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Review

Financial integration and the risk of financial contagion in Africa: Empirical Review

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The process of integration was warmly welcomed around the world since it was believed that financial integration allows capital to travel to its most attractive destination. The concept refers to the degree to which financial systems are interconnected with each other. The degree of financial markets integration across the world has varied from country to country and as well as from region to region. Africa, being a developing region, has not been an exception to movement towards full financial integration being experienced across the developing world. Financial integration has several benefits and as well as costs. The most significant cost of financial integration is the risk of financial contagion. Financial contagion may be defined as a systematic effect on the likelihood of speculative activity in one country's financial markets arising from similar activity in another country's financial markets. The fact that financial integration can foster financial stability and as well as propagate a financial crisis through financial contagion effects means that it is a double edged sword. For most regions, the model of financial integration to follow has been the European Union. A model proposed for Africa prioritizes financial development and financial regulation policies, as it moves towards achieving full financial integration. Policy efforts should focus on harmonizing market rules and practices, fostering financial market developments at a multilateral platform and developing institutions more generally. This will ensure that countries maximize the benefits of financial integration whilst minimizing the contagion risk.

Keywords: Financial Integration, Financial Contagion, Financial Development, Africa.

INTRODUCTION

Globalization has promoted international trade and investment flows across countries**.** This has seen countries becoming more and more integrated, particularly in the areas of trade and economic co-operation. This process of integration was warmly welcomed around the world since it was believed that financial integration allows capital to travel to its most attractive destination (Kaminsky, 2010:2). Due to the crucial nature of financial markets in facilitating trade among countries, the last few decades in particular have seen a rapid increase in the degree of international financial Integration (Davis, 2011:2). Such growing integration being witnessed in financial markets all the world is being spurred by deregulation, globalization and advances in information technology (Reserve Bank of India, 2007:285).

The degree of financial markets integration across the world has varied from country to country and as well as from region to region. As expected, developed countries have experienced deeper financial integration than developing countries. This has been due to the fact that the developed world has experienced higher levels of financial development and trade liberalization than the developing nations. Whilst, in the past many countries in the developing world integration efforts have been biased towards economic and trade integration, there are now increasing efforts biased towards promoting

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financial integration. This has mainly been due to the realization among many countries that financial integration is an important component of efforts to deepen economic and trade integration. Hence, 'efforts to deepen regional financial markets by harmonizing legal, institutional, and macroeconomic policy objectives' (IMF,2011:32) are being made in various regions across the developing world.

Many countries, particularly in the developing world and transition economies in East Asia, Latin America and Eastern Europe, are encouraging inflows of capital by dismantling restrictions and controls on capital outflows, deregulating domestic financial markets, liberalizing restrictions on foreign direct investment, and improving their economic environment and prospects through the introduction of market-oriented reforms (Agénor, 2003:1089). Such measures compounded by the international investors need for higher rates of return and as well risk diversification opportunities, has resulted in an increase in capital inflows towards developing nations. Much significantly, there has also been an increase in the number of international financial institutions establishing themselves in the developing world. This has resulted in countries in the developing world becoming increasingly integrated with international financial markets.

Africa, being a developing region, has not been an exception to movement towards full financial integration being experienced across the developing world. Improving macro-economic and political conditions in the region are attracting investors, thereby resulting in increased capital flows towards the region. Furthermore, structural adjustment programmers which were undertaken in various countries have resulted in the liberalization of financial sectors. To date, Africa boasts of a significant number of international financial institutions. Though financial integration has been moving slowly in comparison to emerging countries in Asia, the pressure being put on African economies by international organizations such as the International Monetary Fund is expected to push the region towards deeper financial integration.

What is the benefit of achieving deeper financial integration? Economic theory argues that financial integration 'allows for cross country risk sharing, increased investment and a more efficient allocation of resources across countries (Devereux and Yetman, 2010: 2). They also argue that deeper financial integration result in a more sound, stable and resilient financial system that can withstand serious financial shocks. It is therefore expected that this movement toward deeper international financial integration in Africa will not only bring significant economic and welfare benefits, but will also foster financial stability. However, the recent global financial crisis which emanated from the United States and spread rapidly across Europe and other emerging countries integrated with the United States and the European Union, have put into question the basis for furthering financial integration efforts in Africa and other developing nations.

In this paper, we analyze financial integration and the risk of financial contagion in Africa. Much importantly, we propose a model of financial integration that ensures that Africa realizes the benefits of financial integration, whilst minimizing the risk of financial instability arising from contagion effects. The paper is organized as follows:

- Section 1.2: presents an overview of financial integration and financial contagion
- Section 1.3, discusses financial integration in Africa
- Section 1.4: details a model of financial integration for Africa
- Section 1.5 concludes the paper

Financial Intergration and Finanacail Contagion

Globalization has brought about the concept of financial integration. The concept refers to the degree to which financial systems are interconnected with each other. It is a consequence of financial openness in which there are limited restrictions places on the operations and activities of financial markets. It therefore results in the creation of a financial market in which assets are regarded as having identical risks and returns and returns priced identically regardless of where they are transacted (Babecký, 2010:4.). Thus, financial integration can be defined as process of unifying markets and enabling convergence of risk adjusted returns on the assets of similar maturity across the markets (Reserve Bank of India, 2007:285).

Financial integration cannot be separated from economic and trade integration. This is because it is a process that is part of a wider process of economic integration that most importantly also includes trade integration (Brezigar-Masten et al., 2009:8). The process of financial integration includes features such as customs unions, common markets, and possibly forms of political union as well (Making Finance Work for Africa, 2007:3). Whilst the process of financial integration can occur naturally due to its commercial nature, it is usually facilitated by organized organizations such as the European Union (EU), Common Market for Eastern and Southern Africa (COMESA), South African Customs Union (SACU) etc. Such organizations, act as platforms in which individual countries formulate and harmonize integration polices (economic, trade and financial) and as well as commit themselves by signing agreements. Hence, the degree of integration varies from region to region mainly due to differences in the extent of co-operation among group countries in a particular region.

The United States of America is regarded as highly integrated as any other country at international level, whilst the EU is regarded as highly integrated than any other region at regional level. What are the features of highly integrated financial markets? According to Babecký et al., (2010:4) a highly integrated market requires the same access to financial intermediation or trading, clearing and settlement platforms for both parties regardless of their country of origin. In other words, the process of financial integration should involve unimpeded access of participants to various market segments (Reserve Bank of India, 2007:285). Hence, full financial integration should ultimately result in the creation of an efficient market in which there are no barriers to entry or informational asymmetries for financial market participants.

Financial integration has several benefits and as well as costs. According to Babecký et al., (2010:4) the most frequently mentioned benefits of financial market integration include: (i) consumption smoothing due to international diversification of risks (reduction of the large country-specific shocks), (ii) the positive effect of capital flows on domestic investment and economic growth, (iii) improving efficiency of the financial system, and (iv) increasing prudence of financial market agents and (v) the attainment of a high level of financial stability. Conversely the major costs of financial integration include: (i) insufficient access to funding at times of financial instability (ii) inappropriate allocation of capital flows, (iii) loss of macroeconomic stability, (iv) herd behavior among investors, (v) financial contagion and (vi) high volatility of cross-border capital flows (Babecký et al., 2010:4).

Out of all the mentioned benefits of integrated financial markets, the most significant one is that they provide opportunities for expansion and improved risk sharing across borders (Degryse et al., 2009:4; Fecht et al., 2012:2). Risk sharing allows countries to insure themselves against the effects of external shocks (IMF, 2011:32). When countries borrow and lend, they stabilize their consumption around their long-term potential growth, even in the presence of idiosyncratic shocks (IMF, 2011:32) thereby insuring themselves against shocks. This is known as consumption smoothing and it is a consequence of international diversification of risks i.e. the reduction of the large country-specific shocks (Babecký et al., 2010:4). In essence, financial integration enhances the scope for diversification and thereby fosters the resilience of the financial system to regional or sector specific shocks(Fecht et al., 2006:3). In other words, financial integration fosters financial stability.

Conversely, out of all the mentioned costs of financial integration, the most significant one is the risk of financial contagion. What is financial contagion? Financial contagion may be defined as a systematic effect on the likelihood of speculative activity in one country's financial (such as foreign exchange, stock and/or money) markets arising from similar activity in another country's financial markets (Khalid and Rajaguru, 2005:7). According to Fratzscher (2000:2) contagion is the transmission of a crisis to a particular country due to its real and financial interdependence with countries that are already experiencing a crisis. It therefore, exists only when a crisis starts from one economy and spreads to another, when the two economies are located in separate geographic regions, with different structures and weak cross-market linkages (Thomadakis, 2012:3). In simple terms, financial contagion is the cross-border transmission of a crisis. According to Forbes and Rigobon (2002), cited by (Ahrend and Goujard, 2012a:5) it is measured as the transmission of financial market movements beyond the co-movements that would occur in "tranquil" times. Therefore, financial integration can be defined as the transmission of a crisis across borders due to reasons unexplained by macroeconomic fundamentals.

The risk of financial contagion basically arise through interconnected banking sectors and as well as through financial linkages (IMF, 2011:33). In order to diversify their revenue streams and risk, many financial institutions and investors are transacting across borders, thereby fostering financial integration by linking financial systems of different countries (Fecht et al., 2012:5). Such financial interactions between financial institutions are expected to create a more resilient international financial system that can withstand financial shocks. However, as pointed out by Devereux and Yetman, (2010:3-4), such financial market interactions, through interdependent banks and financial institutions in many different countries, are associated with 'contagion' effects among economies to an extent that rather than acting in the traditional manner as a stabilizing mechanism for sharing risk across regions and countries, it seems that the interdependence of financial institutions is acting as an international 'propagation mechanism' for financial crisis.

The interdependence of financial institutions may transmit a crisis, firstly due to direct financial linkages, the fact that financial institutions may have large cross-border holdings and secondly, through indirect financial linkages, in particular the presence of a common lender(Fratzscher, 2000:3). In the case of a crisis, a financial institution with cross-border asset holdings may be forced to sell external assets and a financial institution with cross-border loans may be force to recall such loans or refuse to offer credit, not just to countries that have already experienced a crisis but also to other unaffected countries, thus spreading the crisis (Fratzscher, 2000:3 and OECD, 2012:4). Furthermore, financial linkages in financial markets arising from cross-border investments may also propagate a crisis. If Country A is hit by a shock, the share price of a company trading in Country B but with significant investments in Country A will fall due its cross-border exposure to a crisis. If such cross-border investments are pronounced, investors will be forced to re-adjust their portfolios to avoid losses, thereby resulting in some countries experiencing capital outflows even if their macro-economic fundamentals would not have changed

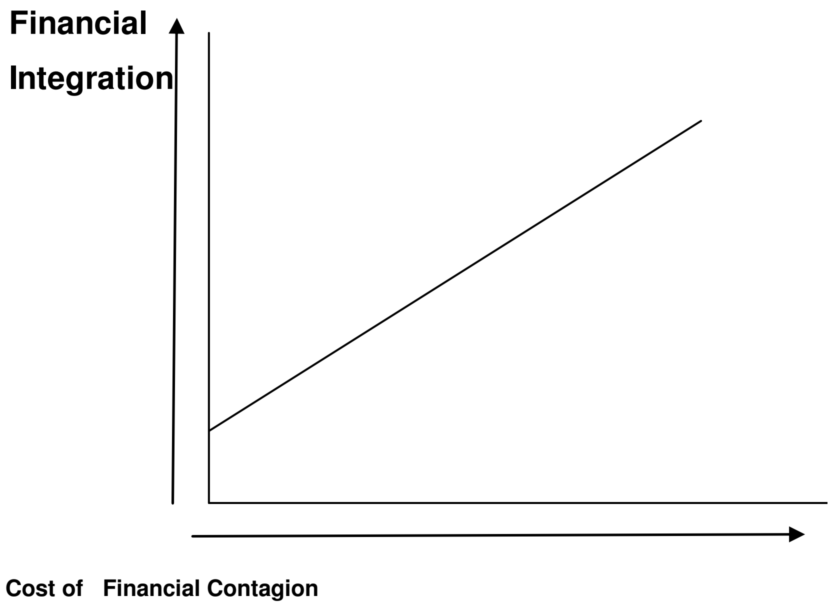


Figure 1. The relationship between financial integration and financial contagion

(Khalid and Rajaguru, 2005:7-9). The spread of a crisis can be much worse due to a herd mentality where investors respond to a shock in one country in a similar pattern based on certain expectation on the movement of the market variables in the whole region (Khalid and Rajaguru, 2005:7).

The fact that financial integration can foster financial stability and as well as propagate a financial crisis through financial contagion effects means that it is a double edged sword. In other words, financial integration can act as a mechanism in which a crisis can be transmitted and can also act as a mechanism in which financial stability can be attained. This implies that there is a tradeoff between financial integration and financial contagion, such that deeper financial integration results in greater cost of greater financial contagion. The diagram above (Figure 1.) shows a simplified representation of the relationship that exists between financial integration and the cost of financial contagion.

However, there has been no convincing evidence which suggests that financial crisis can be propagated by contagion effects arising from deeper financial integration (Kalemli-Ozcan, 2010:1). This is because financial crises can arise from other factors such as weak macroeconomic fundamentals and financial regulation to an extent that it may be difficult to pinpoint financial integration alone as the cause of the spread of a crisis. As the debate concerning the relationship between financial integration, financial contagion and financial stability continues, there seems to be a consensus among policymakers that financial integration and financial stability do not necessarily go in hand. As part of her closing remarks, Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, at the ECB colloquium "European integration and stability" held on the 19th of May 2011 said the following concerning the relationship between financial integration, financial contagion and financial stability.

An integrated financial market is the basis for a smooth and equal transmission of monetary policy, it increases the efficiency and overall welfare of the economy, and enhances the resilience of the financial system from risk diversification. But despite our commitment and our support for financial integration, we also had to learn– with the experience of the past 4 years in mind – that financial integration and financial stability do not always go hand in hand. Indeed we have witnessed that in a financially integrated market risks can spread and spillover to other segments of the financial market, increasing the likelihood of contagion of financial fragilities and systemic risks.(Tumpel- Gugerell, 2011:1)

But why does financial integration sometimes fail to foster financial stability as is largely expected? According Stiglitz (2010), the assertions that financial integration is desirable because it facilitates risk sharing is based on the assumption that technologies are convex and utility functions are concave to an extent that risk sharing is always beneficial. However, in real life, the world is rife with non-convexities such that if technologies are non-convex, expected utility is lowered and integration is non-beneficial as expected (Stiglitz, 2010). The assertions are also based on the assumption that financial markets are frictionless to an extent that risks are hedged efficiently. In the real world, frictionless markets do not exist and as a result risk sharing is incomplete, and financial shocks spill over to real activity (Kollmann and Malherbe, 2010:2). Furthermore, shallow financial integration, underdeveloped financial markets and macroeconomic differences and policy objectives across countries make it difficult for financial systems to contain even minor shocks (IMF, 2011:33). Precisely, the transmission effect of foreign shocks to the domestic economy depends critically on a country's macroeconomic fundamentals and the strength and resilience of its financial institutions (Hernández and Schmidt-Hebbel,2001:23). Essentially, whether the benefits of deepening financial integration outweigh the risks, and whether this process will lead to increasing financial stability, depends largely on the resilience and flexibility of the financial system itself (Babecký et al.,2010:3).Hence, strengthening financial systems and harmonizing macro-economic policies in a group of countries will ensure the creation of a more resilient and flexible financial system that will be able to withstand cross-border financial shocks, even in highly integrated countries.

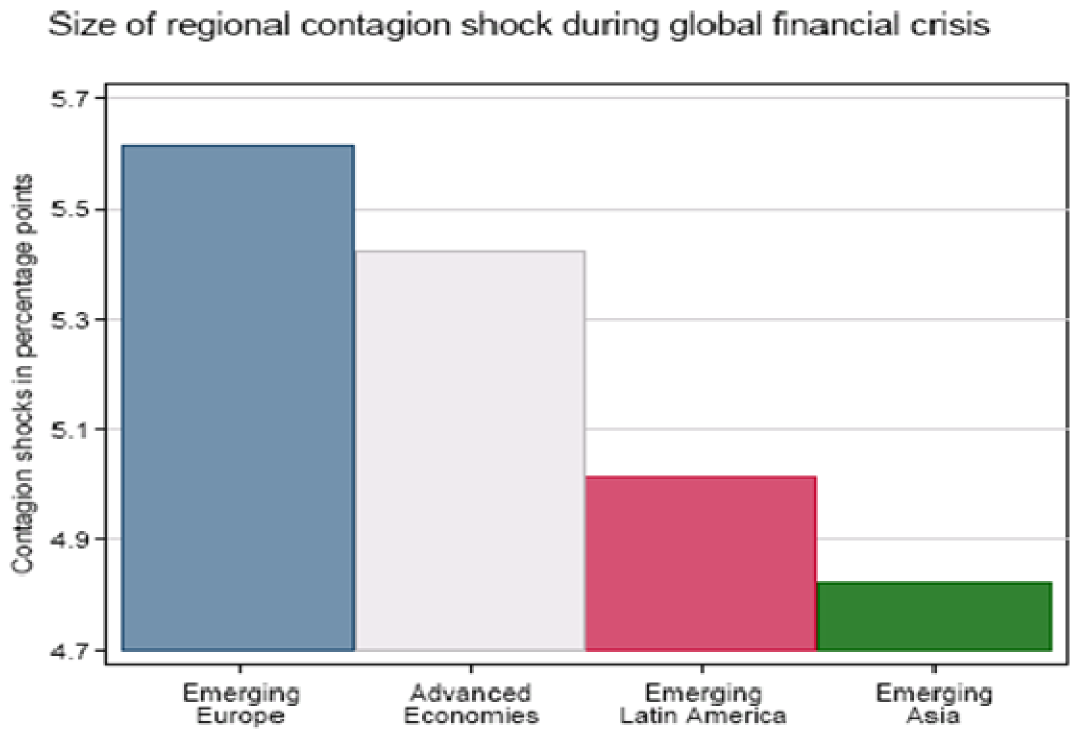
Financial Integration in Africa

The promotion of trade liberalization policies has seen countries around the world becoming increasingly integrated with the global world**.** Economies are becoming more and more integrated to an extent that the macro-economic policies of one nation have the potential of influencing economic developments in another country. Essentially, the world is becoming more and more globalized to an extent that it has become practically impossible for countries to operate in isolation. In such circumstances, the intermediary role that financial markets play in facilitating trade and economic activities has resulted in the increased need for financial integration. Without, financial integration, economic and trade integration would be less efficient and less effective. Hence, financial integration efforts are being promoted in many regions across the world.

For most regions, the model of financial integration to follow has been the EU. With greater financial openness, the EU is regarded as the most highly integrated region in the world. Taking the European Union region as an ideal model of financial integration, many studies and international financial institutions publications have naturally proposed that less developed countries should also adopt economic policies aimed at fostering greater international financial integration (Mougani, 2012:5). As a result Africa has not been an exception in as far as efforts aimed at deepening financial integration are concerned. To date, financial integration in Africa has been progressing both as a result of market pressure and policy change, but with these forces acting without coordination and at different speeds. In the market, foreign banks and insurance companies have been purchasing local intermediaries, and several institutions now have subsidiaries in several countries within a region, and a few have networks that spread across much of Sub-Saharan Africa. In addition, regional securities exchanges have been created and, where they do not exist, cross-listing of securities on multiple exchanges within a region has started to occur (Making Finance Work for Africa, 2007:11). However, countries with exception of South Africa and other middle income countries still lag far behind in terms of financial integration. Hence, international organizations like the IMF are making continuous efforts to ensure that Africa’s financial markets are integrated at both regional level and the international level.

Despite, pressure from international organizations financial integration in Africa has been progressing at a slow speed. This has mainly been due to lack of political will to undertake financial reforms that drive countries towards greater financial integration. The reluctance to implement financial reforms has mainly been due to the fear of losing sovereignty, particularly control over aspects of monetary policy, exchange rate policy and capital account, which also raises fears of the particular countries to manage shocks to their economies (Making Finance Work for Africa, 2007:10). Furthermore, there have been concerns over the unequal distribution of the benefits of integration among a group of countries. For example, there is concern among smaller countries in Economic Community of West African States (ECOWAS) that the benefits of integration will primarily accrue to Nigeria, while similar fears are present in the East African Community (EAC) with regard to Kenya and in the Southern African Development Community (SADC) with regard to South Africa (Making Finance Work for Africa, 2007: 10). Furthermore, economic, cultural and social differences among African countries in the region have made financial integration difficult. For example, the African Union is said to be divided between English-speaking countries (British colonies) and French speaking countries (French colonies). Hence, many African countries prefer to integrate at sub-regional level like SADC, ECOWAS, SACU, COMESA etc., where economic, cultural and social differences are small rather than at regional or international level where the differences are larger.

Though better progress related to financial integration is being noted at sub-regional levels in Africa, there have been concerns over the tendency by some countries to belong to multiple sub-regional associations. According to Making Finance Work for Africa(2007:13) there are many regional associations (and in some cases “region within a region” groups) in existence, and there are over 30 regional trade agreements (RTAs), with each African country on average belonging to four. Such multiple memberships are presenting problems for financial integration efforts. The problems of multiple membership include(i)incompatibility of financial integration policies among sub-regional policies to which



Source: OECD (2012:6)

Figure 2. Contagion effects of the global financial crisis

a country belongs to, (ii)presents several demands to a members country, thereby draining her energy to the extent of failing to successfully implement integration policies of a core regional body (iii) the member country will be confused as to which sub-regional body to prioritize among the multiple bodies (iv) policy makers and institutions are constantly distracted by the conflicting demands and timetables of the various groups in which their countries are members and (v)negotiating and implementing regional agreements among several countries is made difficult, costly and time consuming and this is complicated by the fact that there are many policy issues that take a great deal of time, effort, and political will to resolve (Making Finance Work for Africa, 2007:13). Due to such kind of problems facing Africa, full financial integration is far from being attained; hence a lot of work still needs to be done to remove barriers that are hindering the Africa's drive towards financial integration.

In order to encourage greater financial integration in Africa and other developing countries, proponents of financial integration has been placing much emphasis on the benefits of doing it. As earlier, discussed these benefits, among others include efficient allocation of resources to the most productive sectors, diversification of risk and insurance against shocks. Contagion risk, which is the most significant cost of financial integration, has largely been ignored. However, the recent global financial crisis has brought the subject of financial integration and financial contagion to the forefront. The financial crisis, which emanated from the United States, spread rapidly across the Europe and the rest of the world. The negative shock to the capital base and liquidity of the banking system was followed by a contraction of loan supply to businesses and households and a massive deterioration of economic activity (Kalemli-Ozcan et al., 2010:1). The crisis essentially illustrated how far reaching contagion can be in integrated financial markets (Cornford, 2011:1). According to Gligorov, (2009:20) Europe suffered more from the crisis. This is because the EU is highly integrated with United States. However, some other countries with greater integration with the United States and EU were also affected. The graph above(Figure 2.) shows the extent to which various regions were affected by contagion risk of the recent global financial crisis.

The fact that countries with deeper levels of financial integration were affected by the recent financial crisis was surprising. The integration of global financial markets was supposed to lead to greater financial stability, as risks were spread around the world

(Stiglitz, 2010**).** Hence, the recent financial crisis resulted in Europe and the rest of the world to question 'whether the process of financial integration should continue or whether slowing it down may bring advantages' (Fecht et al., 2012:2) in terms of greater financial stability.

Though weak international capital markets integration with the United States and Europe left African countries (with the exception of South Africa and other middle income regional countries) largely unharmed by the global financial crisis, questions has been raised as to the desirability of furthering financial integration. This is because Africa is on path towards greater financial integration. The extent to which the integrated markets were rattled by the financial crisis certainly sent a warning sign to African countries, as to dangers of advancing financial integration policies. Considering, the slow speed at which financial integration has already been progressing in the African region, serious concerns are being raised as to the extent at which the recent crisis will further slowdown the pace of financial integration in Africa.

For Africa, the major question has been whether the region has the capability to contain contagion risk in case of an extreme shock, similar to the one which originated from the United States. Risk sharing is said to be effective and efficient in situations where the financial system is well developed and also in situations where the countries macroeconomic fundamentals are strong (Rungcharoenkitkul, 2011:28). However, in spite of financial reforms being undertaken in various countries to promote financial integrations, many of Africa's macroeconomic fundamentals remain weak and financial systems remain les developed. In such a situation, we should not expect the African region to reap the full benefits of financial integration and as well contain the contagion risks associated with deepening financial integration. Moreover, financial integration efforts require a country's political will to formulate and implement policies that promote financial integration. Such political will and support will be hard to acquire and achieve as long as concerns regarding the desirability of financial integration in achieving financial stability remain. Hence, it is important that mechanisms that ensure that African countries reap the full benefits of financial integration whilst minimizing the risk of contagion are put in place.

Mechanisms that ensure maximization of financial integration efforts and minimization of contagion risks, require a full knowledge and understanding of such benefits. Unfortunately, there is lack of clarity about the extent of benefits from financial integration and the potential cost involved and such a situation is causing a dilemma to policy makers (Rungcharoenkitkul, 2012:4). Whilst Africa ponders about the real benefits of financial integration, International Monetary Organizations and the World Bank are pilling pressure on them to undertake financial reforms that ensure deeper financial integration. With many countries in Africa, essentially being reliant on such international organizations for debt finance, the pressure from such organizations to reform their financial systems is virtually unavoidable. Moreover, financial markets are moving themselves quite rapidly towards integration because of the compelling commercial logic of doing so, even if governments have yet to respond fully to the speed at which the markets are moving (Making Finance Work For Africa, 2007:3). Essentially, this means that Africa's drive towards greater financial integration is also unavoidable, though the speed at which it will happen will continue to differ from country to country. Therefore, there is clearly an urgent need for a model that ensures that the continent reaps the benefits of financial integration whilst minimizing the risk of financial contagion, which is associated with integrated markets.

A Model of Financial Integration for Africa

In light of the recent financial crisis, developing a model of financial integration that may enable Africa not only to benefit from financial integration but also enable withstand shocks arising contagion risk is inevitable. For many years, the EU model of financial integration has been regarded as the ideal model of financial integration. International organizations put pressure on developing nations to follow such a model. However, the recent global financial crisis has highlighted the weaknesses of the EU model of financial integration in as far as containing contagion risks are concerned. As Africa moves towards greater financial integration, Africa needs to develop a model of financial integration, which is different from the European model of financial integration. Such a model will allow the continent to better manage the spread of external shocks across the region. Moreover, with concerns that integration in the region is currently moving at a very slow pace, a model of financial integration specifically made for Africa will not only enable the continent to reap the full benefits of financial integration whilst minimizing the contagion risks, but will also encourage African countries to speed up their integration into the international financial markets.

As a country goes through the process of financial integration, it is important that it ensures that its financial system is strong enough to contain extreme shocks. Proponents of financial integration normally argue that financial integration allows a country to diversify its risk, thereby insuring itself against shocks to its financial system. However, as earlier discussed, we now know that regardless of the extent of financial integration, risks are not hedged efficiently primarily because financial markets are not one hundred percent perfect as economic theories assume. Furthermore, it is illogical to expect financial integration on its own to contain extreme shocks like the one which emanated from United States in 2007 and spread like veldt fire across Europe and the rest of the world. Hence, model of financial integration for Africa should aim not only to increase the efficiency of the financial system to hedge against risks, but should also be complemented by a mechanism that increases the resilience of a financial system against extreme external shocks.

Before developing a model of financial integration for

Figure 3. The link between financial development and financial stability

Africa, it is important to draw important lessons from the recent global financial crisis. One important lesson we must draw from the EU experience is that financial crisis are mainly spread through the financial markets. In other words, integration of financial institutions, in particular the banking sector and also the equities markets are the main channels in which contagion effects are spread. Even in cases where the source of the crisis is not the financial sector but direct trade linkages (or external financial account), in most instances, the crises will end up manifesting itself in the financial markets (i.e. equities, currency or bond markets), or the financial institutions (Ahrend and Goujard,2012:5-6). Another lesson that we learn from the recent financial crisis, is that financial integration encourages financial innovation, but that financial innovation may end up being the source of a financial crisis. The source of the recent global financial crisis was securitized assets. Securitized assets were a very innovative financial product. However, they were very complicated to an extent that investors found them very difficult to understand. As a result, investor ended up exposing themselves to investments which they had limited knowledge of their risk profile.

The two important lessons we discussed earlier, has implications for the aspects of financial integration that we should focus on. Much precisely, they (the lessons) imply that an effective model of financial integration should not only focus on deepening financial integration, but also on the evolution of financial systems as they go through the phases of financial integration. This is because some financial systems might become highly integrated but will lack the operational efficiencies required to deal with a financial crisis. Furthermore, a financial system might be highly integrated but may also lack the regulatory infrastructure that will be able to effectively regulate the complex activities of financial institutions operating in such kind of markets. Therefore, from this discussion two important elements of a model of financial integration arise: financial development and financial regulation.

Financial development is an important element of financial integration. It basically increases he ability of the financial system to hedge risks efficiently. According to the Rungcharoenkitkul, 2011:28), countries whose financial markets are more developed, whose access to advanced instruments such as derivatives is readily available, and whose market participants are better informed as well as more plentiful, are better equipped in dealing with idiosyncratic risks and hence should be more likely to benefit from risk sharing. According to Babecký (2010:6) financial development increases the competitiveness of individual financial institutions thereby increasing the room for risk diversification and risk sharing, even when market frictions are assumed to be present.

A country/region with a poorly developed financial system will not be able to contain risks arising from contagion effects. In other words, the benefit of risk sharing will be outweighed by the contagion risk. Thus, as countries advance policies of financial integration it is important that they also advance financial development so as to increase the risk sharing efficiency of its financial system.

Figure 3 illustrates the link that exists between financial development and financial stability. It shows that financial development leads to efficient risk sharing and eventually to financial stability.

Another, important element of an effective model of financial integration is financial regulation. Development and establishment of effective financial regulatory and supervisory frameworks is regarded as key to securing financial stability. Financial regulation and supervision will encourage prudential behavior in financial markets, particularly with regard to risk management and corporate governance issues. According to Tumpel-Gugerell (2011:2) financial regulation and supervision requires (i) that regulation and supervision be uniformly applied, (ii)that banks' business models and corporate governance become more sustainable, (iii)that financial market activities become more transparent with respect to financial innovations, practices and risk assessments and (iv)that the soundness of the system as a whole has to be ensured. However, it is important to note that financial regulation and supervision can be an impediment to financial integration itself if applied inappropriately. Hence it is important that financial regulation and supervision is applied in such a manner that it does not harm or discourage financial integration.

Figure 4 shows the link that exists between financial regulation and supervision and financial stability. As the diagram illustrates, financial regulation and supervision

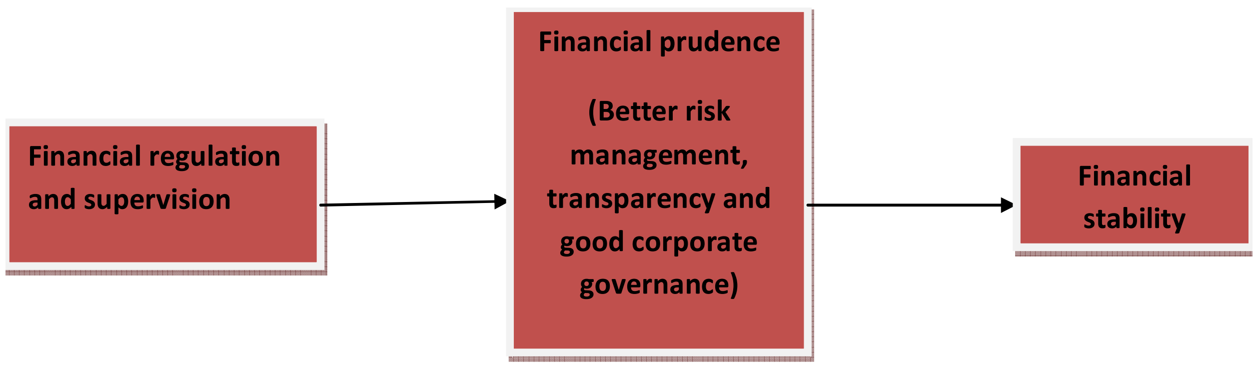


Figure 4. The link between financial regulation and supervision with financial stability

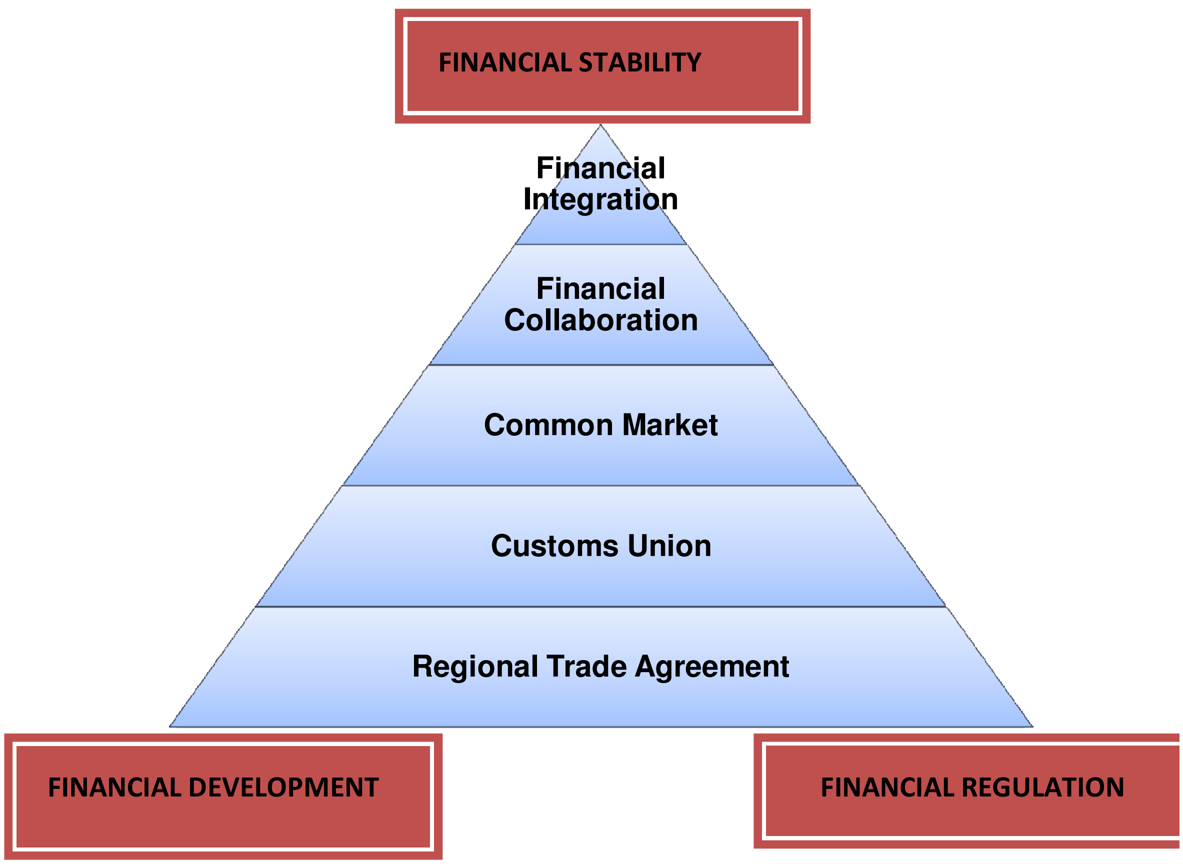


Figure 5. Model of financial integration

encourages financial prudence which will eventually lead to financial stability

The common path to regional integration in Africa and elsewhere (e.g., the EU) has been to start with some form of regional trade agreement, move to a customs union, introduce elements of a common market and only then move from financial collaboration to financial integration (Making Finance Work for Africa,2007:3).As a country passes moves towards full financial integration, financial development and financial regulation act as important pillars in which the process of financial integration ensures creation of a resilient stable financial system that can be able to withstand contagion risks. This is illustrated in a model of financial integration shown Figure 5.

What are the policy implications of the model illustrated above for Africa? The model has important implications for the African continent, in terms of its approach towards financial integration. Much importantly, the model calls on Africa to prioritize financial development and financial regulation policies, as it moves towards achieving full financial integration.

Policy efforts should focus on harmonizing market rules and practices, fostering financial market developments at a multilateral platform and developing institutions more generally (Rungcharoenkitkul, 2011:28). This is important for the African region which has financial systems that are less-developed and poorly-regulated, to an extent that there are incapable of efficiently dealing with external shocks. Essentially, the model encourages Africa to address such challenges in order to reap the full benefits of financial integration. Though the model focuses on the major elements (i.e. financial development and financial regulation) of achieving full integration with financial stability, it is important to note that the model is not a sure-footed solution to ensuring that financial integration leads to greater financial stability. Prudential macro-economic management and harmonization and strengthening of economic structures and policies across the region are also essential in creating sound financial systems that provide insurance against even moderate shocks (IMF, 2011:33). In essence, as financial integration progresses in Africa, not only do we need to focus our attention on issues of financial policy only, but also on issues of economic policy that guarantees overall macro-economic stability.

CONCLUSION

The world's financial markets are becoming more and more integrated. In the past, much integration efforts were biased towards trade integration. However, in recent times there has been a realization that financial integration is necessary in as far as facilitating trade and investment is concerned. The United States and the EU, due to their advanced level of economic development and financial openness are regarded as the most highly financially integrated financial markets in the world. The proponents of financial integration have always presented financial integration as highly beneficial to nations, mainly because it facilitates efficient allocation of resources in the economy and also because it insures countries against the effects of external shocks. However, the recent financial crisis which rattled across Europe and the rest of the world has put into doubt such occlusions. The crisis, which emanated from the United States subprime markets, spread rapidly across Europe and the rest of the world. The extent at which the crisis affected Europe was surprising, the regions level of integration. The recent financial crisis, therefore posed serious questions about the desirability of advancing and promoting financial integration not only in the developed world, but also in the developing world.

The developing world is in the process of moving towards deeper financial integration. Africa in particular, improved economic and political conditions and as well greater investment opportunities for those investors wishing to diversify their risk internationally have resulted in significant improvements in the levels of financial integration in the region. Pressure from international organizations for Africa to adopt financial liberalization policies and as well as integration efforts being put at regional or sub-regional levels are further helping Africa move towards financial integration. Today, Africa boasts of a significant number of international financial institutions who have actually established themselves in the region. Despite the efforts being made in Africa towards full financial integration, there are still concerns about the spread at which the region is moving towards full financial integration. This slow speed of financial integration in Africa is mainly attributed to lack of commitment towards achieving greater financial openness and as well as the problem of multiple memberships i.e. member countries belonging to several sub-regional organizations that has conflicting interests. With doubts being placed on desirability of furthering financial integration due to the recent financial crisis, there are new concerns that such developments (recent financial crisis) may also discourage African countries from advancing financial integration, thereby further slowing down the speed at which the process is moving.

With weak macro-economic fundamentals, poor financial regulatory frameworks and less-developed financial markets, questions are also being asked as to the capability of a financially integrated Africa to withstand financial shocks as major as the one that devastated the United States and Europe in 2007. For many years, Europe has been the ideal model of financial integration for Africa. However, with what happened in Europe, Africa will be forced to develop its own model of financial integration that enables the region to withstand contagion risks.

An effective model for Africa may be one that increases the resilience of a financial system. Such a model may be one that increases the risk sharing efficiency of a financial system and also one which is financially prudent. This is because financial systems that have higher ability to share risk and are also more prudent, have a better capability of securing a country's financial stability. Risk sharing efficiency of a financial system can be increased by developing financial markets. Thus a financial system which is well developed is likely to have numerous financial products that will enable financial participants to efficiently diversify or hedge against risks. On the other hand, the prudence of a financial system can be improved by building effective regulatory and supervision frameworks that will promote transparency and good corporate governance practices by financial intermediaries and participants. Hence, financial development and financial regulation and supervision are core elements of a resilient financial system.

The transition to full financial integration usually start with a regional trade agreement, then moves to a customs union, then to a common market, then to some kind of financial collaboration and lastly to full financial integration. As countries pass through these stages, financial development and financial regulation and supervision should also be promoted. This will ensure that countries maximize the benefits of financial integration whilst minimizing the contagion risk. In other words, financial development and financial regulation and supervision should be the main pillars of a process of financial integration that ensures that countries maximize benefits of financial integration whilst minimizing the contagion risk. However, it is important to note that overall macro-economic conditions also play in the transmission of shocks. Hence, focus should not be only on policies biased towards financial development and financial regulation, but also on overall macro-economic policies that supports overall economic stability.

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