the kind of business.

Credit to the private sector relative to the growth of financial institutions reflects the poor performance of the financial sector in resource mobilisation. Furthermore, the bulk of the credit channelled to the private sector is mainly directed towards short-term investments and foreign exchange speculation. Part of the reason for this is the uncertainty surrounding lending to a private sector that is highly informal, has higher default rates and unpredictable business performance. In addition, the government has introduced an interest free credit which is given to support the growth of the private sector. This means that most financial MNCs are finding it hard to match the interest rates based on market forces to that of free



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government grants to the private sector. This is exemplified by the following statement by an official at the Private Sector Lending department in Firm A:

Moreover, the government is introducing loans that are interest free and in most cases they do not pay back. This situation somewhat affects the ability of the private sector to sustain themselves through financial discipline and proper planning. This does not help the private sector to formalise their activities. This is a distortion of the free market system whereby prices are determined by the market forces. As long as the government engages in interest free loans and proper planning to get that money back in order to use it to fund other initiatives, it renders the private sector perpetually ineffective. Market distortions by the introduction of free loan schemes for the private sector affects the growth of the economy and the ability of the financial services sector to efficiently function in the system.

In Ghana, the introduction of new loan schemes by the government are usually politically motivated and in reality such loans are given to the cronies of the ruling government typically to get votes or to prove that the régime is doing something to support the private sector. But many years of such activities have proven ineffective and have also added to the national debt. *Political money* affects the development of the financial services and creates distortions of financial prices. McKinnon (1991) and Shaw (1973), building on the work of Schumpeter (1911), argue that government involvement and intervention on the banking system restrains the quantity and quality of financial FDI flows and other forms of investments.

Structural Problems with The Repatriation of Profits

Part of the reforms was the removal of restrictions on how much profit MNCs can repatriate back into their country of origin. Currently, there are no restrictions regarding the conversion and subsequent transfer of funds but there are a lot of bureaucratic processes involved which are very time-consuming and not consistent in terms of delivery. A lack of ICT systems to handle these transactions makes it even more arduous for investors. The foreign exchange system has also been liberalised as part of the financial sector reforms and hence exchange rates are determined by market factors. Inflation and a consistent depreciation of the Ghanaian currency in comparison to all major trading currencies affect overall profit levels. The Ghanaian currency can easily be exchanged for all major foreign currencies. Section 27 of GIPC Act 478 guarantees the unconditional transferability (by using any authorised dealer bank in freely convertible currency) of dividends, technology transfers fees, interest payments, and remittances of sale by firms, although there is a growing concern about the cost of using inter-bank transfers. A member of staff at the Treasury department of Firm B indicates:

...it used to be very difficult to repatriate funds abroad and even though there have been regulatory reforms, there are other prevailing difficulties such as the processes and procedures and the regulatory requirements for repatriation. Ghana's financial



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services sector is stabilised and investors see it as a safer place to invest especially when they look at what is happening in the sub-region.

Ahead of Department at Firm A indicates:

Capital repatriation was a huge problem but there is a new regulation in place which is focused on helping the successful establishment of the offshore banking agenda. However, it will take time for things to work smoothly, the financial sector reforms were started about ten years ago and we don't expect things to work at once. Why would investors bring in their money if they cannot take it out when the need arises?

Similarly, an official of the Treasury department at Firm A indicates:

Flight of capital used to be a big problem in Ghana whereby the BOG would not authorise a massive transfer of capital from an account in Ghana to another account abroad. But now things have improved, there is now free exchange control regulation and ease of transferring capital to an overseas account once it can be proven that the capital was brought into Ghana for the purpose of investment.

According to a BOG document on trade flows (2010), Ghana's foreign currency needs are met through gold and cocoa export revenues and donor assistance. This means that any fall in the world prices of these major commodities will cause temporary shortages of foreign currency as this is a repetitive occurrence on Ghana's balance of payments. This situation has been the major cause for delays in the acquisition of foreign exchange and the subsequent constraint on the repatriation of funds even in the absence of official bureaucratic processes that restrict the transfer of investment capital.

Weaknesses of The Supervisory Processes

Evidence from the fieldwork indicated that financial MNCs A and B had a feeling that the regulatory agencies need to improve the procedures of consultation with the regulated institutions and other stakeholders of the financial services sector. Alpha bank argued that there is some degree of consultation; however, it is limited to requests from the main regulatory bodies only when there is the need for them to propose certain changes. This system does not allow for an effective discussion and the involvement of the major stakeholders who can affect or may be affected by proposed changes in the sector. Stakeholders mostly affected include individuals who depend on the sector for employment, corporations, SMEs, and the service providers (which in most cases are financial MNCs in Ghana). Furthermore, the weakness of the participatory supervision feeds mistrust between regulators and the regulated causing a removal or reduction of both existing and future investments.

Most importantly, whereas the criteria for licensing financial MNCs are normally based on general licensing regulations and are based on a *written code*, assessments are commonly



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perceived to be non-transparent and biased and all these stimulate the perception of politicisation in the financial services sector. A manager at the Department of Internal Controls, Firm B indicated:

Most of the major contracts in Ghana are awarded based on political affiliations and I believe that this should not be the case. I can say that the NPP administration was more business friendly than the present NDC administration. There is also a widespread perception among most foreign banks in Ghana that regulatory bodies are not entirely independent but are rather subject to political pressures and investments don't increase in such conditions.

In addition, the market concentration of six major banks in Ghana points to a tilted competition best classified as oligopoly. The reforms in the financial services sector have not yet been able to stimulate adequate competition in the banking industry in Ghana. This means that new entrants have not been able to penetrate the top echelons.

CONCLUSION

This paper has analysed the degree of impact that Africa's financial sector reforms has had on the financial sector. Specifically, it has examined the progress made so far in the transition from financially repressed to reform and post-reform with a view to documenting the current structural/fundamental limitations affecting the sector. The empirical study recognises that there are inherent shortcomings prior to and following the reforms which include institutional limitations of the private sector, incentives provided by the government through reforms, structural problems with the repatriation of profits and weaknesses of the supervisory processes. In addition, this paper has demonstrated the importance of qualitative inquiry in assessing the reasons for institutional and administrative factors affecting financial FDI inflows into SSA. The findings of this study have provided new insights on a very critical topic but which have been largely ignored in the existing literature. Future research will focus on the impact of corporate social responsibility on the performance of international financial institutions in emerging markets.

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