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# Financial integration, capital market development and economic performance: Empirical evidence from Botswana

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ABSTRACT

A substantial body of literature suggests that financial market development plays a significant role in economic growth through fostering savings mobilization, easing risk management, promoting technological transfer and reducing information and transaction costs. However, the effect of financial integration on growth remains an empirically controversial topic. This paper explores the impact of financial integration on economic growth in Botswana over the period 1974–2009. We do not find a direct, robust and statistically significant association between financial integration and economic growth in Botswana. However, our results show that financial integration is positively and significantly correlated with financial development in the Botswana economy. Although the relationship between financial integration and growth initially is, at best, weak, we believe this is not to say that financial integration does not promote economic growth, as it could do so indirectly through fostering financial development. Policy-wise, we observe that institutional quality, lower level of government spending and a stable macroeconomic environment are important determinants of both financial development and long-term economic growth. Thus, the Botswana government should continue strengthening and developing its capital market to international standards so as to attract both local and foreign investors and encourage foreign investment in the non-mining sectors. The government should ensure that financial reforms are coordinated, law enforcement authorities are strengthened and property rights are protected to reduce investment risks.


## 1. Introduction

Many of the Sub-Saharan African (SSA) countries have undertaken various forms of financial and macroeconomic reforms in the past two decades to accelerate economic growth, fostered financial innovation and enhanced trade integration. While most of these structural adjustment programmes were targeted to modernise SSA's financial markets, they were also meant to create a macroeconomic environment conducive to promoting private investment and improve allocative efficiency. Generally, financial integration implies that the domestic financial market is linked with or intertwined with global financial markets (Volz, 2004). In many parts of the African continent, regional financial integration has been launched. Regional financial integration is an arrangement where a group of neighbouring countries legally agree to interlink their financial systems in order to deepen and broaden their financial markets; at a higher level, over and above individual country markets, a set of countries can actually build regional markets (Wakeman-Linn and Wagh, 2008). These include: the Southern African Development Community (SADC); the Southern African Customs Union (SACU); the Common Market for Eastern and Southern Africa (COMESA); the Arab Maghreb Union (UMA); the Central African Economic and Monetary Community (CAEMC); the East African Community (EAC); and the Economic Community of West African States (ECOWAS) as documented by the African Development Bank (2010) and Ahmed (2011). Besides being a member of SADC and SACU, Botswana is also a member of international bodies like the World Trade Organisation (WTO), International Monetary Fund (IMF) and United Nations (UN).

From both the theoretical and empirical literatures, regional financial integration is considered necessary because: (i) it motivates countries to upgrade their financial reforms; (ii) it induces productivity and efficiency through competition with outside markets; (iii) it increases foreign direct investment (FDI) inflows; and (iv) it enables small African markets to trade regionally and globally, thus providing greater opportunity for growth (African Development Bank, 2010). Being a member of regional financial integration bodies, countries may benefit from the envisaged free trade areas (FTAs) and Economic Partnership Agreements (EPAs) that are ongoing between Africa, the European Union and the rest of the world. Through these channels, regional integration and international financial integration are expected

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to bring growth benefits, and greater trade and investment. However, as highlighted by Aziakpono et al. (2009), several setbacks can transpire in the implementation of regional financial integration such as: (i) abnormal distribution of capital flows across regions (ii) possibility of difficult access to capital flows by less developed economies within the region (iii) capital misallocation within the local economy; and (iv) macroeconomic destabilisation. Thus, it has been suggested that any positive effects of financial integration may take a while to be experienced owing to adaptation of local financial systems (Klein and Olivei, 1999; Volz, 2004).

International debates on the effects of financial integration are ongoing (Chen and Quang, 2012; Edison et al., 2002; Schularick and Steger, 2010). On the other hand, evidence of growth benefits from (international) financial integration based on cross-section studies has been inconclusive (Thaicharoen et al., 2007).[2] It has also been argued that growth benefits of financial openness are conditional on differences in institutional quality and macroeconomics policy settings (Thaicharoen et al., 2007). It is also important to mention that there are very limited studies on SADC and SACU member states (whether individual or group) on the impact of international financial integration. Despite there being numerous empirical studies, the growth benefit of financial integration has remained unresolved, especially from the perspective of developing countries. The aim of this paper is to examine whether financial integration helps foster economic growth in Botswana. Secondly, the research aims to investigate whether there are some indirect channels through which international financial integration acts as a catalyst for further financial market development and economic performance. Thirdly, given that Botswana is one of the fastest growing economies in the region, we believe it will make a prime case study to observe the impact of financial integration developments and investigate whether such financial integration-growth links are conditional upon other economic characteristics. Finally, unlike other African countries, Botswana has undertaken ambitious and targeted economic liberalisation reforms to promote the private sector and achieve economic diversification in the last two decades. Thus, due to improvement in data availability, this study which evaluates the benefits from financial integration is timely.

## 2. Brief background on Botswana's economic system

Botswana is one of the African economic tigers. With remarkable macroeconomic stability characterised by a well-managed budgetary system, the country has been able to achieve and maintain high economic growth rates over many decades and it is one of the most stable countries in Africa. Since its inception in 1966, Botswana moved from being a low income to a middle income class country with its GDP per capita estimated to be US$16,800 in 2012 as compared to about US $236 in 1967. Through careful management of its mineral resources, especially diamond mining and beef exports, the country has seen its revenues accumulating from the independence era to date; thus transforming itself from one of the poorest and invisible colonial states to having a shining international stature in the African continent. Being a member of the African continent that has been characterised by economic mismanagement, complex economic stability and political instability and continuous ethnic conflict and tension, Botswana managed to achieve political stability and sustained economic development. The country has had four peaceful presidential successions within its 47 years of independence from British rule. For the past two and a half decades the country's growth has been one of the fastest in the world. More or less, during 1960–1990 Botswana was the fastest growing country in the world, with an average annual increase in GDP of 13.9% from 1965–1980 and 11.3% from 1980–1990 (Good, 1992). Overall, the average real GDP growth has been almost 10% for the period of 1960–2000, while real GDP per capita growth was above 7%. In contrast to many other African countries, Botswana has a competitive and market-friendly economic environment, and it is believed that most of the institutions operate effectively and the rule of law/democracy prevails. The country has sound legal system, strong educational policies, sound infrastructure and one of the best credit risks in the continent. One of the country's most appreciated attribute is its open door policy (friendly market environment) to its neighbours and the world at large. Its central geographical positioning in Southern Africa plays a very pivotal role. This success story is not without challenges of unequal income distribution, lack of prudent financial management, HIV AIDS, unemployment and poverty. In order to overcome these obstacles, the country's leadership has introduced several programmes like the National Development Plans, youth empowerment and poverty eradication schemes to name a few. Nonetheless, the literature (Wakeman-Linn and Wagh, 2008) argues that government dominance in the African capital markets crowd out the private sector resulting in narrow and illiquid markets. They further noted that African financial markets are bank oriented and as a result investment in projects that need long-term financing is compromised. Unfortunately, Torre and Schmukler (2007) observed that in emerging economies, the implementation of financial integration is more focused on the banking sector and less consideration is given to the capital markets yet the African Development Bank (2010) advocates that developed capital markets are highly needed to facilitate FDI inflows. Botswana, as most African countries, is characterised by a narrow and very illiquid capital market and financial market integration may help to broaden and deepen the country's markets. Furthermore, the country's envisaged economic diversification strategy provides an opportunity for private sector inclusion and less government dominance in building sustainable economic growth. Continuous efforts to develop both the public and private sectors are underway and the future seems bright for Botswana at this stage.

## 3. Brief literature review

Financial integration is generally associated with broad and deep financial markets (Klein and Olivei, 1999; Volz, 2004). This literature suggests that policy reforms to open up capital accounts of developing economies should be pursued so that financial markets can be developed. The importance of the financial systems cannot be over emphasised as they are the vehicle through which capital flows to productive projects with highest returns. They also facilitate capital movement across international borders. Therefore financial markets play a bigger role in economic growth even though their role still remains an issue of debate as pointed out by Levine and Zervos (1996). A financial system is composed of money markets and capital markets, each of which uniquely plays a very important role of financial intermediation (Pagano, 1993). Unfortunately, Torre and Schmukler (2007) observed that in emerging economies, the implementation of financial integration is more focused on the banking sector and less consideration is given to capital markets. In the case of SSA, the African Development Bank (2010) advocates that developed capital markets are highly needed to facilitate FDI inflows. For this reason, China was advised to develop a deep and liquid bond market that can handle the envisaged massive capital inflows (Borst, 2012) in preparation for capital account liberalisation.

Unlike the situation in industrialised economies, capital markets in emerging economies of Africa are characterised by a relatively small number of listed companies, few market participants, low capitalization, and low trading volume (African Development Bank, 2010). In order to overcome the small size and illiquidity of the developing markets in Africa, Ahmed (2011) suggests that regional financial integration should be embraced. Moreover, Obstfeld (1994) postulates that integrated capital markets are critical in enhancing efficient resource allocation and encouraging international risk sharing, thereby supporting economic

[2] It is important to note from the literature that international financial integration has been used in connection with financial openness. Henceforth, the terms financial integration and financial openness may be used interchangeably.