Journal of Economics and Business 79 (2015) 100–117

Contents lists available at ScienceDirect

Journal of Economics and Business

Financial integration and stability in the Southern African development community

Sephooko Motelle, Nicholas Biekpe *

University of Cape Town, Graduate School of Business, South Africa

ARTICLE INFO

Article history:
Received 31 March 2014
Received in revised form 23 January 2015
Accepted 26 January 2015
Available online 3 February 2015

JEL classification:
G00
G1
F3
F4

Keywords:
Financial integration
Financial stability
FGLS technique

ABSTRACT

One of the benefits of financial integration is that it enhances financial stability because openness to international competition requires that countries conform to international standards of reporting and financial regulation. Moreover, financial integration facilitates transfer of technology and know-how that improves efficiency and stability in the domestic financial sector. However, a significant threat of financial integration is the risk of financial instability. This study tests the hypothesis that deeper financial integration causes financial instability in the domestic financial systems. The study performs a panel causality test based on feasible generalised least squares (FGLS) technique to test the validity of this hypothesis in the Southern African Development Community (SADC). The findings validate the hypothesis and reveal the importance of effective monetary policy, real interest rate and exchange rate policies to curb financial instability and achieve a narrow financial intermediation spread.

1. Introduction

Financial intermediaries act as a conduit for the transfer of funds from surplus to deficit sectors of the economy. Levine (1997) states that financial institutions mobilise and allocate domestic resources, support trade and provide avenues for diversification and hedging to mitigate financial risk as well

* Corresponding author. Tel.: +27 219146778; fax: +27 21914438.
E-mail address: nicholas.biekpe@gsb.uct.ac.za (N. Biekpe).

http://dx.doi.org/10.1016/j.jeconbus.2015.01.002
0148-6195/

as allow easier access to opportunities for investment. Consequently, financial sector development provides impetus for economic growth. Furthermore, financial integration is perceived to have the potential to give traction to financial development. Edison, Levine, Ricci and Slok (2002: 1) states that: "capital flows can foster a more efficient allocation of resources, provide opportunities for risk diversification, and help promote financial development." Nevertheless, in order for the indirect benefits of financial integration to translate into robust economic growth, Kose, Prasad, and Taylor (2011) underscore the need for the right initial conditions, to be established before a country can proceed on the path of financial integration. Such initial conditions include financial and institutional development, trade openness and, as well as, stable macroeconomic policies. Even though financial integration can lead to surges in capital flow into developing countries, resulting in increases in the pool of domestic savings, sharp reversals of capital may have damaging effects on domestic financial stability. The 2007–09 global financial crisis has been instructive in this regard. Kose et al. (2011: 148) observe that, for developing countries, "financial linkages have served as a channel for the global financial turmoil to reach their shores."

In the context of Africa, many attempts have been made to seek to understand both the benefits and feasibility of financial integration. For example, Guillaume and Stasavage (2000) study a number of regional blocs in Africa to ascertain whether African monetary unions can improve policy credibility. Buigut and Valev (2005) explore the feasibility of a monetary union in East Africa, and Houssa (2008) investigates the effect of asymmetric shocks in West African monetary unification. Few exceptions, in the literature on the phenomenon of financial integration in Africa, do examine the issue in the context of financial instability. For instance, Enowbi and Kupukile (2010) find evidence of a significant positive relationship between financial and economic liberalisation and financial development for a panel of 50 African countries. Despite this positive effect, the experience from the global financial crisis that began in the United States of America at the end of 2007 shows that financial liberalisation can be costly. For example, for the Central African Franc Zone (CFAZ) member states, macroeconomic effects of the financial crisis had significant costs in terms of credit contraction and output losses (Price & Elu, 2014).[1] Using evidence from 15 African countries, Asongu (2014) argues that initial conditions associated with the size of the financial sector are, especially, important for financial integration to have real financial gains. In addition to this, sound supervision of financial institutions is essential for efficient allocation of foreign capital into productive investment without undermining financial stability. In fact, Price and Elu (2014) recommend stringent capital requirements that restrict bank leverage to reduce the exposure of members of the CFAZ to adverse macroeconomic shocks.

In Southern Africa, few attempts have been made to study financial integration. For example, Aziakpono, Kleimeier, and Sander (2007) finds evidence of financial integration in Southern African development community (SADC) based on interest rate pass-through. The common monetary area (CMA) countries manifest the deepest roots of financial integration and there is also some emerging convergence-club in SADC where the common monetary area is the centre. Seychelles and Malawi tend to move towards this core group. For members of SADC, Aziakpono (2006a) finds a high degree of financial integration especially among the CMA countries. However, the benefits for financial intermediation and growth remain diverse and low. Aziakpono (2006b) argues that lack of competition in the banking industry, especially in Botswana, Lesotho, Namibia and Swaziland, may be one reason why there are no significant benefits from financial integration for economic performance in Southern African customs union (SACU).

This study tests the hypothesis that deeper financial integration increases the risk of financial instability in the domestic financial system in the context of SADC.[2] By testing this hypothesis, this study contributes to existing body of knowledge in two ways: *First*, the concept of financial instability tends to

[1] CFAZ consists of two separate regional currency unions in sub-Saharan Africa in which the CFA franc currency is pegged to the euro: West African Economic and Monetary Union (WAEMU) and Economic and Monetary Union of Central Africa (CEMAC). WAEMU includes the countries of Benin, Guinea Bissau, Burkina Faso, Cote d'Ivoire, Mali, Niger, Senegal and Togo. CEMAC includes the countries of Cameroon, Central African Republic, Chad, Republic of Congo, Equatorial Guinea, and Gabon.

[2] SADC comprises Angola, Botswana, Democratic Republic of Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia and Zimbabwe. Madagascar which was been suspended in 2009 has been reinstated in January 2014.