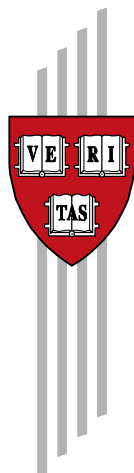


# **Characteristics and Behavior of African Factor Markets and Market Institutions and Their Consequences for Economic Growth**

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CID Working Paper No. 31  
December 1999

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## **Working Papers**

Center for International Development  
at Harvard University

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### **Abstract**

This paper provides a detailed characterisation of the structure and behaviour of African factor markets and the institutions that impact on their operations. It shows that the African factor markets are imperfect and inefficient, thus constraining economic growth. The paper posits that for the current reform programmes to succeed, policy that enhances the efficiency and competitiveness of the African factor markets must be put in place.

**JEL Classification:** G1, J3, J4, J5, J6, O1.

**Keywords:** Labour Markets, Financial Markets, Economic Growth, Africa.

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This paper was prepared for and presented at the Workshop on "Explaining African Economic Growth Performance," held at Harvard University, March 23-25, 1999. The workshop was sponsored by the African Economic Research Consortium and the Weatherhead Center for International Affairs.

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### **1. Introduction<sup>1</sup>**

Africa has embarked on economic reform programmes to redress the developmental failures of the past. Prior to the widespread adoption of reforms, every economic indicator has pointed to a continent in crisis. Africa slipped down from the impressive performance recorded in the first two decades after independence, to its present economic crisis. The statistics are terrifying. Africa harbours the poorest, the most heavily indebted and the least developed countries in the world. Most African countries are now poorer than they were in the 1970s. Inflation rate is higher, employment growth rate has slowed down and for most of 1980s, real per capita income growth rates were either zero or negative for most of the countries. On the eve of another millennium, Africa is yet to recover the lost ground. African development crisis continued to pose serious challenges to development economists and policy makers alike.

Several attempts have been made to explain the African growth performance. Such factors as low level of savings, low level of investment, poor technology, inappropriate government policies, among others were put forward. However, recent evidence from the endogenous growth models has shown that these traditional factors may not be sufficient to fully explain the African growth experience (Elbadawi and Ndulu, 1994). Economists have increasingly alluded to the influence of structural problems and the absence of well functioning institutions in these countries. Evidence from macro and microeconomics studies has lent support to the crucial role of institutions (Easterly and Levine, 1997; RPED<sup>2</sup>, 1994).

One of the institutions identified, as constraining African growth potentials is the African factor markets. The market is largely perceived as rigid and inefficient. The structure of the markets however predates African independence. At independence, Africa inherited from the colonialists an economy based on rigid controls and regulations. The factor markets typify this case. The Colonialists used legislation and other repressive policies to control the labour and capital markets. After independence, most African government continued those policies and in most cases tightened the control, under the misconception that this will facilitate the mobilization of productive resources for accelerated economic development. Over three decades later the reverse is the case.

Hence, factor market reforms form a critical component of the economic reform programmes adopted by most African countries since the 1980s. This presupposes that a flexible factor

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<sup>1</sup> The comments of Professors T. Ademola Oyejide and Akin Iwayemi and Participants at the Centre for Econometric and Allied Research (CEAR), University of Ibadan, Staff Seminar Series on earlier drafts are gratefully acknowledged. The AERC provided the financial support for this work.

<sup>2</sup> RPED is the Regional Program for Enterprise Development. The program is a World Bank unit co-ordinating a joint-effort by bilateral and multilateral donors to understand manufacturing in Africa.

market will enhance productivity growth and facilitates a more efficient utilization of scarce resources. However, the failure of the reform programmes to stimulate the desired growth and transform the continent has generated considerable criticisms, and has led to reform fatigue in many countries provoking policy reversals and slow-down in the initial speed of reforms. A central criticism centres on the inadequate understanding of the structure and operations of the African markets. According to Bigsten, et al., (1998), and Velenchik (1996a) very little is known about how African markets operate in practice. Yet, Fafchamps (1999) recognised that in spite of its imperfections and inefficiency, markets may be more “important in Africa than in developed countries”.

Although, the African factors markets share many features with other factor markets elsewhere, they however, exhibit some peculiar characteristics. This is especially true of the informal factor market. Perhaps, one incontrovertible fact is that formal factor markets in Sub-Saharan Africa (SSA) are rudimentary and evolving, thus accounting for only a small share of the factor market. In this study, we make an exploratory analysis of factor markets in the continent, describing the characteristics and the behaviours of the African factor markets and the institutions that impact on their behaviours. For this purpose, we subdivide the factor markets along the traditional lines of labour market and capital market.

The rest of the paper is organised as follows: in the next section we present the theoretical linkage between factor market and economic growth. Section 3 discusses the structure and operations of the African labour market and the institutions, which impart on its performance, while section 4, deals with a review of the African financial market. In section 5, we discuss how African factor markets affect economic growth. Section 6 is the conclusion.

## **2. Factor Markets and Economic Growth**

There are three essential ways of organising allocation of resources, viz. gift exchange, markets and hierarchies (Fafchamps, 1999). The mechanisms for allocation of resources, however, differ across the three modes. While each of these modes has its relative strengths and weaknesses, most economists today have come to regard the market as the optimal and most efficient means of resource allocation (World Bank, 1981). No wonder, countries around the world have substituted the market mechanisms for the erstwhile method of heavy-handed interventions and government regulation. Traditionally, the argument for free enterprise is anchored on the efficiency property of perfect competition. Perfect competition fosters Pareto efficiency in the economy. Pareto efficiency occurs when no possible reorganisation of production can make anyone better off without making someone else worse off. In other words, competitive allocation cannot be dominated.

The efficient functioning of the market system is based on a number of conditions. These include the existence and efficiency of certain legal and institutional foundations that guarantee private property; a well developed infrastructure that ensures reliable access to transportation and communication at minimum costs; and a ready information about quality that must be symmetric (Oyejide, 1999). It also imposes some expectations on the conduct of the practitioners; for instance, economic agents must be honest (Williamson, 1975; North, 1973). When these and other necessary conditions for market efficiency are present, the market mechanisms constitute an important pillar

of a growing economy. It facilitates trade and the shifting of resources to the areas of their optimal use in response to price signals.

However, markets must be competitive if they are to allocate resources efficiently. Markets may fall short of efficiency for a number of reasons, such as externalities, imperfect competition, inadequate information, incomplete markets, public goods, merit goods, macroeconomic instability among others. In the absence of competitive market, market allocation may no longer be optimal. Again, the outcome of competitive markets, even when efficient, may not be socially desirable whenever market outcomes fail to correspond to the society's ideals about the fair distribution of income and consumption. This extreme case of market failure is more of equity consideration than efficiency criterion. Public intervention is then justified mainly in terms of promoting efficiency in market operation.

Factor markets are the markets for factors of production such as labour, capital and land. However, in most discussion, attention often focuses on labour and capital. Perhaps, this is because land is regarded as a free gift of nature, with relatively inelastic supply. Factor markets are critical because the prices of factors of production - wages, interest, and rent help determine what income workers, investors, and landowners will receive. How prices are set in factor markets and how they affect factor productivity are relevant questions that affect the whole process of economic growth<sup>3</sup>.

The labour market mediates between demand and supply of labour. It incorporates the complex network of interactions between employers and employees. It is a dynamic process of continuously matching the changing needs of the economy's productive apparatus with the changing skills and preferences of labour force participants (Berry and Sabot, 1981). The capability of the labour market to perform this role defines its efficiency or otherwise. An efficient, flexible and responsive labour market contributes to growth through the rapid matching of skills to needs and by improving resource allocation across firms and industries (World Bank, 1993). A well functioning labour market also promotes growth indirectly by increasing efficiency through division of labour and specialisation (Oyejide, 1999).

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<sup>3</sup> This can be illustrated as follow:

Assume the following production function:

$$Q_t = f(K_t, L_t) \quad (1)$$

$Q_t$  = output at time t

$K_t$  = stock of capital at time t

$L_t$  = employment at time t

By totally differentiating equation (1), we have

$$Q_t = \partial K_t / \partial q_t f'(K_t) + \partial L_t / \partial q_t f'(L_t) \quad (2)$$

Where  $\partial K_t / \partial q_t = s$  = savings rate

$f'(K_t) = \phi$  = marginal productivity of capital

$\partial L_t / \partial q_t = l$  = labour growth rate

$f'(L_t) = \gamma$  = marginal productivity of labour

$$Q = s\phi + l\gamma \quad (3)$$

Hence there are two components of the economic growth function, factor accumulation and factor productivity. The market structure plays critical role in the two components.

The efficiency of the labour market is determined by the extent to which it performs the following functions:

- \* allocative function: This is the process of matching workers and employers through the wage rate.
- \* reallocative function: This involves reallocating workers among sectors by matching skills with job requirements through relative wages.
- \* dynamic or intertemporal allocation: This is a situation where the labour market provides information about the incentives for the generation and allocation of human capital over a period of time.

The wage rate performs the mediating role of continuously matching the supply and demand of labour in the economy. The labour market should be flexible to bring about changes in wages to equate the quantity of labour supplied and the quantity demanded. There are two leading theories about the labour market. The first is the flexible wage theory. This is based on the assumption that labour is traded in markets that operate much like commodity markets, with the real wage continuously and freely adjusting to keep the quantity demanded equal to quantity supplied. According to this theory, unemployment only arises from the fact that it takes time for labour to move from one sector to another, or from one region to another. Hence, fluctuations in unemployment are seen as fluctuations in the natural rate of unemployment.

The second theory is the sticky wage theory. This assumes that the dominant form of trading in the labour market is a wage contract that specifies a fixed money wage for a fixed period of time. Because money wages are sticky, real wages do not adjust quickly enough to maintain the equality between the quantity of labour and supply. Hence, unemployment is above its natural rate.

The efficient functioning of the labour market is therefore very important for economic growth. Two major factors which have been identified as affecting efficiency of the labour markets are, first, labour market segmentation or fragmentation and second, institutional factors. Labour market segmentation reduces the efficiency of the labour market because it prevents labour to move from sector with lower marginal productivity to another sector where marginal productivity will be higher. This imposes both static and dynamic costs on the economy. The static costs arise from the misallocation of labour as marginal product among workers with the same human capital endowments differs across sectors. In general, the static cost is much lower than the dynamic costs. An example of the dynamic costs could be found under public sector production, where employment is often kept higher than optimal, necessitating the diversion of resources from productive employment to keep inefficient firms afloat (Gelb, Knight and Sabot, 1991).

Institutional factors are also critical to the performance of the labour markets. These institutional factors include the activities of government, and the trade unions. Government activities affect the labour market via, hiring and firing regulations, minimum wage legislation, non-wage labour cost and unemployment benefits. Studies that have found negative impact of protective labour policy on economic performance include Assaad (1997), Doeringer (1987), Stevenson (1992). However, other studies by Standing (1991) and Blank and Freeman (1994) argue that labour market regulations improve workers' commitment to enterprise and thus raise work motivation and productivity.

One consequence of labour market distortions is high level of unemployment. Open unemployment represents a loss in national output, and creates a gap between potential and actual national output. Open unemployment is concentrated in urban areas and usually associated with wage unemployment (Agenor, 1996). It occurs when the ruling wage rate fails to clear the labour market due to the presence of various distortions. However, underemployment is more pervasive than open unemployment. Empirical information shows a weak correlation between the rate of output growth and the unemployment rate. This, however, has been attributed to the spillover effects across different segments of the labour market and shifts in production activities, which are not adequately reflected in published official data (Agenor, 1996). This is especially true in developing countries where the informal sector is quite large. Hence, loss of employment in the formal sector spills over to the informal sector. This, therefore, mitigates the adverse output and employment effects of macroeconomic shocks.

The financial market is also critical to the growth process. Bencivenga et al. (1996) argue that there is a close relationship between the effectiveness of an economy's financial markets and its level of real development. They contend that the industrial revolution would have been impossible in the absence of financial markets to provide liquidity. Ample evidence in the literature shows that financial and real sectors' developments are interwoven. Oyejide (1994) provides theoretical insights into the two-way relationship between development in the financial and the real sectors. He claims that the financial system and the real sector could both grow together in a mutually reinforcing way or could both stagnate and decline. Cross-sectional evidence from the work of King and Levine (1993) shows that on average, the level of financial development is strongly correlated with the average rate of per capita income. And also that the level of financial development significantly predicts economic growth. Gregorio and Pablo (1995) reveal that financial development has a dual effect on economic growth. First, the development of domestic financial markets will enhance the efficiency of capital accumulation. Second, intermediation will raise the savings rate, and thus the investment rate. It must be mentioned however, that the process of growth itself has feedback effects on financial markets by creating incentives for further financial development (Goldsmith, 1969).

Most of the issues discussed under the labour market also apply to the financial market. In a free functioning financial market, the interest rate is the price that allocates the supply of credit to the demanders. The interest rate should be high enough for some individuals to desire to postpone their consumption and also low enough for another set of individuals to desire to take loans and be willing to repay, given their current consumption needs or investment opportunities (Barley, 1994). A credit market would be Pareto efficient in the standard economic sense, if it is not dominated and if there is no possibility of arbitrage.

The first fundamental welfare theorem insists that competitive markets will only yield a Pareto-efficient outcome in the absence of externalities. However, the standard model of perfect competition cannot be fully applied to the credit market. Credit markets diverge from an idealized market in a number of ways (Barley, 1994). First, the issue of repayment in credit market is highly complicated. A debtor may be unable to repay or unwilling to repay. Cases of unwilling to repay require a framework of legal enforcement but with a condition that the costs of enforcement are not too high to dissuade lenders from borrowing out in the first place. Second, information in credit

markets is highly imperfect, and this alone, is enough to cause credit markets to work imperfectly. Third, monitoring the borrower's actions after taking the loan is equally an issue of concern.

Efficiency in the allocation of credit should be examined in light of these in-built problems in credit markets. For example, in the real world, monitoring is not costless and information and enforcement are not perfect. It is necessary to accommodate these imperfections and thus operate within the framework of constrained\_pareto\_efficiency\_. This new standard will help to explain why the lender will reduce the amount to be lent to a borrower because of monitoring difficulties, and which could in fact be efficient in a constrain sense. Again, the required test of efficiency remains absence of Pareto improvement. Interventions in credit markets are justified when inherent credit market problems will likely result in a lower level of output. However, in the light of previous discussion, this will only occur if a free market fails to bring about a constrained Pareto-efficient allocation of credit. With the concept of constrained Pareto-efficiency, the full set of feasibility constraints for allocating resources is internalised.

### **3. The African Labour Market**

There are several perspectives about the structure of the African labour market, some of which fall on either side of the ideological divide. One of these considers that wages in Africa are too high, while productivity is too low. The World Bank notes in its 1978 World Development Report that "one of the serious obstacles to early industrialization in Africa is the high wage and salary structure" (World Bank, 1978). Lindauer and Velenchik (1994) also support this view by arguing that labour productivity in Africa is 'low' relative to wages<sup>4</sup>. However, the recent sharp decline in real wages across the continent has mellowed this particular view<sup>5</sup>. The current view is that African wages are low because productivity is low (Adenikinju, Iwayemi and Olofin, 1998). However, these various perceptions have implications for the various policies that have been recommended to resolve the African development crisis. Hence, it is useful to examine the structure of the African labour market.

Most African countries are characterised by labour surplus relative to other factors of production. Their colonial antecedents and the cultural and social norms prevalent on the continent have influenced the structure of labour supply in Africa. The growth rate of labour supply in Africa is higher than what obtains in other parts of the world. The annual rate of labour force growth in the SSA in the 1980s was 2.6 per cent, compared to 2.2 per cent in South Asia and 1.8 per cent in East Asia. This growth rate is substantially higher than the labour force growth rate in developed countries at their take-off phase.

Apart from its high growth rate, the profiles of the labour force is also important. The cohort distribution of the population in 1990 shows that less than 21 per cent of the population were under 20 years and only 6 per cent were above 60 years. The labour force in Africa is predominantly male. Females account for 32.5 per cent of the labour force in 1990. This figure however, fluctuates

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<sup>4</sup> 'High' wages in Africa has been attributed to the role of powerful trade unions and pervasive government labour regulation.

<sup>5</sup> The data used in these two studies covered the period before the adoption of SAP by most African countries. After the adoption of SAP unit labour costs (ULC) declined across these countries (see Adenikinju, Iwayemi and Olofin, 1998)



widely across the continent. Mali had 16 per cent, compared to 51.4 per cent for the Republic of Benin. However, labour participation rate is low for both males and females. In 1990, it was 51.2 per cent and 28.6 per cent respectively on the average for the continent. Comparative figures with other countries of the world reveal the low participation rates of women in Africa, relative to their male counterparts: In Estonia and Latvia, 87 per cent of males and 85 per cent of females participate in the labour market. In Sweden, the female participation rate is about 80 per cent (Oxenstierna, 1991).

The structure of labour demand is different from the labour supply. Labour demand in the continent, at least in the formal sector is influenced by the foreign based production structure. Labour force demand has grown less rapidly than labour force growth. This has been the case, especially with the economic crises that envelop the continent since the early 1980s. While the labour force demand has slowed down, especially for skilled labour, labour supply growth has continued its upward trend. This divergence in labour demand and labour supply structure, coupled with a labour force that is growing faster than the total population have made unemployment a major challenge to African countries. The rapid expansion of labour demand has been hampered by the slow down in domestic economic activities and the non-competitiveness of African output in the world market arising from the low labour productivity and the past wrong economic policies, which had discriminated against the tradable sectors in the past.

### **3.1. Typology of the African Labour Market**

Mazumdar (1989) characterised the labour markets in Africa into three: the urban-formal, urban-informal, and rural labour markets. This characterisation was informed by at least two postcolonial developments. In the first place, the colonial legacy of sharp income differential along the European/African divide was replaced after independence with the urban/rural divide. The urban sector inherited the privileges of the departed Europeans. Second, the governments import substitution policy and public works programmes were either cited or yielded their benefits in urban areas. According to Jamal and Weeks (1988) these developments presented a picture of a country sharply divided between the privileged urban elite and wage earners operating in the modern sector and the vast undifferentiated rural sector where the peasantry works and produces the wealth to pay for the privileges of the modern sector workers. Between these two are increasing population of the informal sector operators or urban squatters who had migrated into the cities in anticipation of a 'better life'.

This characterisation of the African labour market structure has been widely referred to as the Urban Coalition Thesis (UCT) or the Urban Bias Thesis (UBT). The arrowheads of these theses were Lipton and Bates. Bangura and Beckman (1989) have identified Bates (1981) as providing the intellectual backing for the World Bank perception of the African labour market in the 1980s. The Urban Coalition (UC) was blamed for the prevalence of rural poverty, poor agricultural performance, trade and budget deficits and the distortion of the labour market in Africa (Adesina, 1994). This view goes thus: the state has been hijacked by the coalition of urban-based interest groups. Hence, the urban group not only cornered most of the state expenditure for its constituencies, but also uses the state capacity for violence to punish and deter rural people's activities and autonomous organizations. Similar view was recently articulated in Collier and

Gunning (1997) who see the government as suppressing urban food prices and taxing agricultural exports to subsidise industrial production in the urban sector. Jamal and Weeks (1993) had contested this position. They argue that for several African countries the urban wage premium over rural incomes was actually reversed in the 1980s.

Table 1 provides a characterisation of the African labour market. The labour market is heterogeneous. The labour market is structured along the rural and urban divide. In the urban sector, we have the formal and informal sectors<sup>6</sup>. However, it is possible to identify intra-sectoral segmentation within each of the sectors. Similarly, the rural market is not entirely homogeneous as can be seen in the table. While not indicated in the table, there also exists some form of unemployment in the rural areas.

**Table 1: Structure of the African Labour Market**

Urban	Rural
The formal sector - (i) Public and large scale firms (ii) Private (large enterprises)	Wage labour on plantations
The Informal sector (i) Informal sector wage labour (ii) Self-employed workers (iii) Casual wage labour	(i) Workers in the small-scale farm sector (ii) owner (operational small-scale farm sector) (iii) owner (including sharecroppers)
The unemployed	Non-agricultural workers (i) self-employment full-time (ii) self-employment part-time (iii) wage labour part-time (iv) Landless full-time wage labour

source: Mazumdar (1989, p.3).

**Figures 1 to 3** provide a graphical illustration of the relationship across the three labour classifications. Since, the urban formal and urban informal labour markets draw their labour from the rural agricultural sector, it follows that urban sector wages must be high enough to draw people out of the rural agricultural sector. Furthermore, the differences in the relative wage rates are both a reflection of differences in average productivity (AP) of labour and role of institutional factors in wage determination. The large endowment of land per agriculture worker implies low AP of rural labour. On the other hand, the high urban formal wage rate is a reflection of the non-competitive factors such as minimum wage legislation, rent-sharing arrangement<sup>7</sup>, labour unions, etc.

<sup>6</sup> The formal sector is largely composed of the public sector and private large enterprises. While there are important differences in the operation of the two sectors, they share a lot in common. For instance, wages are institutionally determined. However, the public sector is the wage leader as it largely sets the minimum wage rate. While the minimum wage rate is lower in the private sector than the public sector, the average wage rate is higher in the former than the latter.

<sup>7</sup> The urban private formal sector benefited from the protectionist stance of the government in the pre-adjustment era and were willing to pay their workers higher wages as part of their rent sharing strategy.

### 3.2 Salient features of the African labour market

Agriculture accounts for over 60 per cent of employment population in SSA, mostly in smallholder farming. The distribution of working population in Africa shows that industry accounts for less than 6 per cent, services 17 per cent and agriculture 41 per cent. The unemployed was 4 per cent while those outside the labour force accounted for 32 per cent. The distribution of the labour force also shows the relatively small proportion of wage-labour in total labour employed in each sector. This is shown in Table 2.

**Table 2: Distribution of Labour Force in SSA**

Sector	% Distribution
Industry:	
(i) wage industry	3
(ii) non-wage industry	6
Services	
(i) wage services	9
(ii) non-wage services	15
Agriculture	
(i) wage agriculture	6
(ii) non-wage agriculture	55
Unemployed	6

Source: World Bank (1995) Labour And the Growth Crisis in SSA: Regional perspectives on World Development Report, 1995

Table 2 further shows that a majority of Africans work in their own farms (55 per cent), or in the informal enterprises (non-wage sector). The World Bank estimated that about 21 per cent of SSA labour force is engaged in the informal sector either as proprietors, paid employees, unpaid family workers or apprentices. Official unemployed defined as those seeking work but unable to find any is estimated at 6 per cent of the labour force. The table also provides an indication of the relative importance of the informal sector in the different sectors of the African economy. In the urban sector, the informal sector is quite strong in both the industrial and services sector, especially in the latter. About 63 per cent of the labour in the services sector are engaged in the informal sector. The figure for industrial sector is 61 per cent. However, in the rural sector, informal agriculture predominates. Nearly 90 per cent of agricultural activities in the rural sector takes place in the informal sector.

Table 3 shows the distribution of the labour force in four African countries. The structure of labour force distribution in these countries is typical of what prevails in most African countries: agriculture is the major source of employment. South Africa is perhaps the only exception.

**Table 3: Employment Structure in Selected Countries, 1960-1987) Share of total (%)**

Category	Cote d'Ivoire		Ghana		S. Africa		Tanzania	
	1964	1987	1964	1987	1964	1987	1964	1987
Agric Workers	74	52	44	44	18	4	80	77
Non. Agric employees	6	11	11	12	35	40	7	9
Non-Agric Self employed workers	6	9	17	18	5	4	2	5
Unemployed workers	3	2	4	2	3	7	2	1
Out of the Labour force	11	26	24	24	39	45	9	8
Total ('000) working age population	2360	4870	7513	7780	8600	22704	6076	13086

Source: World Bank (1995).

The modern sector in most African countries is weak accounting for no more than 10 per cent of total employment. The public sector accounts for a preponderant share of formal sector employment in most of the countries. In Nigeria, Collier (1986), estimates that in 1986 the public sector accounted for about 60 per cent of modern sector employment. Vandermortele (1991) estimates that in Africa the public sector is often responsible for 50 per cent or more of modern sector wage employment. Similarly, Lindauer, Meesook and Suebsaeng (1988) find that the public sector in SSA accounted for between 20 and 80 per cent of all wage employment in the formal sector. Hollister and Goldstein (1994) also find that the public sector has been the dominant employer of educated labour in developing countries, including Africa.

Many governments in SSA acted as 'employer of last resort', particularly for university graduates. This led to two major outcomes. First, it led to the ballooning of public sector payroll in the 1980s. The relative size of the public sector in these economies can be gleaned from three measures: (i) government wage bill as a share of GDP; (ii) government wage bill as a share of current expenditure; and (iii) government wage bill as a share of total revenue. Government wage bill as a percent of GDP varies across African countries. The three topmost countries in Africa in 1986, were Lesotho, 17.1 per cent; Congo, 12.5 per cent; and Zimbabwe, 10.5 per cent. Uganda had the least proportion with 1.4 per cent. However, the share has declined in most of these countries in the post-adjustment era. In 1996, Lesotho's share declined to 15 per cent; and Congo, 9.3 per cent. However,

Zimbabwe's share rose to 11.7 per cent; and Uganda 3.0 per cent. The mean for the continent was 7.0 and 5.8 per cent in 1986 and 1996, respectively.

In 1996, government wage bill as a percentage of current expenditure was over one-third in 25 of the 32 African countries studied by Lienert and Modi (1997). While the exact figures varied across the countries, the mean for all the countries was 35.3 per cent. Three countries - Central African Republic, Guinea and Senegal led the pack with 49.4 per cent, 48.9 per cent and 49.7 per cent, respectively. Guinea-Bissau with a proportion of 15.2 per cent has the least. Finally, wage bill, as a share of total revenue in Togo was 100.8 per cent in 1993; 81 per cent in Chad, while the Gambia had the least share of 21 per cent. The mean for all the countries in 1993 was 46.5 per cent.

The second consequence of automatic employment of graduates by government is that it led to the creation of jobs with zero or negative marginal product. This impeded the process of human capital deepening brought about by allowing better educated workers to move to lower-paying occupations, leading to increase in educational level in those occupations and consequently increasing labour productivity (World Bank, 1993). Again, this also had the unfortunate impact of keeping the earnings attached to graduate employment high and increases the search time for such jobs. Mazumdar (1994) reports that in four African countries namely, Kenya, Zimbabwe, Zambia and Cameroon, earnings increase with the level of education. Thus, in all the four countries the dominant result is the increasing returns to education as one moves from primary through secondary to university levels. Similar finding was reported for South Africa (Kingdon and Knight, 1999) and for Nigeria (Okuwa, 1999). This finding contradicts earlier studies which had found declining rate of return pattern by level of education (Psacharopoulos, 1985).

Two major features of the African labour market, especially in the post-adjustment period are, first, the growing incidence of occupational multiplicity and, second, the high rate of labour turnover. A growing proportion of the wage earners is engaged in secondary jobs. However, the incidence of multiplicity of jobs is by no means limited to urban wage earners. The high variability of crop income in the rural areas and the absence of insurance have made job diversification an important exigency. Hence, many rural households fragment their landholding into many plots, and nearly all of them combine food growing with livestock, cash crops or wage employment (Collier and Gunning, 1997). In a study of two villages near Kano in Nigeria, Amerena (1982) finds that 31 and 34 per cent of farmers participated in non-farm occupations in both dry and wet seasons, but between 64.9 and 90 per cent of them put non-farm work as their major source of cash income. Many of these people rely on younger members of their families and their wives to run their farms, while some others use hired-in wage labour.

The second feature of the African labour market in the post-adjustment period, is the high turnover rate. While this may suggest an active and dynamic labour market, it also reflects the high instability of the market. The economic reform programmes have contributed to the large movement of workers from the formal to the informal sector. Vandermerstele (1991) reports that wage employment growth in 14 SSA countries decelerated from about 3 per cent in 1975-80 to only 1 per cent between 1980 and 1985. The decline was steepest in the industrial sector where employment growth decelerated from 2.6 per cent to merely 0.1 per cent per annum over the same period. Stagnating or declining wage employment in the context of a rapidly expanding labour force leads

inevitably to rising unemployment, especially in urban areas. On average the urban unemployment rate has doubled over the past 15 years (Vandermortele, 1991).

There are two characteristics of the unemployed: their youthfulness, and their high level of education. While the youths account for roughly one-third of the labour force, they account for between 60 per cent and 75 per cent of the unemployed in the region. The higher incidence of youth unemployment is a result of their lack of sufficient work experience, social contacts, and maturity. There is also the sex dimension to unemployment. Women are vulnerable to unemployment, which reflects a structural imbalance on the labour market. Their unemployment rate is usually twice as high as men's are. Also, contrary to what obtains in developed countries, unemployment in SSA seems to be positively correlated with the level of education. This represents a negative social return on the massive investment of African governments on tertiary education.

The high incidence of unemployment has generated two types of reactions from the employers in the formal private sector. First, is the reduction in the earnings of new entrants (Levy and Newman, 1989). Second, employers have now raised the standard for applicants. There is an increasing demand for applicants to possess multiple-skills or demonstrate plurality of talent/capability. This is to allow for flexible usage of such workers in many different activities in the same organisation to save cost. The qualification and cognate experience requirements for almost every job are being steeply raised within short periods. This is not just the rise of credentialism, but a deliberate attempt to easily eliminate the unwanted segment of the rather large pool of available candidates for virtually every advertised position. Thus, it is becoming very difficult for fresh inexperienced graduates of the school systems to pick a 'first' employment in the formal sector. A recent survey monitoring the Nigerian labour market shows that in an economy with a high youth unemployment rate, 56 per cent of the available jobs in 1996 called for at least five years of experience as entry qualifications. Both high qualifications and many years of experience are now required simultaneously. Experience is no longer accepted as compensatory for lack of requisite academic or professional qualification.

The same study shows that there is a greater opportunity for lower level jobs in the Nigerian labour market. The preference is shifting towards elementary occupations and service workers categories that earn lesser income and receive less priority in post-employment training. Thus, the human capital deepening which we noted was absent in the public sector is gradually taking place in the private sector. University graduates now do the jobs that were previously reserved for secondary school graduates. In Zimbabwe, there is a shift in preference to casual workers rather than full employees.

The informal and agricultural sectors of the economy have played the role of labour sponges to the unemployed in the formal sector, though at strongly reduced wage and income. Vandermortele (1991) reports that informal employment increased by a respectable 6.7 per cent per annum between 1980 and 1985, far above the urban labour force growth and the labour absorption in the modern sector. The informal sector created some 6 million new jobs on the urban labour market between 1980 and 1985, while the modern sector added only 0.5 million new jobs in the same period. While the modern sector absorbed a mere 6 per cent of the new labour force recruits, about three-quarter of them were absorbed in the informal sector. However, as output growth has generally not kept pace with the rate of labour absorption, the informal sector is primarily creating low productivity jobs and

promoting precarious form of employment. Hence the sector is “increasingly operating as refuge which hides the extent of unemployment by converting it into underemployment” (Vandermoortele, 1991).

Another feature of the African labour market, though by no means peculiar to it is the prevalence of child labour. Again, this is largely an outgrowth of the post adjustment period. There is greater occurrence of dropouts from each level of education, as children had to work to augment the family income. Even those who did not drop out completely from school had to spend a considerable proportion of the after school period working. This trend has been facilitated by the declining returns to education in the post-SAP era. Thus, the future supply of manpower in these countries may be compromised. In 1990, 29 per cent of African children between the ages of 10 and 14 were working in the labour force. In Burundi and Mali, the figures were 48.1 per cent and 58 per cent, respectively. Canagarajah and Thomas (1997) show that in Ghana, child labour is concentrated mostly in the rural areas. On gender basis, boys contribute more to the child labour pool than girls do. While child labour is more common in agricultural related activities, in the rural areas, in the urban centres, a significant proportion is involved in trade and commerce.

Finally, rural-urban migration in line with the Todaro-Harris model has been observed. However, recent evidence has shown that this may not be due to the simple urban-rural income differential (Jamal and Weeks, 1988 and Stark, 1991). Other issues important in migration decision include, income uncertainty and deprivation, influence of other members of the family units, truncation of the national labour market along ethnic and state divide; and constraints in capital, commodity and financial markets which prevent entry into specific labour markets.

In recent years, the pace of rural-urban migration has slowed down considerably, and in some cases it has been reversed. This is not unconnected with the sharp fall in rural-urban income differentials. Jamal and Weeks (1993) argue that the fall in real wages eliminated any rural-urban wage gap. However, in a study of Ghanaian labour market, Boateng et al., (1992) provide evidence that real incomes in urban areas remain substantially above rural incomes. Appendix 1 shows the recent trends in the African labour market.

### **3.3 Functioning of the African Labour Markets**

#### **3.3.1 Alternative Views of the Functioning of the African Labour Markets**

There are two competing views on how the African labour markets function<sup>8</sup>. The first view sees a labour market that is competitive, where wages are flexible and the markets clear. In addition, similar labour is equally priced. Proponents of this view include Rosenzweig (1988) and Benjamin (1992). The competitive theory argues that inter-industry wage differentials are a reflection of unmeasured differences in the quality of labour or compensation for non-pecuniary job attributes which serve to equalize net advantages between industry or some combination of both.

There are many objections against the competitive positions (Krueger and Summers, 1987). They show that while variations in age, education and work experience may capture very large part of the

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<sup>8</sup> These two views are summarised in figure 4.

differences in labour quality between industries, controlling for these factors does not greatly reduce the dispersion in pay, holding occupation and gender constant. Longitudinal data are also hard to reconcile with the competitive theory: as workers move from industry to industry, their earnings change, while their individual endowments and personality traits do not (King, 1990).

The alternative view (non-competitive view) argues that the labour markets in Africa are segmented and that wage differentials are large (see for example, Bevan, Collier and Gunning, 1989 and Teal, 1995). The non-competitive view embodies two related theories. The first is the efficiency wage theory that argues that firms have incentives to pay workers more than their supply price to improve performance. According to this view, some firms find it profitable to pay wages above the market clearing level as a means of reducing shirking, minimizing turnover, increasing the size or quality of their applicant pool, or exchanging productivity enhancing 'gifts' with their workers (Akerlof, 1982, 1984). One implication of this is that firms paying efficiency wages hire fewer workers for any given level of output, generating unemployment (Velenchik, 1996b).

The second is the rent sharing theory. This theory argues that workers in high wage industries are sharing in the monopoly rents that would otherwise accrue to the owners of the capital alone. There are a number of variants of the rent-sharing hypothesis- trade unions or the 'expense preference' on the part of management which take advantage of the independence which they obtain from the separation of ownership and effective control to internalize the welfare of staff as well as that of shareholders.

Empirical studies of the African labour market have found support for the two competing views. Hoddinott (1995) reports a negative relationship between wages and unemployment in Côte d'Ivoire, thus supporting the efficiency wage argument. Teal's (1995) findings support the presence of the two contending theories in the Ghanaian labour markets. Using Ghana's data, Teal (1995) found that the labour markets do clear, although they were not competitive.

Empirical studies have shown that wages increase with firm size in the manufacturing sector of most African countries (Mazumdar, 1994; Teal, 1995; Velenchik, 1996a,b). Mazumdar (1994), in a study of wages in the manufacturing sector of four African countries - Kenya, Zambia, Zimbabwe and Cameroon-, reports that wages seem to increase almost monotonically with firm size in all the four countries. Workers in the very large firms, other things being equal, earn 230 per cent more than workers in micro-enterprises in Zimbabwe, and between 54 and 97 per cent more in the other three countries. However, while controlling for human capital endowment of workers in the firms reduced the size coefficient, it did not totally explain the differential. Advocates of competitive labour markets have attributed these differences to unobserved human capital factors and also to different labour policies pursued by small and large firms.

Velenchik (1996a) attempts to explain the observed wide differences between earnings in large firms and small firms in Zimbabwe. She found that controlling for competitive factors such as differences in labour quality, sector of operation, training, and job quality did not fully explain the differential. She then adduced the 'wage premium' to the presence of non-competitive factors.

Mazumdar (1994) similarly finds that labour productivity is higher in large firms relative to small firms, even after controlling for differences in capital intensity. The extent of the production



differential between the very large and the small-micro firms varies from 63 per cent in the Cameroon and Zimbabwe to 89 per cent in Zambia. This finding provides an empirical basis for the rent-sharing theory. The argument is that since workers in the large firms having access to more capital, better training and other facilities are more productive, then it follows that they are able to generate more surplus per worker than what obtains in the smaller firms. The rent earned by these profitable firms would be shared with workers under a bargaining process. Traditional model argues that the relative bargaining power of the firms and workers determine the distribution of the rent (Velenchik, 1996b). Collier and Gunning (1997) however doubt the bargaining power of African workers. They argue that the real bargain may be between firms and governments: the government generates rents for firms on the implicit understanding that these are partly used to pay a wage premium. Lindauer and Velenchik (1994) similarly argue that while labour unions exerted significant impact on wage outcomes in the pre-1980s, this power has waned considerably under the pressure of economic declines and stagnation.

Available evidence on African labour market thus far indicates that a simple competitive paradigm is not adequate to explain the functioning of the African labour market. Teal (1995) attributes the divergent views to the nature of the data employed – time series or cross-sectional. In the case of Ghana, he showed that relative wage rigidity across firms, at a point in time, co-exist with wage flexibility over time.

### **3.3.2 Equilibrium Determination in the African Labour Market**

Standard characterisation of equilibrium differs across the various types of labour market structures subsisting in Africa. In the formal market, the nominal wage rate is presumed to be institutionally determined. The wage rate so determined is above the market equilibrium wage rate. The institutional wage rate is presumed to be inflexible downwards<sup>9</sup>. Hence there is disequilibrium in this market as unemployment results.

In the urban informal market, the minimal government and labour unions roles, ensure that equilibrium subsists in the market. The wage rate is endogenously determined. The informal market clears at a lower wage rate than what obtains in the formal sector. This is why the formal sector usually enjoys preference among first time job seekers. Most first-time job seekers are prepared to queue for a long time in expectation of public sector job. This behaviour has been reported in Ethiopia (Mengistae, 1998) and Tunisia (Rama, 1998). In most cases the support rendered by the extended family structure aided the long wait for these jobs.

The rural market is also similar to the informal market in terms of determination of equilibrium. The interactions of the forces of demand and supply of labour determine the wage rate. The average wage rate is the lowest among the three markets. The relative low labour productivity in this sector keeps the wage rate relatively low, and is able to hide the significant underemployment that exists in this sector. It should be mentioned however, that the methods of hiring and paying farm labour in the rural areas, are complex and it is difficult to assess wages. Workers may be paid in kind, or as a

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<sup>9</sup> Recent events have disproved the inflexibility of nominal wages in African formal sector. Cameroon, Burkina Faso, Niger, and even Nigeria actually reduced the wages of their public employees. In the aftermath of financial crisis in Nigeria in the early 1990s, many banks reduced the pay of their staff.

fixed daily wages. Share contracts are also widespread in Africa. Share cropping is a method by which landlords acquire access to the labour of other people. This system has been adjudged to be inefficient.

In both the informal and the rural market sectors, the household is the primary unit that determines both the demand and supply of labour, unlike in the formal sector where the two decisions are separately determined by different agents. In this case, firms make decisions on labour demand, while the households decide on labour supply. The immediate implication of this is that while in the informal and rural markets, decision on employment are easily reconciled, the different objectives of the two agents involved in the formal market make equilibrium hard to attain.

However, this does not suggest that these markets are completely insulated from each other. One important aspect of the structure of labour movements in developing countries is that the proportion of the labour force in public service jobs is much higher than in most industrial democracies. In several African nations, public sector workers make up 60 per cent to 80 per cent of non-agricultural workers (Heller and Tait, 1984).

The high proportion of wage labour in the public sector means that the sector's wage and employment policies are important both in their own right and also because of spillover effects into the private sector. Heller and Tait (1984) estimate that central government decisions on wages and salaries in developing countries are likely to affect 15 per cent to 40 per cent of employed workers in the urban labour market and therefore have a pervasive 'leverage' effect on domestic unit wage costs.

The different markets also interact at the level of participation. The sharp decline and compression of real wages in the public sector after the introduction of SAP has led to participation of workers across the labour markets. Public sector workers now work in the informal sector. Many urban workers also reactivate the farms they hold back in the rural areas and maintain hired-in labour. Swindell (1985) shows that there is imperfect specialization of African rural labour between farm and factory, or between farm and non-farm activities. Non-farm work by men may be part of improving or maximising household incomes, or it may stem from the necessity of providing cash, if opportunities are not available at home to produce agricultural surpluses from their own farms.

Private sector employment has also been affected by some of the programmes under adjustment. For instance the adoption of trade liberalization led to a fall in private sector employment. During the years of adjustment, 1987-1992, public sector employment fell by 10 per cent in Ghana (Canagarajah and Mazumdar, 1997). Trade liberalization and public ownership divestiture will, of course, continue to entail a significant reallocation of labour across firms and activities.

### **3.3.3 The Efficiency of the African Labour Market**

Perhaps, the next question to consider is the efficiency of the African labour market based on the criteria we mentioned in section 2. The persistence of unemployment in spite of continually declining real wage does not necessarily suggest that the labour market has malfunctioned in terms of its allocative function. Rather, it shows that there are other important determinants of labour

demand, such as the level of aggregate demand (Jamal, 1992), and imperfect competition in the product market (Horton, et al., 1991). Levy and Newman (1989), in a revealing study on the labour market in Cote d'Ivoire, indicate that further declines in real wages are unlikely to provide the answer to unemployment problem in the country. It was apparent that real wages dropped throughout the period, but clearly this was not sufficient to offset other deterrents to employment. They advise that the government must consider other incentives and conditions to generate the recovery in employment. Teal (1995) argues that the declining real investment is the missing link in the transmission of real wages to higher employment. In practical terms, further fall in real wages may not be beneficial to the economy as it will affect the capability of workers to meet basic needs (efficiency wage argument) and would further depress demand in the product markets. What is reasonable is for the appropriate economic policy that is put in place to induce a shift in the demand for labour as shown in Figure 1.

Second, the reallocative role of the labour market has not been achieved because of a number of reasons. Horton, et al., (1991), attribute this failure not to the inefficiency of the labour market per se, but to the failure of other markets, for example, the market for complementary inputs like credit. The deregulation of interest rates and the steep rise in utility charges, such as electricity and fuels, hurt the manufacturing sector and, therefore, reduce its ability to absorb more labour. The manufacturing sector has been limited in its labour absorption because of its import dependence and the dominance of light industry and assembly lines. More importantly, however, Lall (1990) identifies the inadequate technological capability needed for adjustment in these countries. Other important sectors such as mining and agriculture have also been constrained in the extent to which they could serve as the employment-growth hub.

Clearly, the labour market has failed in the area of its third function, namely, inter-temporal allocation of labour. However, this may have arisen because both private demand for education and public provision of training programme have not been sufficiently sensitive to labour market signals (Ikpeze, 1995). The excessive government intervention in the labour market had also exacerbated this problem.

However, the inefficiency of the African market manifests in many other ways. First is the coexistence of large number of people seeking jobs and vacancies. In other words, there are frictions in the matching process between job seekers and vacancies. Employers and workers use a variety of formal and informal channels to gather and disseminate information on the job matching process. Formal channels include official advertisement of jobs and the registration of vacancies and workers' availability through employment agencies. Informal sources include, 'business associates', current employees, or 'friends and relatives' as informants and referees. A study of the labour market in Ethiopia shows that the use of formal channels is restricted almost entirely to the public sector (Mengistae, 1998). Ninety-three per cent of employees in the public sector learned about their jobs using the official channel. The corresponding figure for workers in the private sector was 4 per cent. About 55 per cent of private firms identified relatives, friends or business associates as the most common source of information on new workers, while another 36 per cent identified current employees as the most common source. Interestingly, about 32 per cent of workers in the private sector discovered their jobs in the course of door-to-door search or heard about it 'by word of mouth' (Mengistae, 1998).

The choice of job-search channel has been found to have implications for earnings and job stability. A Regional Programme on Enterprise Development (RPED) study of Kenya manufacturing sector shows that workers who use official channels earn wages that are 1.8 times larger than workers that use their network of personal contact do. It was also found that there is more stability for jobs found through official channels.

The absence or inefficiency of information clearing agency for vacancies raises the transactional cost for both the employer and job seekers, which ultimately reduces the efficiency of the labour market. The labour market policies and institutions in Africa are such that labour market efficiency is low (Rama, 1998). Employment offices set up by the governments to provide placements and information on job vacancies have been largely ineffective. They are constrained by lack of qualified staff and revenue. There is also the need to broaden the scope of their services to include counselling and training.

Cultural factors also increase the length of time the job seekers have spent on the job queue. Many first-time job seekers take advantage of family support to wait for the right job opening, while rejecting existing work opportunities that are attractive. This is a case of voluntary unemployment. Voluntary unemployment is less likely among those who had a job and lost it. Alternatively, increased education raises the expectations of new entrants to the labour market, making them reluctant to take jobs that are actually available. The long wait may also be due to mismatch between skills and jobs. The immediate benefit of the compressed wage structure is that it reduced the incentives for educated workers to conduct a lengthy search for a relatively high-wage job and thereby remained unemployed instead of accepting a job at a lower occupational level.

### **3.4. Factors Influencing the Functioning of the Labour Market**

#### **3.4.1. Labour Market Integration in Africa**

It is quite established that labour market is segmented in Africa (Terrell 1992, Gaag & Vijverberg 1989, Maglad 1998 and Ikpeze, 1995) and the segmentation is done across geographical, occupational, and industrial markets. In African countries the labour market for formal sector workers is strongly separated from the market for informal sector. The separation is in terms of culture, class and even mode of recruitment across the two markets. According to Doeringer and Piore (1985), the formal market is defined by the existence of highly structured internal labour market which provides 'good jobs' with security of employment, relatively high pay and prospects for advancement. The informal labour market on the other hand is characterised by absence of internal labour markets, offer only 'bad jobs'. In this market, labour turnover is high and insecurity rife, job tenure rates are lower, internal training and promotion prospects poor and wages low. The limited number of ports of entry into the formal labour markets impedes mobility between the two sectors. This is further restricted by the adverse effects of unstable employment on the behavioural traits and work habits of those trapped in the informal sector, who become increasingly unsuitable for stable formal jobs (King, 1990).

In the colonial era, labour could easily move across tribal and ethnic divides. However, in the post-colonial era labour markets have been truncated into sub-zones. This has imposed on the country an

artificial disequilibrium such that observed labour demand in one area cannot be redressed via spatial mobility because of an artificial limit as to where one can go in search of a job (Okigbo, 1991). Aderinto (1985) on the study of manpower issues in Nigeria noted that non-state indigenes are 'openly discriminated against in appointment, secondment and utilisation' and where indigenes are not available, preference is accorded expatriates. This supports Collier and Garg's (1995) findings that kinship allegiance plays important role in the African public sector.

This barrier is less effective in the private sector for two reasons. First, since the operation of large business often cuts across ethnic/state barriers, it is in the interest of the firm to promote a policy of spatial deployment of manpower that transcends state/ethnic boundaries. In other words, production in the organised private sector is carried out on an inter-kin group basis, thus minimising the patronage that kinship will enforce.

Second, in the informal sector free entry and wage flexibility combine to enlarge the scope of non-indigenes' employment (Ikpeze, 1995). In spite of this, production unit in the informal sector production is mostly organised on intra-kin group basis. The kin-group arrangement lowers transaction costs compared with atomistic behaviour (Collier and Garg, 1995).

International migrants are much fewer in African countries than internal migrants. While, South-North migration from SSA is relatively small, cross-border migration is a major socio-economic issue in Africa. This has been facilitated in recent years by rising nomadic population, spells of war and natural crisis, cultural affinity and the continuous cycles of booms and bursts. The regional high growth hubs usually hold attractions to surrounding countries. Initially, Nigeria, with her oil, but in recent times, South Africa, with her mines, seems to be the centre of attractions due to economic and political opportunities in the country.

From the 19th century onwards, the production of agricultural surpluses have been dependent on labour from economically underdeveloped areas in order to supplement local supplies which are limited by low population levels. Thus, the groundnut pyramids in the Gambia and Senegal, the cocoa export boom in Cote d'Ivoire and Ghana were built by migrant labour. Burkina Faso serves as a major source of labour reservoir for Cote d'Ivoire, Ghana and many countries in West Africa.

The extent and character of international migration can have important effects on the operation of labour markets in both the sending and the receiving countries. When outflows of labour are high enough, they can serve as a valve for excess labour supply, reducing unemployment. At the same time, however, they can be differentially selective by skill level and sector and therefore cause labour shortages in both short and the long run (Hollister and Goldstein, 1994). The flow of remittances however, serves as an important source of foreign exchange, and incomes to households. It also affects the pattern of demand for both commodities and factors.

In addition, cross-border migration has some important social costs. For instance, it leads to increased competition with domestic unskilled labour, which drives down wages further, and where the level of unemployment is already high, migration could worsen domestic labour market situation as it unleashes nationalistic feelings and often attracts backlash. For instance, aliens were expelled from Nigeria in 1983 as the government accused them of being the source of its economic problems. The flow of migrant workers to Ghana during the booming Cocoa period was

significantly curtailed by the Alien Order of 1969. In 1983, the military government of Burkina Faso introduced the Laissez-passer decree to curtail migration, though without success.

Similarly, there is a regional segmentation in migration within a nation. Migration is towards the high growth regions, especially the so-called economic centres. Even though most of the migration is family based, employment related migration has increased substantially during the period. A study on the Nigerian migrants shows that in Nigeria the average age of migrants was about 33.9 years. Males account for about 49.9 per cent of them and females 51.1 per cent. 60.1 per cent of the migrants live in urban areas; 21.8 per cent of them received no education and were not literate in any language.

Most migrations seem to originate from the rural areas. Most of them are seasonal and circulatory. The seasonality of farm work creates an uneven demand for labour, except in the few areas where irrigation is practised. Migrated workers form the bulk of hired farm labour. Hired farm labour has become important in those areas where production for the markets has developed most. Farm surveys have shown that the proportion of hired labour can be very high. For example, Galletti, et al. (1956) find that in the cocoa belt of south-western Nigeria, on average 41 per cent of farm labour used for cocoa was hired, while in some instances it reached a proportion of 78 per cent.

### **3.4.2. Institutional Factors**

The labour market occupies a strategic position in the economy that has continued to attract close attention of the government the world over. This is because the market sets wages and employment conditions that have profound impact on workers and their families. Government involvement in the labour market comes either through direct intervention or through policy measures that guide the relationship between the employers and the employees in the economy. Governments intervene directly in labour market to achieve certain social goals, such as protecting the vulnerable or ensuring adequate health and safety conditions. Some of the common ways by which government policy affects the labour market directly are through bans on child labour, protection for women and minorities, hiring and firing regulations<sup>10</sup> and minimum wages<sup>11</sup> (Ghanem and Walton, 1995). The minimum wage legislation has particularly generated strong positions. Proponents of minimum wage believe that if appropriately applied, minimum wage legislation can raise the income of the poor at little or no cost in overall employment. Opponents argue that minimum wages make things worse by raising production costs in the formal sector and reducing employment. More workers are

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<sup>10</sup> For instance, in Zimbabwe, the government played the role of labour's advocate, getting involved in hiring, wage setting, lay-off and dismissals (Velenchik, 1996a). Prior to 1991, government approval was required for all dismissal. When approval was granted, the delay was often as long as two years and many requests were denied. Fallon and Lucas (1991, 1993) find that these policies negatively affected labour demand in the manufacturing sector during this period. However, SAP brought about a change in the process as the government reduced its role in labour market.

<sup>11</sup> Minimum wage legislation is sometimes the outcome of wage commissions. Wage Commissions are often set up during periods of labour discontentment. In Nigeria, between 1941 and 1982, 10 wage commissions were established. The commissions utilised changes in cost of living index rather than productivity changes for granting wage increases. Instead of an ad hoc committee, the Nigerian government established the Productivity, Income and Wages Board in 1977 as a permanent institution to collect and analyse statistics in wages, income and price changes in both the private and public sectors.

then forced to seek jobs in the unregulated informal sector, pushing the wages of the working poor below their previous levels. However, Teal (1995) and others have argued that minimum wage legislation is hardly effective in Africa outside the public sector. Other sectors often ignore the minimum wage as they pay either a higher rate or lower rate than the prescribed minimum wage.

In the formal sector, wage determinations are outcomes of the activities of three key players - labour unions, employers, and government<sup>12</sup>. These three players are motivated by different, at times antagonistic, objectives. The labour unions are motivated by the desire to maximise the wage bill, union membership or both, and would utilize the threat of strike wherever possible to achieve both. On the other hand, the employers would want to keep the cost of production as low as possible and would, therefore, resist any wage increase. The government is like the unwanted guest at the dinner table. It is difficult to predict on whose side the government is, although, its stated objective is to use the income policy to protect the vulnerable and minimise social frustration in the non-unionised sectors. Similarly, it seeks to avoid or mitigate the negative impact of labour disputes on developmental efforts in the economy. Hence, some governments enact labour legislation to curb labour unrest and also encourage tripartite wage negotiation. The government also uses its powers to prevent unilateral or bilateral actions of the private sector that is perceived to jeopardise future income policies. A good example of this happened in Nigeria in 1977. The construction industry had attempted to attract workers into the industry by offering higher wages than the prescribed minimum rates. The government perceived this as a threat to future wage negotiations, and responded with the promulgation of the Trade Dispute (Amendment) Act 54 in 1977 to prevent employers from granting higher minimum wage to new employees without the approval of the Minister of Labour (Otobo, 1983, 1984).

In the formal sector, public sector wage and employment policy has implications not only for the public sector but also on the private sub-sector. In particular, the public sector could act as a leader in the wage determination of the large-scale private sector. Previous examples have shown that wage determination in the public sector has impact on the private sector. For instance, in Nigeria, the strike by Amalgamated Union of UAC African Workers (UNAMAG) in 1950 was a reaction to the inability of the private sector to follow the lead of the public sector. The colonial administration had granted a 12.5 per cent cost of living allowance to its own employees.

In the case of the rural private sector, government policy has direct effects on the earnings of labour in the exportable sector. This was particularly the case among the cocoa-growing farmers in Ghana, Cote d'Ivoire and Nigeria. The exchange rate policy of the government has implications for farmers' income. The active role of the Ghanaian government in the marketing of cocoa has meant that the margin of the selling price of cocoa going to the producers has been heavily influenced by the government's fiscal policy (Canagarajah and Mazumdar, 1997). In the pre-reform period, the over-taxing of cocoa farmers and the massive over-valuation of the exchange rate affected the welfare of farmers. Ghanaian cocoa producers received 15-40 per cent of the prevailing world prices, those in the neighbouring country, Cote d'Ivoire received at least 66 per cent (Canagarajah and Mazumdar, 1997).

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<sup>12</sup> For example, in an empirical model of wage determination and strike activity in Nigeria (Owoye, 1994) shows that the lagged wage, prices, union density and wage commissions exert significant effect on wages. With respect to the frequency of strikes, the results show that the price level, the degree of unionisation and the wage commissions have positive and significant effects on the incidence of strikes in Nigeria.

The extent of government interventions in the labour market has diminished with the introduction of the reform programmes. Since the mid-1980s many developing countries, including Africa, have tried to contain public sector employment growth through freezes on hiring and lay-off of temporary staff. In Sub-Saharan Africa, for example, recruitment freezes were imposed in Benin, The Gambia, Mauritania, Nigeria, Sierra Leone, Somalia and Tanzania. Since 1987, Kenya has allowed hiring only if it does not result in a net growth of civil service posts. Automatic hiring has been discontinued in countries that previously guaranteed government jobs to school graduates (Benin, the Central Africa Republic, the Congo, Guinea, Mali, Rwanda, Somalia and The Sudan)<sup>13</sup>. Temporary staffs have been laid off in the Congo, Cote d'Ivoire, Ghana, Nigeria, Rwanda and Somalia. In Zimbabwe, minimum wage legislation has been abolished, except in agriculture and for domestic workers. Manufacturing wages are now set through a process of industry-wide collective bargaining between workers and firms, although the process is still monitored by the government, and wage increases must be approved by the Ministry of Labour. Senegal also launched its labour market reforms in 1986. Key elements of the reform involve the abolition of the labour office in 1987, hiring practices were liberalized, and the use of temporary labour relaxed. The public sector abolished automatic recruitment for training schools, and downsizing the civil service through a voluntary departure scheme.

Apart from the government, the other key institution having influence on the labour market outcome is the labour union. However, the labour unions role in Africa must be understood in the context of their historical role in political independence. The alliance between the newly independent governments and labour unions was carried into the immediate post-independent governance. However, the romance soon turned sour as labour unions shifted their attention to the defence and protection of the interests of wage earners which, in most cases, clashed with the interests of the government. The case of the Trade Union Congress (TUC) in Ghana is illustrative of this situation. The TUC was in alliance with Nkrumah in Ghana. While Nkrumah supported the union's position against foreign companies he, however, prohibited strike by workers in public employment (Damachi, 1974).

In the post independence era, the labour unions have changed their role to primarily the protection of their members' interests. Higher wages for union members either reduce business profits or are passed on to consumers in form of higher prices. This leads unionised firms to employ fewer workers, increasing the supply of labour in the non-unionised sector and depressing wages (Ghanem and Walton, 1995). The estimated union premium in Ghana between 1992/93 was estimated at about 31 per cent, while that of South Africa in 1985 was between 10-24 per cent (World Bank, 1995). Using 1993 South Africa data set, Schultz and Mwabu (1997) found that African unionised workers receive a wage premium of 19 per cent over the African non-union workers with the same observed characteristics. Kingdon and Knight (1999) also report the presence of strong union premium in South Africa. Union wage premiums are highest in regulated sector and concentrated industries, such as electricity, telecommunications and oil (Ghanem and Walton, 1995).

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<sup>13</sup> Rather than automatic employment, governments in some of these countries attempted to promote self-employment programmes to make the youths rely less on formal sector employment. In Nigeria, such programmes include the establishment of the National Directorate of Employment (NDE) and the People's Bank. However, tight financial constraint has reduced the capability of the government to prosecute these programmes.



However, it is obvious that whatever influence labour unions had in the past has waned considerably. It is difficult to accept that the labour union in Africa is a powerful force in either economic or political decision making. The huge unemployment rate, the economic decline and low percentage of workers in the modern sector has reduced union power in Africa. In the same vein, one may expect a resurgence of union power with improved economic fortune and democratic regimes across Africa.

#### **4. Financial Market**

The financial market is very critical to rapid economic development. The market deals essentially with the reconciliation of demand and supply for financial instruments. Financial markets (or the capital market as broadly conceived at times) perform their allocative functions in three ways: they aggregate savings, allocate funds to competing investments and monitor performance (World Bank, 1993).

Within the context of the LDCs in general, Porter and Ranney (1982) identify salient features of underdeveloped financial markets. These include low ratio of financial assets to national wealth (or GNP), prevalence of self-financing of investment, domination of financial institutions in the 'modern' sector by commercial banks whose pre-occupation is no more than to accept deposits and make well-secured loans for working capital purposes. Other features include the compartmentalisation of the financial system, and existence of 'unorganised' system of curb markets and moneylenders with sometimes unrelated, and generally much higher, interest rates.

There is a wide scope for the operation of financial markets in Africa (Collier and Gunning 1997). They will provide insurance and forward markets to minimise the high-risk environment of Africa. Financial markets will also increase the array of liquid assets compared to the illiquid assets prevalent in the continent. Finally, financial intermediation will minimise the negative impact of policy reforms and price shocks prevalent in Africa which make current profitable investment to be weakly correlated with past profits.

In spite of the obvious needs for financial services, the financial sector is still weak, rudimentary and underdeveloped. Africa has much less financial depth than other developing countries. Gift exchange is still prevalent in the continent. This is due partly to the years of repression of the financial sector and partly due to the failure to integrate the informal sector into the main financial stream. Easterly and Levine (1997) estimate that the lack of financial depth reduces, on average, Africa economic growth by 0.3 percentage points.

Table 4 presents a comparative information on financial depth of Africa vis-à-vis other LDCs. The table indicates that Africa performs relatively poorer than other LDCs on all the indicators: fiscal deficit is higher, the savings rate is lower, and financial intensity is also lower.

**Table 4: Financial Depth and Growth: Differences between SSA and other LDCs**

	Means of Explanatory Variables	
	SSA	other LDCs
M <sub>2</sub> /GDP	0.22	0.35
M <sub>2</sub> /M <sub>0</sub>	2.18	2.61
Savings rate	10.45	17.52
fiscal deficit	-0.049	-0.042

Source: Collier and Gunning (1997)

Appendix 2 further shows that while the Asian countries achieved steady increase in their M2/GDP ratio through 1960s and 1990, the African countries, both individually and as a group experienced declining ratios in the 1980s.

Part of the reason for the low level of financial depth in Africa is that the process of financial intermediation is costly. While some of the causes are inherited from the colonialists, others are policy induced, while others still are a reflection of the weak institutions prevalent in the continent. African countries inherited a financial sector from their colonial masters that is highly regulated and elite based, to the exclusion of the vast majority of Africans. The banks demand for marketable collateral on a continent where assets are few and illiquid. The banks are predominantly foreign-based and catered primarily for the colonial trading community. The cost of financial information about firms are unusually high, and thus small firms with little creditworthy reputation are exempted or attracted relatively higher cost of credit compared to the well established big firms.

The exclusion policy of the colonialists thus led many African governments to establish their own banks after independence. However, financial repression by government compelled the banks to follow the trend under the colonial period. Lending practices concentrated on the minimisation of risks. The demand for collateral and the high costs of obtaining financial information about firms again ensured that only the big and reputable companies benefited from the lending activity of the banks. The public banks provided credit to the government and loss-making parastatals. The weak control and political factors which characterised the operations of the banks led to corrupt lending practices which manifested in high default rates, typically in the range of 40-95 per cent (Collier and Gunning, 1997).

The private banks are mostly oligopoly thereby making the sector suppliers market. This is especially true in small countries such as the Gambia, Ghana and Malawi. Spreads were high and double what prevailed in developed countries (Seck and Nil, 1993). For instance, in Malawi, where there are only 2 commercial banks, interest rate spread rose from 7 percent in 1985 to 9.5 percent in 1991 (Cole and Duesenberry, 1994). Similarly, in Uganda, spread widened from about 9 percentage points in 1991 to around 12 percentage points by mid-1995. Banking spread in Kenya settled at about 5 percentage points after reforms. The large spread principally accounted for the profitability problems associated with the large stock of non-performing assets in the banking system and the general inefficiency of the banks (Hadjimichael, et al. 1996).

The high costs of operations of the banking sector have been exacerbated by past policy of the government, which imposes both explicit and implicit taxes on the sector and also by the poor performance of the legal system, which has reduced the efficacy of assets as collateral. These and other factors curtail the developments of the formal financial sectors. Within this context, the informal financial sector has, therefore, been complementary to the formal sector. However, a number of factors reduce the extent to which the informal sector can make up for the limitations of the formal sector. The first is that the fund available in the informal sector is highly limited and short-term because of the low level of per capita income on the continent. Second, the constituencies served by the two markets are different. The formal financial sector caters primarily for the modern sector while the informal financial sector caters for the traditional - informal and rural household and enterprise sector. While there is evidence that some of the informal financial sector channels some of its funds into the formal financial institutions, there is little evidence of a reversed flow. For example, co-operative funds are sometimes deposited in the banks. A study of the Iqqub in Ethiopia shows that 85 per cent of the contributions of members are often kept as reserves in the bank (Aredo, 1993). Participation in the Iqqub also does not necessarily preclude a person from borrowing from the bank.

Ekpeyong and Nyong (1992) find a complementary relationship between the formal and informal credit market in Nigeria. A majority of small-scale enterprises (SMEs) depend on the informal market as sources of additional capital after being set up. Informal financial institutions provide about 10 per cent of the initial investment for Nigerian SME firms. This, however, increased to about 56 per cent of subsequent investment funding. RPED study of Kenya manufacturing firms indicated that informal financing play significant role in loan structure of micro firms.

#### **4.1 Characteristics of the African Financial Markets**

The major characteristic of the financial sector in Africa is its dualism. Dualism is an outcome of the parallelism and fragmentation of the African financial markets (Steel, et al., 1997). The dualism is in the sense that there exist side by side with the formal (organised and largely foreign) financial markets the informal (unorganised and traditional) financial markets. Financial markets are defined as formal when they fall under the control of state credit and related financial laws. These include banks and non-bank financial institutions. There are also semi-formal financial institutions which, though exist outside the purview of the monetary authorities, are nevertheless required to register and operate under some government regulations. Examples of this are the co-operative societies.

However, the informal financial market operates outside the ambit of official regulation and controls. They form an important segment of the credit market in Africa. However, since the activities of the practitioners in this market are informal, unregulated and often unrecorded they necessarily escape official statistical scrutiny.

According to Seibel and Michael (1987), each of the two markets has its particular strengths and weaknesses. Formal financial markets excel in modernity, in access to national and international refinancing institutions and in access to other supporting institutions, none of which applies to informal financial markets. However, the scope of coverage is limited to a small proportion of the

population. Informal financial markets excel in accessibility, popular participation, basic needs orientation, organizational flexibility, local adaptability, situational appropriateness and socio-cultural integration at local or regional level, none of which applies to formal financial markets.

However, within the formal financial sector there is some form of segmentation. Financial institutions are segmented in terms of economic activities, sources of funding for institutions and asset holdings. For example, commercial banks concentrate on short-term loans; mortgage banks concentrate on residential and commercial constructions, while development banks provide long-term loan. Post-independence African governments set up development financial institutions (DFIs) to provide long-term credit and equity to the real sector. However, the DFIs never managed to gain their independence and therefore continued to depend on government funding. Their presence worsened the segmentation of the financial sector.

At independence, banks in most African countries were located and concentrated their operations in few urban centres, on a continent where over 70 per cent of the population live in the rural areas. For example, in pre-revolution Ethiopia, 64 per cent of bank branches were located in Addis Ababa alone (Aredo, 1993). Thus savings were only mobilized from urban population and organisations. The major sources of credit for the bulk of the rural populations are friends and relatives. A survey carried out by the Ethiopian Ministry of Agriculture between 1983-84 shows that friends and relatives account for as high as 78 per cent of the total credit extended to the peasant sector during the survey period. The rest of the credit came from peasant service co-operatives (19 per cent) and local money lenders, 3 per cent (Ministry of Agriculture, 1984, cited in Aredo, 1993).

In a study covering four African countries (Ghana, Malawi, Nigeria and Tanzania), Aryeetey et al. (1997) identify some important features of the informal sector of African financial markets. These include that:

- \* financial transactions do not involve legal documentation;
- \* lending decisions are based on first-hand information on the borrowers;
- \* risks are not classified;
- \* collateral security is required but applied more flexibly;
- \* financial flow from more formal to informal markets is negligible;
- \* sources of loanable funds are often limited to mobilized savings and reinvested profits;
- \* divergent interest rates;
- \* delinquency and default rates are low;
- \* low costs of credit administration in terms of screening, monitoring and contract enforcement costs;
- \* informal clients enjoy ability to obtain credit from more than one source;
- \* cost of funds is low since informal lenders' costs are limited to pre-screening the clients' ability to pay, not in terms of the use of funds.<sup>14</sup>

In spite of the rapid growth of the formal financial sector (FFS), the informal financial sector (IFS) continues to thrive in Africa. Sabapathy (1994) observes that IFS have thrived for so long and continue to do so both when many formal financial institutions fail, and when the formal systems

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<sup>14</sup>The value of time that money lenders allocate to loan administration is equivalent to only 0.6 to 3.2% of loan amounts in Ghana, Malawi, Nigeria and Tanzania as against 1.7% to 12.9% for bank loans to small scale enterprises and up to 18.9% for large scale enterprises.

develop and expand. Seibel and Micheal (1987) argue that the single most important factor determining the spread and the development of IFS has been the growth of the monetary economy. Others have argued that the popularity of the IFS across Africa could be attributed to the fact that they provide some types of financial services that people demand, which are not provided by the formal financial institutions. Baydas, et al, 1995 found this to be true of informal finance in Egypt. Furthermore, Steel, et al (1997) argue that the low transaction costs and loan losses incurred by the informal market operators while servicing their clients is an indication that the informal financial institutions provide a reasonably efficient solution to the information and enforcement problems that characterise African economies.

Table 5 presents a summary of characteristics of the formal and informal financial institutions and markets.

**Table 5: Summary of Characteristics of the Formal and Informal Financial Institutions and Markets**

<b>Formal Financial Markets</b>	<b>Informal Financial Markets</b>
High fixed, low variable cost	No fixed, but high variable costs
Highly structured	Relatively flexible
Controlled by legal systems	Uncontrolled by legal systems
High degree of security	Low degree of security
High in static efficiency	High in dynamic efficiency
Broad spatial resource base	Narrow spatial resource base
Well defined	Poorly defined
Impersonal	Personal
Emphasis on private property rights	Emphasis on communal property rights
Use of bank accounts and currency	Use of currency and physical goods
Complex organisation	Simple organisation
Large transactions	Small transactions
Profit-motivated in general	Security motivated
Economic focus	High social content in focus
Universalistic	Particularistic

Source: Adapted from Hyuha, *et al* 1993, and p. 11.

Another feature of the financial markets in Africa is the prevalence of government controls and interventions. Until recently, most African government intervened extensively in the operations of the financial sector. Competition was limited because entry was controlled. Interest rates were

regulated and banks were also compelled to channel loans to preferred sectors of the economy irrespective of profitability.

#### **4.2 Financial Market Integration in Africa**

A major feature of the African financial market is its segmentation and fragmentation<sup>15</sup>. Three distinct explanations can be found in the literature to explain the evolution of financial market fragmentation. The first explanation, based on the financial repression hypothesis which was made popular by Mckinnon 1973; Shaw 1973; and Fry, 1982, attribute fragmentation to repressive government policies. Such repressive policies include restriction on market entry, public ownership, high reserve requirements, interest rate ceilings, and restrictions on capital transactions with the rest of the world. The outcome of the repressive policies was the emergence of parallel markets to cater for the needs of those who are rationed out of the formal markets. Thus, government control sustains the parallel market. Roemer and Jones (1989) argue that the success or otherwise of reforms that eliminate controls can be captured by resultant change in volume of economic activities in the parallel markets.

Second, financial market fragmentation has been attributed to structural and institutional factors. These embody three hypotheses. First, is the Imperfect Information Hypothesis (IIH) developed by Hoff and Stiglitz (1990) which revolves around credit worthiness and differences in the costs of screening, monitoring, and contract enforcement across lenders. This explanation suggests that poor information systems encourage segmentation by raising the cost to formal institutions of acquiring reliable information on both systemic and idiosyncratic risks for all but the largest clients. For informal credit agents, the average cost of their operations is quite low due to the sunk costs information channels. To this effect they have upper hand in terms of information costs. This is because they rely on localized and personal information that gives them local monopoly power. Expectedly, however, the information set that they enjoy equally constrains their ability to scale up.

The second hypothesis argues that segmentation may also develop out of weaknesses in the infrastructure that supports the financial system. Absence of a well-functioning insurance market and of markets for the sale of confiscated collateral hinders efficient financial market. Demand for collateral often excludes creditworthy small-scale borrowers from enjoying credit facilities from the formal financial markets. This is more rampant where land tenure is not legally explicit.

The third hypothesis posits that the informal credit agents prosper because they emphasise personal relationships. Social sanctions, reputations and group responsibility substitute for collateral and help enforce repayment. Informal sector has two notable parts: autonomous and reactive. The former predates the formal sector, while the latter emerges in response to controls over the formal sector. Informal sector credit directly takes care of spillover demand by providing residual finance for those excluded from the formal market.

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<sup>15</sup> Markets are said to be fragmented or segmented when prices differ from one part of the market to another because of physical isolation, markedly different endowments, tastes, risks or market behaviour. Put differently, fragmented or segmented markets develop because of price disparities mostly caused by inherent characteristics of the market. Therefore, government interventions can only exacerbate and deepen the disparities in such markets, suggesting that controls are not the root cause of fragmentation or segmentation.

Existing literature on why credit markets are segmented in Africa reveals that information imperfections are minimised among small groups where characteristics of individuals tend to be well known, and monitoring borrowers' behaviour becomes relatively inexpensive. Udry (1990) establishes that individuals in Nigeria tend to lend to people they know in order to economise on information flows. In essence, therefore, it is argued that formal institutions suffer from greater problems of imperfect information thereby making them to be vulnerable to the combined problems of adverse selection and moral hazard (Besley, 1990)

The third argument is a corollary of the imperfect information paradigm. The common belief is that formal financial markets are noted for high level of inefficiency and bureaucracy. Five indications found in the literature to suggest the efficiency and supremacy of informal market over the formal ones are as follows:

- \* Credit sources in the IFIs are heterogeneous.
- \* The terms and conditions attached to the informal loans are very simple and free from red tape. "Loans are made against no better security than the farmer's verbal promise to discharge his obligations".
- \* Informal credit sources appear to complement formal sources; rather than act as their substitute.
- \* Credit in the informal sector is not entirely used on provident expenditures' or 'wasteful consumption' alone.
- \* Informal financial markets appear to be used by both small-scale and large-scale farmers, thus, producing a good interaction between the FFs and IFs.

Furthermore, the formal financial institutions have largely excluded the rural areas in their operations and concentrated primarily on the urban areas. Apart from locating these institutions mainly in the urban areas, the requirements and documentation required for credit facilities are beyond the rural households and enterprises. Hence, they have to recourse to the informal sources that have served them before the advent of the formal institutions. Rural population, therefore, relies on co-operatives and credit unions, informal groupings such as Rotating Savings and Credit Associations (ROSCAS), and other varieties that meet their financial service needs. In this sense, it is unlikely that the service provided by the informal financial sector lenders can be fully replaced by formal sector institutions in any African country, considering the relative size of the rural population.

It should be emphasised at this juncture that financial market segmentation might arise with or without repressive financial policies. This, perhaps, can help to explain why financial reforms and financial liberalization have not significantly reduced the volume of financial transactions passing through the informal financial markets. It is not to be expected therefore, that IFS will cease to exist even if the FFS is able to attain maximum efficiency in a pareto-optimal sense. Evidence from previous studies, as cited in Hyuha, et al (1993) for Ghana, Malawi, Senegal and Zaire suggest that both FFS and IFS complement each other in the saving-investment process.

Aryeetey *et al* (1997) argue that one way by which economic development can be facilitated, given the fragmented nature of financial markets in Africa, is to pursue policies that will lead to better integration among different segments of the financial system, that is, formal, semi-formal and

informal. They believe that better integration will help mobilise household resources to enterprises with high potentials. There is evidence that informal institutions have less business links with the formal ones, both for deposit of funds and for obtaining credit.

Chipeta and Mkandawire (1992) observe that moneylenders' accessibility to formal financial institutions' credit is extremely low in Africa. In Malawi they notice that the absence of meaningful links between FFS and IFS created a phenomenon whereby seasonal idle cash balances on which no interest is earned exist even at a time when the liquidity of FFS was under strain. Aryeetey (1992) finds similar phenomenon in Ghana where the linkages between the formal and informal systems provided little or no positive benefits for borrowers or savers. The direct implication of absence of effective linkage in the economy as a whole would be expected to be negative as local investment will be discouraged,

In effect, the fragmented nature of financial markets in Africa constitutes a challenge to policy formulation. The first direct policy implication is that the informal credit markets, by virtue of their existence and, regardless of the extent of their linkages with the formal one, have a crucial role to play if monetary policy is to produce desired effect, especially with respect to availability and cost of funds at the aggregate level. Cole and Park (1983) have established that the informal credit markets have the ability to mitigate the more arbitrary and disruptive consequences of credit controls in the formal credit markets and thereby contributing to the maintenance of high rate of economic growth. Secondly, given that segmentation might be rooted in institutional and structural characteristics of African economies, meaning that financial dualism is an outgrowth of structural dualism of the economy as a whole, then, the strategy for financial markets integration should include measures that will transform and institutionalise the IFS, as well as informalise the FFS. According to Steel, et al (1997), if financial markets were fragmented, reforms in the formal financial sector would have little or no impact on informal activities, which would respond more to changes in financial demand and supply in the real economy than to changes in financial policies. This would no doubt weaken the efficacy of financial policies and constrain the success of financial liberalization.

## **4.3 Operations of the Financial Market**

### **4.3.1 Rural Credit**

The rural credit market is very important in Africa. This is primarily because most Africans live in the rural areas and depend on agriculture for livelihood. Crop income is highly variable suggesting the need for an insurance system. However, the combination of the problem of moral hazard, covariance of the risks and geographic isolation precludes the use of insurance (Collier and Gunning, 1997). The small number of informal credit suppliers also limits the size of the rural credit market. The limited amount that can be raised under this system constrains the amount and scope of investment that can be undertaken by the majority of rural households. The credit market in the rural sector is based on high observability rather than collateral. A number of reasons account for this. First, the bulk of rural capital stock is in the form of land and animals. Land is unsuitable as collateral because of the structure of ownership of land based on communal holdings where



property ownership is loose, social and not private; land also has little value, given its relative abundance. Animals are also unsuitable because they are highly vulnerable as a store of value.

The rural credit markets are relatively more developed in West Africa than in the Eastern and Southern Africa (Collier and Gunning, 1997). Even then the informal credit market subsisting in West Africa only caters for short-term credit and only restricted to people living in the same locality. In typical cases, both the lender and borrower live in the same area and are very familiar with each other.

#### **4.3.1.1 Functioning of the Rural Credit Market**

There are two views about the functioning of the rural credit markets in developing countries including Africa. These are the traditional monopoly power and competitive market views. The first view associates high interest rates in Africa to the monopoly power of the village moneylenders. Whatever is the strength of this view is rendered useless as alternative, cheap institutional credit fails to drive the traditional moneylenders out of the market. Also, interest rates charged by traditional moneylenders remain as high as 900 per cent per year, and, in some periods, credit is unavailable at any price.

On the other hand, the competitive market view insists that high interest rates constitute a reflection of competitive credit market that have internalised the risks of default. If this view is correct, then intervention in credit markets is not necessary, especially on efficiency ground.

Hoff and Stiglitz (1990) observe that neither of the two views adequately explains the working of rural credit markets in developing countries as reflected in the characteristics of financial markets in Africa. They identify the features of financial market not captured by the two views to include the following:

- \* the formal and informal sectors coexist despite the fact that formal interest rates are substantially below those charged in the informal sector;
- \* interest may not equilibrate credit supply and demand; this implies that credit rationing will always be necessary and that in periods of bad harvests, lending may be unavailable at any price;
- \* credit markets are segmented, providing room for differential interest rates that cannot be explained away by likelihood of default and/or local events;
- \* there is a limited number of commercial lenders in the informal sector, despite the high rates charged;
- \* in the informal sector, interlinkages between credit transactions and transactions in other markets are common; and
- \* formal lenders tend to specialise in areas where farmers have land titles.

They then provided an alternative approach based on the imperfect information paradigm (IIP). This new view is based on three important observations, which they claimed are inherent in African financial markets:

- \* borrowers differ in the likelihood that they will default, and that it is costly to determine the extent of that risk for each borrower. This is otherwise known as the screening problem;
- \* it is costly to ensure that borrowers will take those actions, which will make repayment most likely. This is the incentives problem; and
- \* it is difficult to compel repayment. This is the enforcement problem.

The position of the IIP is that, it is the markets' responses to these three problems singly or in combination that can be used to explain the observed features of rural credit markets in Africa.

Two sets of mechanism can be relied upon to solve the three problems identified above; these are direct and indirect mechanisms. The former involves designing contracts by lenders, which a borrower must respond to in his own interest. Lenders are expected to obtain information about the ruddiness of the borrower and on that knowledge take actions that will reduce the likelihood of default and choose to repay the loan whenever the borrowers have the resources to do this. These contracts may be inbuilt into the credit markets themselves, for example, the interest rate and loan size, or related markets (for example, rental agreements) that will influence behaviour in credit markets.

Direct mechanisms involve lenders expending resources to screen borrowers and enforce loans. Thus high interest rate is needed to support the cost of these activities. Direct mechanisms, especially through personal relationship, trade credit linkages, insufficient loans, etc can be used, even when they result in monopolistic competitive structure with interest rate that spreads between different segments of the rural credits markets. When this happens, it is believed that the entry of institutional credit by new institutions may not break the money lenders' power, except these new institutions can overcome the problems of screening, incentives and enforcement.

The thinness of credit markets has been directly associated with the feedback effect of high interest rate. Lenders' inability to cover the opportunity cost of the funds simply because the default rate is high at the prevailing interest rate further puts pressure on the rate of interest. This process generates a situation whereby only riskiest projects with the higher probability of default are undertaken (Akerlof, 1970).

Directing, screening and monitoring costs, which vary among lenders in African countries, are suggested to constitute a set of explanations for credit markets segmentation. The need for segmentation is to reduce the negative effects of asymmetric information between borrowers and lenders. Udry (1990) finds in the case of rural credit market in the Northern part of Nigeria that direct mechanism for screening and monitoring relied on geographic lines and kinship groups. He observes that as much as 97 per cent of the value of credit transactions was done at the level of individuals residing in the same village or belonging to same kingship group. Feder *et al* (1989) establish reliance on kinship and village sanctions as a mechanism for contract enforcement in rural China. Another method of direct mechanisms is the use of interlinked credit contacts to minimise screening, incentive and enforcement problem. Traders provide the most common form of interlinkage. This results in trade-credit linkage (Siamwalla, *et al* 1990). Under this linkage, lenders often insist that their clients should sell all their crops to, or through them. What trade-credit linkage does essentially is to make information on the size of the borrower's operations available to the creditors and to no one else. While it is appreciated that trade-credit interlinkages help to resolve

information asymmetry as well as the enforcement problem, they, however, create asymmetry of information across lenders.

Hoff and Stiglitz (1990) identify three other devices employed in Africa to limit the consequences of information asymmetric and enforcement problems, namely, collateral requirements, usufruct loans, and rotating savings and credit associations. Inability to truly screen and monitor borrowers has forced formal financial institutions, mostly commercial banks to insist on land as collateral. A typology of usufruct loan is one where a lender occupies and uses the borrower's land until the principal is repaid. Adegboye (1983) observes a practice in Nigeria that conforms to usufruct loan arrangement. The practice involves procuring loans by transferring to the lender the right to harvest the borrower's land. In the case of rotating savings and credit association (ROSCA), the practice even predated monetization (Bouman, 1983), and it has continued to remain a major source of credit in Africa countries (where they are called "tontines"). Tontines have been found to be highly successful in Cameroon<sup>16</sup>.

Direct screening and enforcement process is active and costly. Hence, the possibility of imperfectly competitive credits markets. Aleem (1990) shows that total average costs of lending as a fraction of the amount recovered, was comparable to the average interest rate charged in the area covered by his study. Also mean marginal costs as a fraction of the amount recovered were found to be much less than average interest charged. The direct conclusion from these findings is that rural credit markets in Africa are characterised by monopolistic competition. Each lender has a downward-sloping demand curve from borrowers tied to him, such that he can price at above marginal cost. Aleem (1990) indicates that screening and enforcement costs are about 1 per cent of marginal costs of lending operations, but entry of new money lenders keeps pure profits close to zero by driving the price down to the average cost. As would be expected of monopolistically competitive markets, each lender operates on too small a scale, meaning that he spreads his fixed costs over too small a clientele.

One important suggestion offered by the imperfect information paradigm is that the action of lenders will necessarily depend on the amount of information they have about their clients and the enforcement power they possess. It is to be expected that, formal and informal lenders will also approach their borrowers differently on the basis of differences in the degree of information and enforcement power that they have. The existence of the informal sector in credit market is therefore related directly to the abilities of moneylenders especially in African to:

- \* perform a better screening of clients;
- \* possibly offer better incentives to make repayment more likely, and, in the process;
- \* solve the enforcement problem by compelling repayment.

The direct implication of the relative advantage enjoyed by moneylenders is that the moneylender's power is unlikely to be broken by the entry of institutional credit unless the new institutions

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<sup>16</sup> The operation of the Tontines was reported in the The New York Times as follows: "Tontines, build on trust, are generally made up of homogenous groups -people from the same ethnic background, the same work-place or the same neighbourhood. If you don't make your payment on the tontine, the community rejects you. If you are banned from one group, you are banned from the others. Indeed, several years ago, several Bamileke traders committed suicide because they realised that they could not make their tontines payments". It is, therefore, clear that ROSCA draws strength from pre-established social ties.

themselves find substitutions for the direct mechanisms used by moneylenders to overcome the problems of screening, incentives and enforcement (Hoff and Stiglitz 1990). On account that interest rates are higher in the informal credit markets, borrowers must be expected to first source loanable funds from the formal sector. Therefore, borrowing from the informal sector would be expected to occur usually after the borrower has failed to find formal credit. Excess demand for credit in the formal credit market implies that at a given interest rate, which is always lower than informal lenders' rates, formal credit will be rationed. In the case of Ghana, Aryteetey (1992) observes that the only possible exception to higher interest rate in the informal credit market is credit from friends and relatives.

Figures 5 and 6 summarised the relationship between the formal finance and informal finance.  $r_1$  is less than  $r^*$  in the formal market in the face of excess demand for credit, not only as a result of interest ceilings, but to also avoid the problems of adverse selection and moral hazard (Stiglitz and Weiss, 1981; Stiglitz, 1989). Thus, non-price mode of rationing which may not be efficient is then adopted. While it is possible for households and micro-enterprises to cross over to the informal market thereby shifting the demand curve in the market outward, other firms, however, remain in the formal market where they have to cope with constraints imposed by limited funds in the formal finance system.

#### **4.3.2 Trade Credit**

One important source of external credit that African firms have access to, but often ignored in most formal analysis, is trade credit. Trade credit is credit offered by suppliers to buyers in the course of exchange transactions. The importance of trade credit is particularly marked among small and medium-sized firms, which serve as the training platform for entrepreneur and hence constitute an essential component of a healthy economic structure. An important distinction between trade credit and bank loans is that the former, unlike the latter, is not guaranteed by any formal collateral. In Zimbabwe, Fafchamps (1997) reports that suppliers of trade credit rely on trust and reputation. They collect information about clients directly, by inspecting the client's business premises or home and by asking friends and others about the client's reliability. Large firms with a well-established reputation are more favoured by this style of screening. Nevertheless, many small firms eventually benefit from the system once they have established a track record.

One shortcoming of trade credit as observed in the case of Zimbabwe manufacturing is that suppliers modulate credit terms by type of borrower. This creates inefficiency in the credit market. Available evidence in Zimbabwe indicates that African firms are less likely to obtain trade credit than other firms are, whenever suppliers factored in variables like firm size, age and other sector of activity. This implies that ethnic consideration is an important factor in the Zimbabwe's trade credit market. Fafchamps (1997) attributed the discrimination against Africans to two factors, first, they are perceived as less reliable in repaying loans, and second, they are less well connected and have few acquaintances in banking and finance. These two factors are potentially strong enough to deprive Africans the privilege of external finance through trade credit.

It needs to be mentioned that trade credit in one form or the other constitute an importance source of finance in Africa. Baydas, et al (1995) found that in Egypt, bank employees with the Principal Bank

for Development and Agricultural Credit (PBDAS) who also doubles as traders provide trade credit to fellow employees. Goods sold ranged from food products to gold and jewellery items, to furniture. The buyers were then allowed to pay installments. In most cases, the longer the period of repayment the higher the implicit interest rate on the goods purchased. Farmers were also reported to allow butchers to acquire animals for slaughter but to pay several weeks later. Similarly, farmers turned merchants received fertilizers and other inputs from wholesalers to sell to other farmers. While no explicit interest was charged on credit sales, farmers that paid cash were charged lower price than those who received credit<sup>17</sup>.

It is interesting to find that most of the employed merchants source their finance for trading activities from self-help financial groups with the generic name of rotating savings and credit associations (ROSCAS) known as gam'iyas in Egypt. Baydas, et al (1995) actually found that employee/merchants in Cairo were often leaders of PBDAC gam'iyas and members in others. Furthermore, the farmer-merchants were often moneykeepers who provided easy access to funds to deal with emergencies as well as discouraging impulse buying.

### **4.3.3 The African Formal Financial Sector**

African countries differ in the sophistication of their financial market. Kenya, Zimbabwe and South Africa are considered to have very sophisticated financial system by African standard. The structure of the banking sector was inherited from the colonial masters. They are predominantly oligopolistic with high level of concentration. The desire to encourage local participation in the banking sector led to increase licensing of indigenous banks after independence. Non-Bank Financial institutions (NBFIs) and specialised banks were also licensed to facilitate economic development.

African countries inherited a financial sector from their colonial masters that was highly regulated. Most African countries followed a policy of low interest rates and target credit directly at priority area. The main aim of low interest rate policy was to keep the costs of funds low, with the belief that cheap credit will promote development through increased investment. Administratively set interest rates were not only low but lack flexibility. This prevents the banking sector from adjusting their lending rates to reflect the riskiness of projects. Consequently, financial institutions in Africa concentrate on low risk established projects, leaving the high-risk projects with no funding. The low interest rate also hampers mobilization of funds as private agents prefer alternative means of investment and capital flight. Available credit is then rationed among competing investors based on non-price methods such as the quality of collateral, client's bargaining skills, political leverage and loan size rather than the expected productivity of the investment (Ngugi and Kabubo, 1998).

Nissanke (1994) identifies a major feature of the formal financial sectors during this period: the coexistence of 'excess liquidity syndrome' (ELS) and; non-performing term loan' (NPTL). The excess liquidity syndrome is used to refer to a situation where the banking institutions, especially the commercial banks hold liquidity in excess of the required statutory level. The implications of the ELS are several. First, banks lack incentive to mobilize additional savings. Nissanke (1994) reports

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<sup>17</sup> As noted earlier, trade credit is also sometimes used by the traders to lock in the buyers to him. This is to minimise screening, incentive and enforcement problems.

cases where banks in Ghana and Malawi turned back depositors. Second, it hampers the steady flow in the savings-investment circuit. Third, ELS has also been shown to be responsible for credit supply crunch to the private sector. Finally, the prevalence of excess liquidity also reduces the efficacy of monetary instruments for stabilization.

African banks were also reputed to carry a considerable number of non-performing loans and suffer from low recovery rates. Nissanke (1994) estimates that repayment rates of banks in SSA were as low as 20-40%. This factor was particularly important in the explanation of the bank crisis that resulted after financial liberalization policy was adopted in these countries. Hadjimichael, et al. (1996) argue that the high levels of nonperforming loans in the Uganda banking sector could be attributed partly to the policy of directed credit allocation particularly in the 1970s.

There has been a rapid roll-back of the heavy-handed controlled of the financial sector in the aftermath of the adoption of the structural adjustment programme<sup>18</sup>. Hence most African governments have liberalised the sector and have shifted from the use of direct control to indirect instruments to influence the financial sector. Hence, interest rates have been liberalised, directed lending has been lifted and more banks have been licensed. In Nigeria, one immediate impact of the deregulation was the rapid increase in the number of banks. The number of banks rose from under ten before deregulation to 119 after deregulation. However, the deregulation soon saw the lending rates jumping through the roof. It is not clear whether spread actually reduced even with the increased competition in the sector, partly because most depositors are uninformed. There is, however, no doubt that interest spread rose significantly in 1993 after liberalisation (Sobodu, 1998). Similar experience was reported in Kenya (Ngugi and Kabubo, 1998).

However, the Central Banks in many of these countries were not sufficiently equipped and experienced to manage the new deregulatory environment. Some of the new private banks were better equipped than the Central Bank. The weak supervision of the banks coupled with the changed environment meant a death-knell to many of them. There was widespread distress of banks in many countries. Many banks in Nigeria went under after the government withdrew its support. Several causes were adduced for the spate of distress. Ebhodaghe (1994) identifies the causes of distress among Nigerian banks to include the adverse economic environment, ownership structure, political interference in the management of banks, impact of deregulation, outright theft as well as regulatory and liquidity risks. Sobodu and Akiode (1994) consider the degree of dependence of banks on the inter-bank money market as a factor in explaining the banking sector crises in Nigeria. Many of the banks were accused of placing money with finance houses where the interest rates were much higher than in the formal inter-bank market. The failure and closure of many of the finance houses triggered serious crisis in the financial sector. This is because the mass collapse of finance houses also meant the collapse of the inter-bank money market as a secondary market for funds to banks.

The high interest rates and subsisting costs of operations in the aftermath of the reforms prevent the real sector from benefiting from the financial deregulation. Collier and Gunning (1997) note that the persisting high costs of operations are indicative that policy may not have been the overriding underlying factor. The banks are also constrained by the problems of weak management and the

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<sup>18</sup> The frequent policy reversals have led to credibility problems. In the case of Nigeria, the interest rate was deregulated, then regulated and then deregulated, all within the spate of two years.

absence of information and legal security. In addition, the banks now find government securities a more profitable investment outlets than lending to the private sector. It is also true that the probability of survival for manufacturing firms after reforms has diminished. The manufacturing sector which has been pampered and shielded from competition for a long time now find it difficult to adjust to the new post-reform environment. Thus, the sector is burdened by high domestic cost of foreign inputs, high cost of utilities, weak domestic demand and poor quality and declining supply of public infrastructure. Osota (1994) finds a shift in the portfolio of commercial banks in Nigeria between 1991 and 1992 with the loan asset ratio falling from 27.4 per cent to 23.4 per cent. At the same time the stock of stabilization securities as a proportion of total assets increased from 5.7 per cent to 8.1 per cent over the same period.

#### **4.3.4 Exchange Rate Markets in Africa**

The banking sector also plays an important role in the foreign exchange market<sup>19</sup>. It serves as an intermediary between the public demanders and suppliers (usually official) of foreign exchange. Exchange rate markets in Africa are polarised. There is the parallel market that operates outside the purview of official regulations. For Nigeria, Odubogun (1995) identifies three distinct markets for foreign exchange transactions between 1986 and 1990. These are the official market, the bureau de change, and the parallel market.

Most African countries had overvalued currency by the early 1980s. For all or most of the SSA countries, their currencies were overvalued due to the policy of fixed exchange rate that they adopted. Under the fixed exchange rate regime, African governments, through their monetary authorities, determined the nominal exchange rate independent of the market. Because overvaluation stimulates import demand and suppressed export supply, deregulation in the FOREX market and deficit in trade balances erupted. To confront the resultant disequilibrium, most African countries adopted exchange rate controls. This approach (exchange controls) became widespread on the arguments that exchange control ensures the stability of a nation's currency (Todaro, 1977).

Dordunoo (1994) identifies three major features of the foreign exchange market in Ghana during this period. These features were an excessively overvalued official exchange rate, a thriving black foreign exchange market, and an allocation of official foreign exchange based on import licensing arrangement issued by an Import Programming and Monitoring Committee. Essentially, these features shaped the foreign exchange market in Ghana prior to the economic reform process.

Odozi (1986) argues that the cost of controls and the rules governing FOREX allocation generates high inefficiencies in the FOREX market, and hence, the economy. He, therefore, contends that a flexible regime, which is an antithesis of controls, will generate efficient FOREX allocations and, hence, promote efficient resources allocation in the economy.

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<sup>19</sup> This market is very important across Africa because of the dependence of these countries on external trade. Africa depends on imported inputs and capital. The massive distortion in the market in the past has altered domestic incentives against the tradable sector. It has also been the cause of balance of payment crisis and the continent's debt overhang.

Most African countries, in a bid to restructure the foreign exchange market, adopt more than one exchange rate regime or an eclectic regime that taps the advantages of the two regimes. A dual exchange rate regime is an example of the former, and an adjustable peg, of the latter. Government and the market became the two institutional frameworks determining exchange rates. This, therefore, implies that the efficiency of the system rests critically on the character of the institutions and operational efficiency of the institutions (Odubogun, 1995).

In Nigeria, the era of exchange control (pre-1986) generated a number of negative effects on the economy. The attempts of the Central Bank of Nigeria to stabilise the value of the naira led to the parallel market premium increasing monotonically. A variety of regulatory-induced behaviours such as under invoicing of exports and over invoicing of imports began to spread. Also, other effects like capital flight and the arbitrating of foreign currencies acquired at below market clearing rates in the official market were also noticeable. Parallel market became more prominent in the early 1980s as the economy slumped into distress. Between 1986 and February 1992, various foreign exchange reforms were introduced and experimented with.

However, these reforms failed to halt the continuous depreciation of the nation's currency as reflected in the almost continuously increasing parallel market premium. In March 1992, government opted for a complete deregulation of the system of foreign exchange trading. Yet, the parallel market has remained, except that premium reduced to what probably could be considered as a transaction-costs differential. Nigeria has become a nation of foreign exchange speculators, except again, that no formal organisation of the parallel market exists. The parallel market is ubiquitous as any imaginable place qualifies as a dealing spot. The importance of this market has equally grown as transaction costs in the real and service sectors, including embassies and foreign missions in Nigeria, are implicitly indexed to the parallel rate. The parallel market in Nigeria has survived every attempt to abrogate it.

Kiguel and O'Connell (1995) observe that the importance of parallel markets and their effect on overall economic performance generally depends on the size of the parallel premium, defined as the percentage by which the parallel exchange rate exceeds the official exchange rate. They observe that the premiums in these markets have been more important in Africa as countries responded to macroeconomic imbalances and severe balance of payments problems by tightening controls on foreign exchange transactions. Specifically, Ghana and Tanzania recorded high premium that lasted five years or more between 1973-86 and 1980-86, respectively (see Appendix 5). According to these authors, parallel foreign exchange markets develop in one of two ways. In the first, the economy starts from a unified foreign exchange markets, and the authorities adopt an official dual exchange rate system in response to a balance of payment crisis.

In the second, a parallel market emerges gradually as the authorities impose restrictions on access to foreign exchange in an effort to maintain an overvalued exchange rate. As pressures on the official exchange rate mount, controls on foreign exchange are tightened, and eventually the illegal market becomes macro economically important. Varieties of parallel markets, therefore, include a phenomenon of official parallel exchange rate, whereby governments adopt dual exchange rate systems not only to deal with balance of payments crises, but also to increase the effectiveness of monetary policy or, to help unify the foreign exchange market especially in countries where the parallel market is illegal and/or the government is eager to phase out exchange controls on current



account transaction. Most of such countries have a three-tier foreign exchange market. Selected current account transactions take place at the official pegged exchange rate, others are assigned to an official parallel rate, and the rest take place at an unofficial exchange rate. Ghana and Zambia, for example, held official foreign exchange auctions for a short time in the 1980s that applied to a substantial share of external transactions.

In contrast to a dual system installed temporarily as part of an overall policy adjustment, the emergence of a black market often reflects a systematic bias against devaluation of the official exchange rate. When expansive monetary and fiscal policies raise the rate of inflation and lead to an overvalued exchange rate, the balance of payments gradually worsen. If the government fails to correct this imbalance by tightening macroeconomic policies or devaluing the official exchange rate, it is forced to restrict access to foreign exchange at the official rate. Popular expectations that the authorities will impose a maxi-devaluation or tighten foreign exchange controls add to the demand for foreign exchange by encouraging importers to accumulate inventory and promote the substitution of foreign exchange for domestic assets. The supply of foreign exchange is provided through remittances by exporters, tourists, and workers abroad, all of whom may find it profitable to divert foreign exchange from the official to the illegal market to take advantage of the premium (Kiguel and O'Connell, 1995).

Although the precise volume of trade in parallel market is unknown, the belief is that the volume will be less than that of the official market. However the number of deals completed in the parallel market will undoubtedly exceed that of the official market, as the parallel market is the only market of resort for most agents. The quantities traded in parallel markets are often used to reflect the benefits from reform programme that attempt to eliminate controls. The extent to which parallel markets compensate for the distortions induced by price controls or taxes is said to depend on the institutions involved, the costs of operating in parallel markets, the roles of consumer access to controlled factor and the degree and nature of enforcement.

In terms of risks and costs, sellers' costs include the risk of being caught and punished for selling currency illegally, the cost of avoiding detection, the cost of bribes to avoid arrest, or of fines if caught. The higher prices in parallel markets serve as a mean of internalising the higher costs and risks of operation in this market. Garba (1997) identifies five types of costs also incurred on transactions in Nigeria's official market: documentation cost, late delivery cost, time limit cost, non-transferability cost and communication cost. The existence of parallel market premium is an indication that costs differ in both markets.

Culbertson (1989) argues that outside the differential costs of operating in the two markets, two factors will define the gap between parallel market rate and official rate. According to him, the parallel market premium will vary directly with:

- \* the divergence between official rate and the unobserved equilibrium exchange rate; and
- \* the control structure, penalties and other exchange restrictions which make it more difficult and costly to supply or reallocate foreign exchange to the parallel market.

Empirically, Culbertson shows that black market exchange rates are largely determined by the same set of economic forces that determine the unobserved equilibrium rate. This implies that black market exchange rates are also influenced by the monetary events evolving in a given economy.

It follows from the preceding findings that segmented foreign exchange markets are supposed to be unified, except that exchange rate unification means different things in different contexts. Full unification refers to the adoption of a single exchange rate for all external transactions, with full convertibility if the exchange rate is managed. Partial unification, on the other hand, implies the adoption of a single exchange rate for all current account transactions, while maintaining convertibility restriction portfolio and capital account operations. In Ghana and Tanzania, unification occurred in phases with reductions in the premium accompanying a gradual shift of transactions to a more market determined official exchanged rate. Garba (1997) demonstrates that frequent changes in pricing rules in the official market coupled with weak macroeconomic environment frustrated exchange rate convergence in Nigeria.

In all, the fact that the black market phenomenon is prevalent in Africa is an indication that the official exchange rate is not appropriate. The black market rate provides insight into how overvalued the official rate may become. This provides the basis upon which the black market rate is often considered to be a better guide to efficient resource allocation than the official rate. This notion must be accepted with reservation because of the inefficiency of the parallel market. Bevan *et al* (1989) observe that illegality and information costs impair the efficiency of parallel market. Potential customers are unable to purchase goods despite the presence of active parallel markets owing to seller's inability to advertise their stock in trade. Hence, markets refuse to clear, because there are consumers who are prepared to pay higher prices, but are not approached by the trader.

#### **4.3.5 The Stock Exchange and Capital Flows**

Capital markets in Africa are usually classified as emerging, suggesting that they differ in some respects from those in developed countries. Inanga and Emenuga (1997) note that capital markets in Africa are recent, they have fewer market participants, are less sophisticated and have less skilled investment analysis. One direct consequence of these characteristics is to raise the question as to the markets' capability to mobilise funds and allocate resources efficiently, as well as their ability to endure in their financial intermediation roles for foreign and domestic capital. Africa's market capitalization in 1995 averaged \$0.5 billion, compared to \$18 billion for Asia, \$4.7 billion for Latin America and the Caribbean, and \$1.2 billion for Europe and the Middle East (Jefferis, 1995). However, South Africa is often not included as an emerging market. It dwarfs all others in Africa with a capitalization of \$151 billion.

The weak and small size of the existing 16 stock exchange markets on the continent has limited the flow of capital into the African region. The total capitalization of the stock markets is low by international standards and many of them are not linked with the international financial markets. There are very few financial instruments for risk pooling. In a study of 41 countries covering 1986 to 1993, Demirguc-Kunt and Levine (1995) find that Nigeria and Zimbabwe are among the countries with the least underdeveloped capital markets in the world, with market capitalization to

GDP ratios under 0.1 per cent. This indicates that African stock exchanges are characterised by limited trading activity (see Appendix 7).

Inanga and Emenuga (1997) identify the following features of the Nigerian Capital Market:

- \* Lack of basic information for investment analysis as published annual accounts fail to include information regarding forecast of future cash flows, the market price of the companies shares at the stock exchange and the average price of the company's share during the year.
- \* Settlement process is slow as share transaction takes almost a year to complete while payment of dividends to shareholders is characterized by irregularities; sometimes it fails to reach a good number of investors.
- \* Transaction costs are inversely related to the value of equity issues in the market<sup>20</sup>. To the investor, transaction cost includes the profit opportunity forfeited within the one year it takes to receive share certificates after payment and the interest opportunity lost when an investor's money is refunded after a year if the bid is unsuccessful.
- \* The cost of public issue of debt in the market is higher than that of equity.
- \* Declining capitalization ratio as stock market capitalization fails to keep up with the GDP.
- \* High market concentration as the top 20 companies accounted for 70.58 per cent in 1989, though, the concentration is declining.
- \* Inefficient asset pricing process as stock prices are serially correlated, suggesting that price changes are not independent.
- \* Comparative characteristics indicate the sharp difference between African Stock Markets and other emerging stock markets.

Table 6 shows the difference between African Stock Markets and other emerging stock markets.

**Table 6: Comparative Characteristics of Some Emerging Stock Markets**

<b>COUNTRY</b>	<b>Growth rate of listed companies %</b>	<b>Growth rate of market capitalization %</b>	<b>Turnover ration %</b>	<b>Market concentration</b>
Nigeria	4.8	28.27	1.84	48.00
Turkey	35.00	9,622.0	39.16	45.60
India	21.33	201.33	54.51	19.60
Jordan	0.00	30.49	22.76	44.00
Zimbabwe	2.12	168.00	3.83	-

Source: Inanga and Emenuga (1997) P.20

<sup>20</sup> The other cost elements are application fee (0.5 per cent), valuation fee (0.75 per cent), brokerage fee (1.0 per cent) and vending fee (1 per cent). Other cost items that are often irreducible to be proportional to the size of small offers are payments to auditors and solicitors, advertising and administrative expenses.

Osei (1998) examines factors affecting the development of the stock market in Ghana. He limited his study to the examination of institutional characteristics of Ghana's stock market. The findings of this study are essentially similar to Inanga and Emenuga's. For example, the higher the capital raised by a firm going public, the lower the proportion of cost of floatation in total capital raised in Ghana Stock Exchange. In addition to the absence of efficient stock market at weak-form level, Osei also shows that the law of one price does not hold for the trading of Ashanti GoldFields Company in the London and Ghana Stock Exchanges.

In all, capital markets in Africa, as reflected in the emerging stock markets, are highly underdeveloped. The markets are often dominated by trading in government securities, accounting for over 90 per cent of the total value of transactions. In the case of Kenya and Nigeria, Jeffris (1995) noted that an important motivating factor in the establishment of stock market was the financing of government deficits. This phenomenon has affected negatively the proportion of new funds raised on the market for the private sector which, was less than 1 per cent. The markets are equally criticised for being speculative, since their observed prices and volatility cannot be explained by their underlying fundamentals, thereby leading to adverse real effects for capital formation and welfare. Market discipline is equally believed to be lacking due to information disclosure problems, costly monitoring and enforcement mechanism, and insufficient number of informed investors. All these exacerbate the usual asymmetric information and moral hazard problems.

Haque and Montiel (1991) have established that capital mobility in four African countries included in their study, namely, Kenya, Morocco, Tunisia and Zambia, is significantly different from zero and insignificantly different from one. This finding implies that a completely financially closed economy could be ruled out, but not a completely financially open economy. In this case, the tendency is toward openness and a high degree of capital mobility even though the degree differs across all African countries. This finding has unique implication for the effects of fiscal and monetary policies and for the effectiveness of both capital controls and financial repression.

First, under the fixed exchange rate system that characterises most African countries, high capital mobility will increase the potency of fiscal policy in affecting aggregate demand, while monetary policy becomes relatively ineffective with variations in domestic credit tending to be offset by capital movements. For countries with a weak supervision of their financial system, the larger amount of funds being intermediated through capital mobility, may exacerbate moral hazard problems, and result in a financial bubble that could eventually lead to a financial crisis. Second, high capital mobility will also underline the futility of financial repression as an allocative device, since, at the margin, the domestic cost of funds will tend to move with international interest rates corrected for expected exchange rate changes. Finally, in the presence of high capital mobility, the adverse consequences of real exchange rate misalignment may be greatly aggravated.

At the moment, macroeconomic instability (see Appendix 3) may both raise domestic interest rates by increasing the incentives to take capital abroad, and the degree of capital mobility itself. This is bound to be so, especially when learning to move capital across national boundaries entails a fixed cost worth incurring since the prospective returns are sufficiently remunerative. Once these costs are incurred, the marginal cost of moving funds across national boundaries would be diminished.

One clear evidence that African countries find it hard to insulate their economies from negative shocks of capital mobility at the moment is that, almost all of them are still struggling to avoid exchange rate overvaluation through appropriate fiscal, monetary, and exchange rate policies. Unfortunately too, notable obstacles to financial integration in the weak sense<sup>21</sup>, such as high transaction costs in assets trading, information costs, legal barriers to asset trading (capital controls) and asymmetric risks of taxes, are still prevalent, though in varying proportion in African countries. Montiel (1993) employs the use of gross-flow ratio (GFR) measures to establish that while cases of strong financial integration may be rare in the developing world in general, the majority of developing countries must be regarded, for both policy and analytical work, as de facto financially open<sup>22</sup>. Nevertheless, financial openness in Africa must have been greatly limited again by the interrelated and interlinked phenomena of internationalisation, globalisation, integration and innovations, which are continuously evolving in international capital market (Bhatt, 1989).

Before the adoption of economic reforms, Collier (1998) reports that the rate of return on private capital was lower in Africa than any other region. He attributes this to three major factors: a low productivity environment, insufficient infrastructure, and high risks. However, after the economic reforms of the 1990s, the rate of returns in Africa jumped up. Bhattacharya, et al., (1997) estimate that the rate of returns on FDI in Africa, in the 1990s, was 60 per cent higher than in any other developing countries.

Unfortunately, the enhanced economic environment has not translated into increased capital inflow. Africa continued to be perceived as highly risky. Africa was ranked as the most risky region in the world in 1995. It slid down on the country risk scale prepared by the Institutional Investor from the average of 30 in 1980 to 21 in 1995. Japsersen, et al. (1997) establish a negative relationship between risk ratings and investment globally. The deterrents to investors include the high rate of policy mortality and policy reversals. The frequent outbreak of crises coupled with the very poor state of infrastructure deters many foreign investors from coming to Africa. Moreover, the continent faced stiff competition from other developing regions of the world like the former Eastern Europe, Asia and Latin America, which often have higher stock of human and capital infrastructure.

Thus, the share of global private capital flow coming to Africa declined from about 9.0 per cent in 1970s to about 1.6 per cent in the 1990s (Collier, 1998). Even then the investment in the 1990s has been inward looking and restricted to those investors that have information advantage about the continent. In most cases, these are British and French firms the past colonial masters. The implication of this is that the continent does not yet have access to investment from the global pool of investors.

The integration of the continent into the global capital markets has been limited partly because of the weak stock exchange markets. Nevertheless, there continues to be high rate of private capital flight in the region. The bulk of this money, however, are illegal money stolen from the governments which are then deposited in banks in Switzerland and other western countries. The limited genuine parts of the private capital flight were invested outside of the region because of the

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<sup>21</sup> Weak financial integration between two countries implies that a given financial asset is traded at the same price by residents of the two countries such that no profitable arbitrage opportunities remain.

<sup>22</sup> See Appendix 4 for proportion of commercial and capital flows for African countries.

unstable policy and capital-hostile environment. Collier and Pattilo (1998) estimate that 70 per cent of African private wealth is held outside the continent. Collier (1998) argues that if Africa had been able to retain its own wealth and maintained its share of private capital flows to developing countries which it had in the late 1970s, its capital stock per worker would now be at least comparable to that of South Asia.

**Table 7: Portfolio Composition and Factor proportions by Region, 1990**

	<b>Capital Flight/Private Wealth</b>	<b>Private Capital Stock per Worker (\$)</b>
Sub-Saharan Africa	0.39	1,069
South Asia	0.03	2,425
East Asia	0.06	9,711
Latin America	0.10	17,424
Middle East	0.39	3,678

Source: Collier and Gunning (1997)

The unfavourable terms of trade for most African countries in the 1980s and the debt overhang has reversed the fortunes of these countries. Many of them turned from being net-lenders in the global market to net-borrowers. However, the failure of many African countries to honour their debt obligation means those African countries could only borrow from the world market at considerable risk premium. The ongoing debt crises being faced by Sub-Saharan African countries equally focuses attention on the importance of equity rather than debt, particularly in the financing of risky projects with long gestation periods.

#### **4.4 Institutions and Financial Market**

African governments have been actively involved in the financial sector right from the colonial times. The post-independence government in Africa saw the financial sector as playing critical role in economic development and, hence, must be influenced in the mobilization and channelling of savings to priority areas of the economy.

Government interventions in the financial markets took two forms: The first, is the promotion and direct establishment of financial institutions to assist in the mobilization of funds for economic development. The governments encouraged the developments of non-bank financial institutions (NBFI), building societies, and the Development Financial Institutions (DFI). Arising from overwhelming desires to promote indigenous financial institutions, the sector was subjected to low entry barriers and less liquidity, capital and reserve requirements. However, with little supervision, the increasing number of new financial institutions faced liquidity and solvency problems due to poor financial practices, fraud and mismanagement. This led to the collapse of several financial institutions in Kenya and Nigeria after financial deregulation.

Second, the government also relies on the use of policies to influence and regulate the operators of the market. Prior to reforms, government control interest rates and influence credit allocative decisions of operators. The post reform period has brought about some changes in this area. One key target area of the government after the post reform era is the protection of depositors' interests.

The reforms of the financial sector were partly intended to turn around the financial market from being mainly a suppliers market to give depositors some advantage. However, the ability of depositors to assess the riskiness of bank portfolios and, therefore, request for rates on interest high enough to compensate for default risk is highly limited. This weakness of the market mechanism therefore necessitates the intervention of the government to protect depositors from default risks and also reduce interest spread. Hence, in some countries, such as Kenya and Nigeria, the governments introduced the deposit insurance scheme.

In Nigeria, the deposit insurance was introduced via a Decree No.22 in 1988. The Nigerian Deposit Insurance Corporation (NDIC) represents the institutional platform for managing the scheme. Its key functions include insuring deposit liabilities for all licensed banks and guaranteeing payments to depositors, in case of bank failure. The scheme covers all banks operating in Nigeria. It is virtually funded from premium payable by these banks. The banks were required to pay a fixed annual premium rate of 15/16 of one per cent of their insurable deposit. The fixed rate premium has been criticised for being risk-insensitive (Sobodu, 1998). In addition, the governments try to control banking spread in order to limit monopoly rents. High spreads reduce the efficiency of resource allocation by reducing the volume of investment that can be supported by a given level of saving.

Second, the reform programme also seeks to address the financial health of the financial institutions. In Nigeria, like some other countries, prudential guidelines for banks were introduced in November 1990. All licensed banks were required to undertake a continuous review of their credit portfolios with a view to recognising any deterioration in asset quality. Such reviews were to help systematically and realistically classify bank's exposures based on perceived risks of default.

African governments also introduced bold measures to address financial crises in their economies. For example the government of Senegal embarked on a comprehensive reform programme in 1988. This programme covered a wide range of measures, such as the restructuring and rehabilitation of the banking system, the reduction of the government's share in the equity of individual banks to a maximum of 25 per cent, the consolidation/refinancing and recovery of non-performing loan and the reinforcement of banking supervision. These efforts led to the reduction of the number of financial institutions from 16 to 8 between 1988 and 1991 (Hadjimichael, et al., 1996).

Traditional institutions such as the extended family function partly to provide a low cost solution to adverse selection and moral hazard problems associated with insurance. However, these aspects of the traditional institutions are now being undermined in the modern economy. Some households now find it more expedients to opt out of the traditional obligations despite the penalties of exit.

The legal structure for contractual enforcement and property rights also influences the behaviour of the financial sector. The court system in most African countries does not enjoy the confidence of the private sector. Judges are perceived as lacking autonomy. Furthermore the court system is also slow in resolving disputes. In Kenya, for instance, it is reported that bankruptcy and liquidation take

between 4-10 years (RPED, 1994). Some of the judges are also perceived to be corrupt. Perhaps, the current wave of democratization in Africa can correct for some of the problems revolving around contract enforcement, particularly, if the autonomy of the judiciary is respected.

#### **4.5 Taxation of Financial Market**

Excessive taxation of the financial sector has been identified as one of the major problems hindering the growth of the African financial sector. The problems of the formal financial sector have been compounded by policy-generated increases in costs. Implicit taxation through financial repression varies across the continent. It "ranged from 2-2.5 per cent of GDP in Cote d'Ivoire, Zaire and Kenya, through 4-7 per cent for Ghana, Nigeria and Zambia to 19 per cent in Zimbabwe. Taxation through unremunerated reserve requirements ranges from 1.5 per cent in Tanzania to 7.5 per cent in Ethiopia. These sums are large in relationship to the size of the banking sector, in all cases exceeding the value-added of the banks. Banking is even more heavily taxed than exports" (Collier and Gunning, 1997).

Pardy (1992) posits that taxation (fiscal environment) is a crucial factor of capital market development. Unfortunately, taxation as a factor can either be strength or an obstacle in the process of capital market development. Different effective tax rates on either income or capital gains from different financial instruments will distort capital raising and investment decisions.

It has been observed that the traditional asset taxes alone can create complications in the allocations of resources among competing alternatives, and, in some instances, act against the development of some financial assets, particularly equities. According to Inanga and Emenuga (1996), equities belong to the category of financial assets that suffer from the practice of taxation on income at several stages. For example, first, the corporate income tax could apply at company levels through the taxation of corporate net earnings. Second, there could be the divided tax (withholding tax) levied also at company levels. Third, investors could be taxed when they receive dividend income which is a proportion of the company's distributable earnings previously taxed at company level. Fourth, foreign investors may also pay remittance tax if the dividend income received by them is being repatriated. All these are in addition to capital gains tax that applies when an investor sells company equity shares at profit. Roe (1990) has earlier hinted that the problem of multiple taxation as described by Inanga and Emenuga is common in Africa and is compounded by the existence of alternative securities such as housing development bonds and government securities, which are tax-free.



Table 8 shows the degree of withholding taxes for emerging African markets.

**Table 8: Withholding Taxes For Emerging African Markets**

<b>MARKET</b>	<b>INTEREST %</b>	<b>DIVIDENDS %</b>	<b>LONG-TERM CAPITAL GAINS ON LISTED SHARES %</b>
Botswana	15	15	0
Cote d'Ivoire	50	12	20
Ghana	10	10	0
Kenya	10	10	0
Mauritius	0	0	0
Morocco	20	15	0
Namibia	0	10	0
Nigeria	15	10	20
South Africa	0	15	0
Swaziland	10	15	0
Tunisia	15	0	0
Zimbabwe	15	15	10

Source: Extracted from Osei, 1998 PP. 51-52

One of the major findings of Inanga and Emenuga's 1996 study is that the peculiar buy-and-hold investment attitude of many Nigerian investors results from excessive taxation of capital gains from the sale of shares. This finding confirms the conclusion of previous studies<sup>23</sup> that the Nigerian tax environment is responsible for the observed investor aversion to stock disposal. (See BOX 1 for the major findings of Inanga and Emenuga 1996).

It is equally revealed that several uncommon implicit taxes on financial assets in Africa exist and often add to the explicit ones to produce a phenomenon of over-taxation of the financial sector in general. These implicit taxes are mainly applied to bank deposits in form of seigniorage, reserve requirement, lending targets and interest rate ceiling in the face of inflation. It is equally useful to know that African tax environment has a major role in determining the volume of inflow of foreign portfolio investment since stock markets represent a valuable mechanism for investors and companies in Africa to be integrated into the world capital markets.

<sup>23</sup> See for example, Gill, 1982; Ike, 1984; Akinnifesi, 1988; and Inanga, 1990

*Box 1: Taxation of Financial Assets and Capital Market Development in Nigeria: Major Findings.*

*The findings of the study may be summarized as follows:*

- 1. The taxes on financial assets in Nigeria are withholding tax on dividends, capital gain tax, capital transfer tax and withholdings tax on interest income on bank deposits. Earnings on equities are subject to both dividend tax (15%) and capital gains tax (20%), whereas only withholding tax (15%) is paid on income from other financial assets.*
- 2. Income from investments in non-financial assets, such as unincorporated businesses are, in practice, not taxed. The effective tax on earnings from properties is only the capital gains tax of 20%.*
- 3. The structure of government revenue shows that the contribution of revenues from taxation of financial assets to the total government revenue is negligible. Most of the federal government's revenue comes from oil exports and petroleum profit tax.*
- 4. The estimated nominal rates of return on equities are higher than the rates on other financial assets but lower than the rates on properties (a proxy for non-financial assets). Between 1987 and 1992, equities recorded a 36.66 per cent average nominal rate of return, while bank fixed and saving deposits recorded 20.84 per cent and 15.20 per cent respectively. Properties had a 45.04 per cent rate of return.*
- 5. Due to the combined impact of dividend and capital gains taxes, the effective tax rate on equities is 18.25 per cent compared to 15 per cent on bank fixed deposit and 17.56 per cent on properties. However, despite the higher effective tax rate, the after-tax rate of return on equities exceeds the after-tax yield on bank deposits and the tax-exempt saving deposits by almost 100 per cent. The dividend yield component of the total return on equities is lower than the yield on other financial assets, but higher than rental income from properties.*
- 6. In real terms, equities yield 10.91 per cent pre-tax and 4.22 per cent after-tax rates of return. Other financial assets yield negative pre-tax and after-tax real rates of return. Properties earn 19.29 per cent pre-tax and 11.38 per cent after-tax real rates of return.*
- 7. Owing to the taxation of nominal capital gains, the tax burden on real yields on equities is onerous. As a result, equities suffer an effective tax rate of 61.32 per cent in real terms, as against 27.51 per cent for bank deposits and 41.01 per cent for properties.*
- 8. A simulated effect of taxing real capital gains instead of nominal gains shows that the effective tax rate on real rates of return on equities could have been reduced by 50 per cent over the period 1987 to 1992. This could have resulted in 30 per cent effective tax rate in real terms, which is comparable to 27.5 per cent effective tax rate in real terms on bank deposits.*

## 5. Implications of African Factor Market on Economic Growth

The distortions in the African factor market have been a hindrance to African growth process. In spite of economic reforms, the market is far from being competitive and efficient. Institutional factors continue to impact on the functioning of the markets, and the failures of other markets have direct impact on the performance of the factor markets.

The labour market has been made to bear most of the brunt of the economic reform. Suppression of wage increase was an important part of the reform policies. In almost all the African countries, attempts were made by the government to freeze wage increase. At the same time, other prices in the economy were on an upward trend. Price increases in the economy came through increase in the domestic prices of imports arising from the depreciation of local currency, and second, from utilities prices which were deregulated, and also from money creation process of the government. The combined impact of these has led to sharp fall in real wages. The fall in real wages has the most pronounced effects on the public sector workers. The immediate impact of the fall has been the loss of skilled manpower in the public sector. This has affected the capacity to implement the reform programmes successfully. It has also hindered the capacity of the public sector to attract capable hands to replace those who left. It has encouraged massive corruption in the public service as purchasing power of senior civil servants and even job security was eroded. It also led to the prevalence of "moonlighting" and even "sunlighting"<sup>24</sup> among civil servants, and finally, it brought about a decline in the quality of services rendered by the public sector.

The developments in the African labour market have implications for economic growth. The sharp fall in real wages have profound impact on productivity in both the private and public sectors. Labour market rigidity has also hampered the inter-sectoral flows of labour from low-productivity to higher-productivity sectors thereby resulting in static and dynamic efficiency loss to the economy. Moreover, the huge unemployment of educated youths in Africa, in spite of the massive public investments on education, is an indication of negative social returns on huge investments of over two decades. Not these alone, the decreasing returns to education has led to high drop out rates at all levels of education and promoted the 'brain-drain' syndrome thus compromising the future manpower supply of these countries. It also signals that for a long time to come, Africa may continue to rely on expatriates for skilled manpower.

Not these alone, the low rate of financial deepening in Africa has contributed to the slow growth of the continent. The financial sector has been very inefficient in performing the task of mobilising and transmitting savings into investments. Domestic savings in Africa are low and this reduces the scope to which the continent can rely on domestic resources for economic growth. The limited stock of domestic saving makes the development of an efficient capital market a prerequisite for Africa's access to global investment resource. The growth of domestic capital markets will, therefore, allow these economies to tap additional savings and to improve the allocation of scarce funds.

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<sup>24</sup> We use 'moonlighting' to refer to a case where a worker maintains multiple jobs, such that after closing in the regular job, he now goes to the other job. 'Sunlighting' however refers to a case where the worker manages more than one job at a time, for instance, workers who also doubles as merchants bringing their wares to the office to sell. It also includes workers who switch between two jobs illegally, such that he divides the working week between the two jobs.

The short-termist stance of the African financial system has gone a long way to engender an economic structure that is centred on trade rather than production. Over 90 per cent of investible funds in most of these economies are in the hands of banks through deposit taking. The weak capital market deprives the productive sector of having access to these funds in form of cheap long-term investible funds, and as available pool of funds for venture capitalists ready to back various start-up entrepreneurs with long term funds which they cannot get from banks.

Credit allocation in the past has been largely motivated by political and non-economic consideration. The policy of subsidized credit was a strong incentive to corrupt practices by government and bank officials. Available credit were not channelled to priority areas, credit monitoring was weak producing high loan losses. The limited success recorded by the East Asian countries with targeted credit was because of the presence of highly professional civil servants and public financial institutions which assist in implementing credit policies to promote priority industries and firms. African countries hardly enjoyed that level of competence, limiting the effectiveness of targeted credit policies in Africa.

The existence of a sizeable informal factor market in Africa has significant implications for economic growth. First, it creates information distortions, which affects the conduct of economic policy and the efficiency of resource allocation. Second, the reallocation of resources from the formal factor market to the informal factor market could result in a net welfare loss, since informal activities are, in general less productive than formal activities. This arises partly from the inability of the informal factor market to have a substantial access to the formal financial market. Finally, the operation of the informal market also has negative impact on government fiscal position. Operators of the informal factor market are able to evade tax payments, resulting in loss of tax revenues, while at the same time they benefit from government activities. Hence, a persistent deficit problem could arise, financing of which could have significant adverse economic consequences particularly in developing countries with a weak tax base.

Thus to make the African factor markets a growth pillar, policy must be put in place to enhance the efficiency and competitiveness of the markets.

## **6. Conclusion**

We have demonstrated that understanding the structure and behaviour of the African factor markets is quite vital in finding solution to the African growth crisis. The limited understanding of the structure and functioning of the markets have limited the relevance of the current reform programmes. Existing evidence have shown that the African factor market is segmented. There exists in tandem both the modern formal sector and the traditional informal sector. For both the labour and capital markets, especially the former, the formal sector accounts for a small and declining proportion of the factor market. As Collier and Gunning (1997) rightly observe the small size of the formal labour market is a constraint on the growth process and is a reflection of the constraints facing firms operating on the continent.

The labour market, in particular, has been made to bear most of the brunt of the economic reform programmes. The reform programme has weakened the fragile modern labour market the more. The informal labour market is hardly capable of providing the high productivity jobs anticipated in the reform programme. Moreover, the weakness of the commodity and asset market also limits the flexibility of the labour market.

Part of the solution to the African labour problem involves how best to tap and harness the potential of the informal market for development. Definitely, there is an immediate need to raise the level of productivity in the market. Enhancing the role of labour in economic growth will involve improving labour productivity. However, this will involve more than investment in human capital. A suitable environment for private investment must be established to raise both the quantity and quality of physical capital. Investment in infrastructure is also critical to labour productivity.

Also, the fragmented nature of financial markets in Africa constitutes a challenge to policy formulation. Existing reform programmes have focussed on the formal financial sector with little or no direct impact on the vast informal sector. The informal credit sector remains fragmented and operates on a small scale, serving households, farmers, traders and micro enterprises, but hardly the modern sector. There is, therefore, the need to strengthen the informal financial sector to be able to play a complementary role to the formal sector in financing development, especially by financing the export sector as obtains in East Asia.

In the case of the capital market, policy makers must create the necessary legal framework to guide the operators of the markets. Shareholders and debtholders must have access to reliable reports of the conditions and performance of any company whose securities they wish to hold. More importantly, the shallowness of the African stock market can be remedied both through increased privatisation, as well as by luring more firms to seek listing on the stock exchange. A key incentive here is by granting attractive tax incentives for quoted companies.

Finally, in spite of the widespread adoption of financial reforms in Africa, it is nevertheless important for these countries to put in place efficient markets and financial institutions as these are necessary to promote savings mobilisation and financial intermediation (Collier and Colin, 1989). Price signals transmitted from shallow markets are inherently unstable and volatile (Nissanke, 1994). The extent to which the problems of past repressive policies, the high cost of operation reflecting asymmetric information, and the inability to integrate both the formal and the informal sectors, are addressed directly by policies, will affect the success or otherwise of the current financial liberalisation programmes.

## Appendix 1: Recent Labour Market Trends in sub-Saharan Africa

<b>Jamal and Weeks</b>	<b>JASPA</b>
1. Falling real wages of urban workers	1. Declining real wage
2. Diminishing security and stability of formal sector employment	2. Rising unemployment
3. Fusion of formal and informal sectors	3. Expanding labour absorption in the informal sector
4. Narrowing of income gap between urban wage-earning and the rural population	4. Faltering wage employment growth
5. Worsening of income distribution	5. Improving prospects for rural employment
6. Persistence of rural-urban migration	
7. Changing dynamics of income distribution between urban and rural areas	
8. Primacy of the distributional relationship between rich and poor in both urban and rural sectors.	

Source: adapted from Ikpeze (1994), p.172

**Appendix 2: Financial Ratios of Asian and African Countries, 1960-1990 (M2/GDP)**

Country	1960	1970	1980	1990
Asia				
Singapore		53.2	66.3	64.0 98.6
Hong Kong				69.0 173.9
Taiwan				59.3 151.4
Korea		11.5	33.0	32.9 41.1
Malaysia		24.2	33.9	53.0 66.9
Thailand		23.0	28.3	38.2 74.5
China				45.3 102.7
Indonesia			9.9	19.9 42.8
Philippines		18.9	21.2	21.0 34.4
<b>Average</b>		<b>26.2</b>	<b>31.9</b>	<b>40.2 78.6</b>
Africa				
Botswana				30.7 25.6
Zimbabwe				35.2 32.5
Cameroon			15.1	22.4 19.2
Cote d'Ivoire			25.7	27.1 31.3
Senegal		21.4	15.5	28.3 22.1
Nigeria		12.3	17.4	28.9 22.1
Kenya		22.9	30.5	30.6 29.0
Zambia		15.2	29.2	29.6 22.6
Malawi		14.0	23.1	21.8 20.4
Ghana		16.7	18.9	18.5 13.4
Uganda		21.5	17.6	13.7 10.0
<b>Average</b>		<b>17.7</b>	<b>21.4</b>	<b>26.1 22.6</b>

source: Cole and Duessenberry (1994) p.308.

**Appendix 3:**
**Macroeconomic Stability 1965-1990**

	GNP per capita growth rate (percentage) 1965-1990	Average annual rate of inflation (percentage)	
		1965-1980	1980-1990
Sub-Saharan Africa	Na	na	36.6
Mozambique	-0.2	9.6	25.8
Ethiopia	-0.2	3.4	2.1
Somalia	-0.1	10.2	49.7
Chad	-1.1	6.2	1.2
Malawi	0.9	7.4	14.2
Burundi	3.4	5.0	4.2
Zaire	-2.2	24.7	60.9
Uganda	-2.4	21.4	107.1
Madagascar	-1.9	7.7	17.1
Sierra Leone	0.0	7.9	2.9
Mali	1.7	9.0	3.8
Nigeria	0.1	14.6	4.5
Niger	-2.4	7.5	1.9
Rwanda	1.0	12.5	9.2
Sierra Faso	1.3	6.3	42.5
Benin	-0.1	7.4	5.4
Kenya	1.9	7.2	4.8
Ghana	-1.4	22.9	42.2
Central African Republic	-0.5	8.1	Na
Togo	-0.1	7.1	9.0
Zambia	-1.9	6.3	12.7
Guinea	Na	na	Na
Mauritania	-0.6	7.6	Na



Lesotho	4.9	6.7	12.7
Liberia	Na	6.3	Na
Sudan	Na	11.5	Na
Zimbabwe	0.7	5.8	10.8
Senegal	-0.6	6.3	6.7
Cote d'Ivoire	0.5	9.4	2.3
Cameroon	3.0	9.0	5.6
Congo	3.1	6.8	0.5
Botswana	8.4	8.4	12.0
Mauritius	3.2	11.8	8.8
Angola	Na	na	Na
Namibia	Na	na	13.4
Gabon other Africa	0.9	12.8	-1.7
Egypt	4.1	6.4	11.8
morocco	2.3	7.0	7.2
Tunisia	3.2	6.7	7.4
Algeria	2.1	10.9	6.6
South Africa	1.3	10.3	14.4

Source: Naya and Robert (1994) pp 63-64.

**Appendix 4: Ratio of Trade and Gross Capital Flows to GDP selected African Countries (in percent).**

	<b>Trade Ratio 60-89</b>	<b>Capital Flow Ratio 80-89</b>	<b>Capital Flow Ratio 84-86</b>	<b>Capital Flow Ratio 87-89</b>
Algeria	24.94	7.34	6.22	9.01
Botswana	88.73	10.02	11.02	9.07
Burkina Faso	21.74	4.45	4.92	5.01
Cape verde	44.15	6.38	7.83	4.20
C.A.R.	29.73	6.31	8.37	3.41
Chad	25.02	5.46	6.31	8.80
Congo	59.48	31.64	32.43	32.80
Cote d' Ivoire	40.56	15.07	14.15	17.58
Egypt Arab Rep.	33.16	8.55	7.52	7.62
Ethiopia	17.34	4.10	4.44	5.02
Gabon	54.63	15.93	16.25	21.05
Gambia The	61.39	17.02	19.76	17.45
Ghana	20.55	6.74	7.98	7.11
Guinea-Bissau	28.82	18.07	21.59	31.36
kenya	29.16	5.99	5.50	6.51
Lesotho	131.66	15.87	13.09	17.32
Madagascar	19.22	10.76	9.63	14.45
Mali	28.59	6.73	7.57	8.25
Mauritania	61.36	17.91	19.33	16.83
Mauritius	59.00	7.04	6.78	7.38
Morocco	28.09	7.23	6.86	5.56
Niger	26.29	8.77	9.44	7.18
Nigeria	21.37	9.22	6.55	20.18
Rwanda	16.49	3.34	3.38	3.42

Sap Tome and Principe	51.79	23.60	33.49	14.25
Senegal	39.88	11.35	10.83	9.36
Seycnailes	74.92	11.75	13.55	11.00
Sierra Leone	21.08	12.05	13.95	12.35
Somalia	41.09	12.38	11.77	16.33
South Africa	32.22	2.28	3.25	1.71
Sudan	15.06	4.28	3.32	3.98
Swaziland	99.46	13.74	13.48	19.10
Tanzania	20.06	9.57	13.47	12.00
Togo	53.65	17.40	16.20	14.12
Tunisia	42.59	9.05	8.65	9.25
Uganda	22.18	10.02	8.02	12.03
Zaire	25.30	9.29	8.11	12.28
Zambia	41.64	18.38	20.94	23.88

Source: Extracted from Montiel (1993), PP.28b and 29b.

**Appendix 5: The Black Markets Premium for Selected African Countries (Median values of annual end-of-year figures)**

<b>Country</b>	<b>1970-79</b>	<b>1980-89</b>	<b>Largest Premium over total period</b>
<b>Modest premium</b>			
Kenya	16.8	15.2	44.9
<b>Large premium</b>			
Sudan	85.4	78.8	344.4
Zambia	102.5	40.3	361.9
Tanzania	95.5	214.3	809.1
Ghana	66.3	142.0	4,263.7

Source: Extracted from Kiguel and O'Connell, 1995, P.23.

## Appendix 6: Exchange Rates System in Selected African Countries

Country	Form of Arrangement	Rate Determination	Role of Central Banks's Intervention
Gambia The	Interbank (daily)	Negotiation between banks and their clients	No intervention to influence exchange rate
Ghana	Auction (weekly)	Dutch Auction	Possibly by adjusting supply
Guinea	Auction (weekly)	Marginal Pricing	Possibly by adjusting supply within constraints of external debt obligation
Nigeria	interbank and Auction (daily)	Negotiation between banks and clients and marginal pricing	None in interbanks; variation of supply to auction market
Sierra Leone	Interbank	Negotiation between banks and clients	None
Uganda	Auction (weekly)	Marginal Pricing	By adjusting amount of supply to auction market
Zaire	Interbank (daily)	Negotiation between banks and clients	Some intervention on interbank market
Zambia	Auction (weekly)	Dutch auction	By adjusting enough of supply of auction within external debt servicing constraints

Source: J.P. Quirk *et al* (1987), "Floating Exchange Rates in Developing Countries: Experience with Auctions and Interbank Markets". IMF Occasional Paper, No.53, Washington D.C., I.F

## Appendix7: Market Capitalisation in Emerging Capital Markets in Africa

Country	Date Est.	1994			As at December1997		
		Listings	Market Cap. (\$ billion)	Market Cap. % of GDP	Listings	Market Cap. (\$ billion)	Market Cap. % of GDP
Botswana	1989	11	0.4	9.0	12	0.6	11.5
Cote d'Ivoire	1976	26	0.5	5.6	35	1.0	9.7
Egypt	1883	23	7.0	19.4	650	20.8	28.1
Ghana	1990	18	2.0	32.8	21	0.3	4.5
Kenya	1954	52	1.9	40.4	57	1.8	17.3
Malawi	1995	--	---	----	3	0.1	4.2
Mauritius	1989	36	1.7	60.7	40	1.6	40.0
Morocco	1929	52	5.0	18.5	49	8.9	26.7
Namibia	1992	13	0.2	10.0	33	0.7	21.2
Nigeria	1960	180	1.3	4.2	182	3.0	6.5
South Africa	1887	645	240	226.4	642	234.4	208.4
Swaziland	1990	4	0.3	14.3	4	0.4	40.0
Tunisia	1989	23	2.5	19.2	30	4.0	19.3
Zambia	1994	7	0.6	16.2	7	0.2	4.9
Zimbabwe	1890	65	2.0	40.0	66	2.1	46.7

Source: ADB.

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