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The impact of financial integration in Botswana

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Abstract

This study examines the impact of financial integration in Botswana. Direct and indirect transmission channels to growth are investigated. Financial integration commonly influences growth through encouraging cross border capital flows, transferring technologies and managerial expertise and promoting risk sharing. These market developments that are realized translate into enhanced access to finance as intermediation channels improve. Our empirical results are in line with previous literature in that financial depth does occur in the wake of the financial integration era and positively influences growth in Botswana. Not withholding, our results reveal that market depth has not promoted access to private sector's credit in Botswana so far. To a larger extent, a negative impact of financial integration on growth is observed as there could be short-term risks associated with increased financial openness. Nonetheless, an indirect, significant and positive influence from financial integration through financial access to growth is also observed. This indirect transmission demonstrates that financial integration increases financial innovation which in turn fosters growth in the country. Financial innovation enhances service delivery and improves access to financial services. We observe a positive influence from macroeconomic and institutional variables implying prevalence of sound and prudent supervisory structure and the rule of law in Botswana. Policy wise, there is still need and scope for greater financial integration, financial development and financial access which can contribute to national development goals of sustainable economic growth, diversification, employment creation and poverty reduction in Botswana.

Keywords: Financial integration; Financial access; Economic growth; Botswana

JEL classification: E22; G21; G28; O16; O43

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1. Introduction

Capital inflows in the form of foreign direct investments (FDIs) and portfolio flows resulting from financial integration may imply better access to finance by the local firms and individual households. Financial integration is also commonly known to accelerate domestic financial market depth and is therefore reasonable to assume that financial integration enhances access to finance. Contrary to popular believe, Zaman, Izhar, Khan, and Ahmad (2012) argue that it is not guaranteed that capital inflows will trickle down to the poor. Whilst it is taken for granted and implied by vast literature that well developed financial markets in industrialized economies make access to finance much easier, an investigation on the impacts of financial integration in the European market by Volz (2004) gives evidence that even though financial developments occurred, they did not necessarily improve financing conditions for the local private sector. Nonetheless, Bekaert, Harvey, and Lundblad (2005) conclude that financial integration results in shared risks across markets leading to lower cost of equity capital and more investments, implying improved access to finance. A well-financed private sector enhances growth through technological innovations, investments in high return projects and job creativity amongst other benefits. Some researchers argue that lack of access to finance by both households and firms in emerging markets negatively impacts economic growth and poverty alleviation (Peachey & Roe, 2004; Jefferis, 2009). Financial access entails both usage and financial market depth in that products should be made available as and when they are needed by the users (World Bank, 2006a,b). This study adopts definition for access to finance from Africa (2012), which states that “Access to finance refers to the availability of financial services–in the form of deposits, credit, payments, or insurance–to individuals or enterprises. The availability of such services can be constrained for instance by physical access, affordability or eligibility”.

Previous studies regarding financial integration and its impact on growth are mainly based on panel data. Such approach has been criticized due to its inability to capture country and economic specific experiences in the growth dynamics. Whilst literature on Botswana barely records the influence of financial integration on financial market development and growth (Akinboade, 1998; Meshach, 2007; Eita & Jordaan, 2007), there is a theoretical void on whether financial integration and financial development have a significant bearing on private sector access to finance in Botswana. This study seeks to fill in this literature gap. Botswana is of main interest in this study because of its outstanding economic records amongst African countries and the country prides itself of well-developed institutions, prevalence of rule of law and integrated financial markets amongst others. The study aims to provide empirical evidence that will help point out a number of policy recommendations to improve future financial market operations in the country. This research uses two key measures to analyse access to finance: first, financial innovations (Valverde, Del Paso, & Fernandez, 2007) and second, financial market structure (Beck & Levine, 2002; Rioja & Valev, 2005). Frame and White (2004) say “Everybody talks about financial innovation, but (almost) nobody empirically tests hypotheses about it.” Financial innovations demonstrate financial market management strategies that provide resilient innovative products that are tailor made to the local market and more open than government policies by encouraging private sector participation. Financial market structure on the other hand entails overall market orientation, activities and size; all of which impacts on access to finance. Furthermore this study applies vector error correction model to analyse their interactions and their joint effects on long-term growth.