CHAPTER 3: FINANCIAL INTEGRATION IN THE SOUTHERN AFRICAN REGION

3.1 Introduction

The globe hinges on globalisation and this generates a lot of political and economic alignment problems at regional and continental level.

The economic ranking of many African countries is appalling because of various political and socio economic hurdles. Many African country economies are dilapidated in terms of growth and development. The economic status could be pictured by an adverse outlook in terms of declining growth, double-digit inflation, dependence on aid, poverty, no savings, low investment, high levels of unemployment, high deficits and under utilisation of production resources.

Tremendous efforts have been taken to address some of these problems after the colonial era, to emancipate their economies through economic cooperation and economic integration.

Various initiatives were taken, but mainly in trade and sectoral cooperation and much fewer efforts were made in the financial sector. There is some evidence of monetary and financial cooperation in the western African region and also other regions in the form of currency boards.

The inception of the EMU has sparked a new wave of interest in economic and financial integration in Africa. The formation of an African Economic Community may provide some foundation to empower the African continent in developing technical, technological, political, economic and financial infrastructure to address numerous problems on the continent.

Throughout the continent of Africa vigorous efforts had been made to promote economic development and regional integration, but much needs to be done to address financial issues which will enhance much monetary, fiscal and financial harmonisation with the eventuality of realising an African Monetary Union.

In light of the above, this chapter discusses the concept of financial integration and all issues of financial integration such as the development of various financial markets, instruments, and risks and benefits pertaining to this subject.

The research will also look at barriers prohibiting financial integration and its measurement and finally provide some options for accelerating integration in the southern African region.

3.2 Macro economic overview of the southern African region

Economic and financial integration are influenced and sustained by international economic dynamics as they are by national and regional macro economic policies. Policymakers have to address all macro economic challenges, prior and past economic and financial integration in the southern region of Africa.

The overall economic picture for the region varies from one member state to the other. As a whole, however, the economics of the region are improving with structural adjustment programmes realising some success that can be quantified by their respective economic indicators, with a notable exceptions of DRC, Angola and the ailing Zimbabwe.

The macro economic overview for the region will look at economic growth, exchange rates, budget deficits, external debt and inflation levels of the various member states of the region.

Table 3.1: Demographic and economic indicators for SADC, 2004

	Population *(millions)*	Surface Area *('000 sq.km)*	Population Density *(per sq.km)*	Gross National Income (GNI) *(US$ billion)*	GNI per capita *(US$)*	GDP growth (avg. 1966-2003) *%*
Low income						
Congo, Dem. Rep.	**54.8**	**2,344.9**	**23.4**	**6.4**	**120**	**-2.0**
Malawi	11.2	118.5	94.4	1.9	170	3.0
Mozambique	19.1	801.6	23.9	4.7	250	4.9
Tanzania	36.6	945.1	38.7	11.6	330	2.9
Zambia	10.5	752.6	14.0	4.7	450	0.8
Lesotho	1.8	30.4	59.6	1.3	740	4.2
Angola	14.0	1,246.7	11.2	14.4	1,030	5.0
Zimbabwe	13.2	390.8	33.7	n/a	n/a	3.1
Middle income						
Swaziland	1.1	17.4	64.5	1.9	1,660	5.3
Namibia	2.0	824.3	2.5	4.8	2,370	4.4
South Africa	45.6	1,219.1	37.4	165.3	3,630	1.8
Botswana	1.7	581.7	3.0	7.5	4,340	8.6
Mauritius	1.2	2.0	605.0	5.7	4,640	5.2
SADC total	212.8	9,275.0	22.9	230.4	1,154	

[Source: World Development Indicators, 2005]

3.2.1 The size and structure of the economy

The size and structure of the region's economy will mainly be measured and analysed in terms of the various macro economic indicators as it is used in the Regional Economic Review (2000). The region is characterised by low levels of growth and high population which is not affected by HIV/AIDS.

The other factors include a wide range of weak currencies, which discourages capital flows and investment. The region also has low levels of savings, and consumption and investment. The region also suffers in terms of economic and development infrastructure which is improving because various sectors are developing in the region.

The GNP per capita levels and growth show a mixed picture. There is a group of countries with GNP per capita income levels of around $3 000, which are Botswana, Mauritius and South Africa; the other extreme have GNP per capita of $500 or as little as $190 (Malawi) and with Namibia in the middle with a level of $1 890. In general there is an upward movement in the income levels in the region as illustrated in Table 3.1 above.

The region has relatively low levels of exports and markets. The bulk of the output is generated by SACU and South Africa. This is also depicted in Table 3.2, which indicates that South Africa contributes 80 per cent of GDP in the southern region, 40 per cent of the sub-Saharan region and 25 per cent of Africa as a whole.

The region is fully endowed with all resources and mineral resources but with a very low skilled workforce. The GDP has been mainly dependant on the agricultural sector, but there has been a decline because most of the member countries are industrialised. The service sector appears to be increasing in importance. Table 3.2 illustrates a comparison of shift in output of the region from agriculture, to industry and the service sector.

Table 3.2: Sectoral contribution to GDP by SADC countries, percentage

COUNTRY	AGRICULTURE		INDUSTRY		SERVICES	
	1990	1999	1990	1999	1990	1999
Angola	18	7	41	70	41	23
Botswana	5	4	56	45	39	51
DRC	30	58	28	17	42	25
Lesotho	23	18	34	38	43	44
Malawi	45	38	29	18	26	45
Mozambique	37	32	18	24	44	44
Namibia	12	13	38	33	50	55
South Africa	5	4	40	32	55	64
Tanzania	48	48	16	14	36	38
Zambia	18	17	45	26	37	57
Zimbabwe	16	19	33	24	50	56

[Source: Regional Economic Review, 2000]

Table 3.2 indicates that in 1990 the contribution of agriculture to GDP was a two-digit percentage high with the exception of South Africa and Botswana. However in 1999 much contribution comes from the industry and service sectors. There has been a substantial structural change in the context of overall growth and development of productivity.

In general there exists a considerable heterogeneity in terms of economic development in the region, which is mirrored by the various macro economic indicators in the region.

The analysis from Table 3.3 depicts that on the whole the region is not doing well in terms of savings as a percentage of GDP. Only Namibia, Lesotho, Seychelles,

SA, Swaziland and Zimbabwe had high ratios of above 10 per cent between 1990 and1999 and Botswana taping the list. This also imported the performance of investment levels in the region because savings provide regular capital inflows for investments.

Table 3.3: Domestic savings as percentage of GDP in SADC

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006	2007
Angola	24.4	23.9	19.2	25.1	34.1	36.7	29.4
Botswana	47.4	52.2	50.7	49.8	47.4	44.2	43.2
Comoros	-7.8	-4.0	-5.8	-10.6	-12.9	-15.6	-12.2
DRC	43.7	51.0	51.3	51.3	58.7	70.2	59.6
Lesotho	-20.3	-15.6	-6.1	-11.8	-17.6	-13.8	-12.0
Madagascar	8.4	7.7	8.9	9.4	8.9	10.0	10.8
Malawi	2.7	-16.7	-12.1	-10.6	-23.9	-13.5	-4.0
Mauritius	24.4	24.7	25.8	23.3	18.5	14.4	15.0
Mozambique	9.4	10.5	10.6	13.2	9.4	19.8	16.6
Namibia	13.7	14.6	23.2	22.3	24.7	30.8	32.8
Seychelles	18.4	24.4	21.5	14.7	-5.0	11.2	-0.1
South Africa	18.3	19.8	18.4	18.1	17.8	18.0	16.6
Swaziland	2.1	19.5	19.9	16.8	13.9	11.2	10.9
Tanzania	5.8	11.8	14.5	13.6	11.7	10.5	10.6
Zambia	6.4	8.7	13.1	19.8	20.3	31.8	30.5
Zimbabwe	13.3	-12.5	-21.1	-3.7	-6.7	8.4	17.1

[Source: IMF, 2007]

Table 3.4: Investment as percentage of GDP in SADC, 1997-2007

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006	2007
Angola	21.8	12.6	12.7	9.1	8.1	15.0	13.7
Botswana	25.1	40.7	41.5	38.4	30.1	25.3	25.8
Comoros	12.0	11.0	10.3	9.4	9.3	10.0	13.5
DRC	34.3	23.4	25.7	24.2	22.4	24.3	31.0
Lesotho	46.3	43.8	45.1	34.6	28.0	26.2	26.4
Madagasca	15.3	14.3	17.9	24.3	22.5	21.7	21.9
Malawi	13.4	10.4	10.8	14.4	13.0	14.2	19.6
Mauritius	26.6	20.3	24.9	22.8	22.9	21.2	23.4
Mozambique	28.2	29.8	27.4	22.6	20.4	24.8	27.7
Namibia	22.4	19.7	29.8	26.4	28.3	29.4	31.9
Seychelles	32.6	25.6	10.4	12.7	21.9	31.9	38.3
South Africa	16.2	16.1	16.9	17.7	18.3	20.3	20.4
Swaziland	19.8	19.8	18.0	18.4	18.2	17.2	17.2
Tanzania	16.2	19.2	21.2	21.0	22.2	23.4	24.5
Zambia	17.4	22.0	25.6	24.3	23.5	23.5	25.0
Zimbabwe	15.5	-8.8	-13.0	5.1	4.4	11.0	17.5

[Source: World Economic Outlook, 2007]

From Table 3.4 one can draw a conclusion that generally our investment levels as a percentage of GDP is below 20 percent with few countries having a score sheet below 10 percent like Botswana, Comoros, Madagascar, Lesotho, Malawi, Mozambique and Zambia.

The region's slow growth pace is also attributable to low rates of savings and investments as well as the quality of investment. A regional approach for financial

integration relies heavily on savings and savings for further regional financial development which will benefit the whole region.

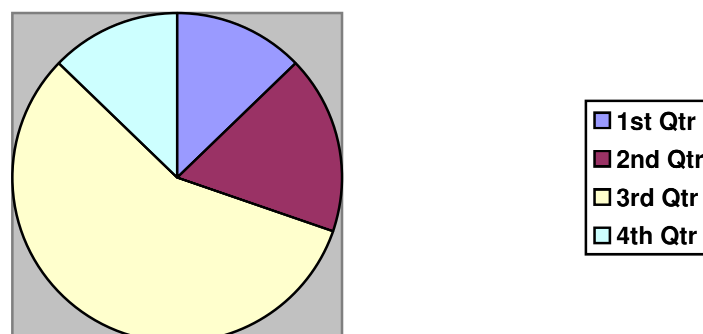
3.2.2 Economic growth performance in the region

The performance of the region in terms of economic growth has been directly linked to the upturn of the global economy after the incursion of the Asian arises, but there have been a number of contributing factors which prohibit progress and sustainable economic growth. The major contributing factors to improvement in economic growth are:

- A notable acceptation of Zimbabwe
- Improved international economic climate
- Deployed regional development of sound macro economic policies
- General economic reforms

However, there still exist other problems which need to be solved like poor investor confidence and lack of capital flow which affect economic growth performance in the southern region of Africa.

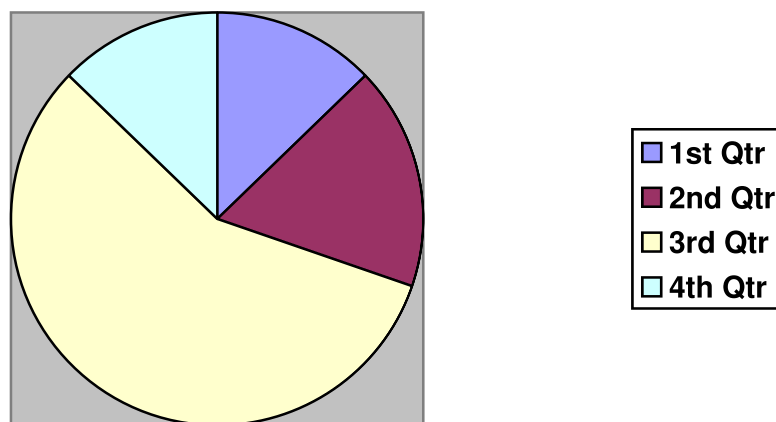
Figure 3.1: Africa's share of global GDP, 2001/2



[Source: Africa Institute of South Africa, 2001/2 (Africa at a glance: Facts and Figures)]

Figure 3.1 illustrates the allocation of global GDP as at 1999 standing at $30 300 billion. The developing world's share of global GDP is 22 per cent and Africa's allocation is 1.8 per cent. This indicates a sluggish pace of economic growth in the whole of Africa as compared to world. The comparison is also bad with the developing world which has a GDP of $600 billion of which Africa's share is only 8.5 per cent.

Figure 3.2: SADC share of Africa GDP, 2001/2



[Source: Africa Institute of South Africa, 2001/2 (Africa at a glance: Facts and Figures)]

In the sub regional context the southern African region has a bigger share in terms of continental GDP, with much of the contribution coming from South Africa.

Figure 3.2 indicates that from the continental GDP of $560 billion, the sub-Sahara region's share is 89 per cent and from a Sub-Sahara GDP of $329 billion southern Africa contributes 50 per cent, of which 40 per cent comes from South Africa. In the southern region, with a GDP of $163 billion, South Africa's share is 80 per cent of which 20 per cent is contributed by other regional member countries.

Table 3.5: Real GDP growth in SADC (Percent), 1997-2007

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006	2007
Angola	3.0	14.5	3.3	11.2	20.6	15.3	35.3
Botswana	8.2	5.6	6.3	6.0	6.2	4.2	4.3
Comoros	2.4	4.1	2.5	-0.2	4.2	1.2	3.0
DRC	2.4	4.6	0.8	3.6	7.7	6.4	3.7
Lesotho	0.5	2.8	3.0	3.8	3.7	5.6	5.1
Madagascar	4.6	-12.7	9.8	5.3	4.6	4.7	5.6
Malawi	1.6	2.1	3.9	5.1	2.1	8.5	5.7
Mauritius	5.7	1.5	3.8	4.7	3.0	3.7	4.1
Mozambique	9.2	8.2	7.9	7.5	7.8	8.5	6.8
Namibia	3.2	6.7	3.5	6.6	4.2	4.6	4.8
Seychelles	3.7	1.2	-5.9	-2.9	1.2	4.5	5.0
South Africa	2.5	3.7	3.1	4.8	5.1	5.0	4.7
Swaziland	2.8	2.9	2.9	2.1	2.3	2.1	1.2
Tanzania	4.4	7.2	5.6	6.7	6.8	5.9	7.3
Zambia	2.4	3.3	5.1	5.4	5.2	6.0	6.0
Zimbabwe	-2.4	-4.4	-10.4	-3.8	-5.3	-4.8	-5.7

[Source: IMF, 2007]

Table 3.5 shows the performance of SADC member states with regard to economic growth (real GDP growth). Rising growth rates is an important objective in an environment of high poverty levels, which applies to much of SADC. The table indicates high growth levels with the exception of Angola. The region has a mixed composition, including successful reformers, countries coming out of civil conflict, and mineral exporters.

Member countries with low growth levels demonstrated generally declining growth performance, and all had growth of less than 5 percent in 2005 and these countries are Mauritius, Namibia, Swaziland and Zimbabwe with its serious macro economic policy problems.

3.2.3 Exchange rate performance in the southern African region

The region is also confronted with the problem of currency convertibility into other international hard currency. The most acceptable or convertible currency in the region is the Rand which has also anchored the MMA which comprises of Lesotho, Namibia, South Africa and Swaziland.

All currencies in the region have depreciated against the US $ and some have been devalued twice or more and there seems to be difficulty in having a sustainable equilibrium level to the US $ in terms of the exchange rate. This is regarded as a serious drawback towards deeper regional financial integration or monetary union for the region.

Table 3.6 illustrates market exchange rates for the region and also shows the extent of exchange rate decline in the region for 2001. Table 3.6 also shows that currencies for the DRC and Angola have been devalued substantially whereas Tanzania, Seychelles, Lesotho, and Botswana have only double declined against the US dollar in the last ten years.

Table 3.6: Real effective exchange rates in SADC, 1997-2006

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006
Angola	100.4	118.0	117.4	140.0	158.4	189.5
Botswana	97.3	109.3	115.0	110.2	107.1	104.0

Comoros	107.0	114.0	116.9	123.8	126.1	129.6
DRC	105.5	104.4	111.2	116.1	115.4	117.5
Lesotho	107.0	77.9	112.2	132.2	132.8	129.8
Madagascar	98.3	119.9	106.0	80.4	85.0	85.7
Malawi	105.8	109.3	80.4	73.3	75.2	73.2
Mauritius	95.1	91.6	89.5	87.2	82.6	81.6
Mozambique	97.2	90.5	97.7	83.5	85.3	85.6
Namibia	99.8	87.2	104.6	111.9	112.7	109.7
Seychelles	96.7	109.1	101.1	94.3	92.3	88.6
South Africa	104.0	73.9	97.3	107.6	108.5	104.1
Swaziland	97.9	88.3	102.8	113.2	113.2	112.0
Tanzania	98.8	90.8	75.0	67.7	65.7	62.6
Zambia	102.8	110.9	101.7	107.8	134.7	176.4
Zimbabwe	99.9	359.0	198.0	69.0	63.3	81.2

[Source: IMF, 2007]

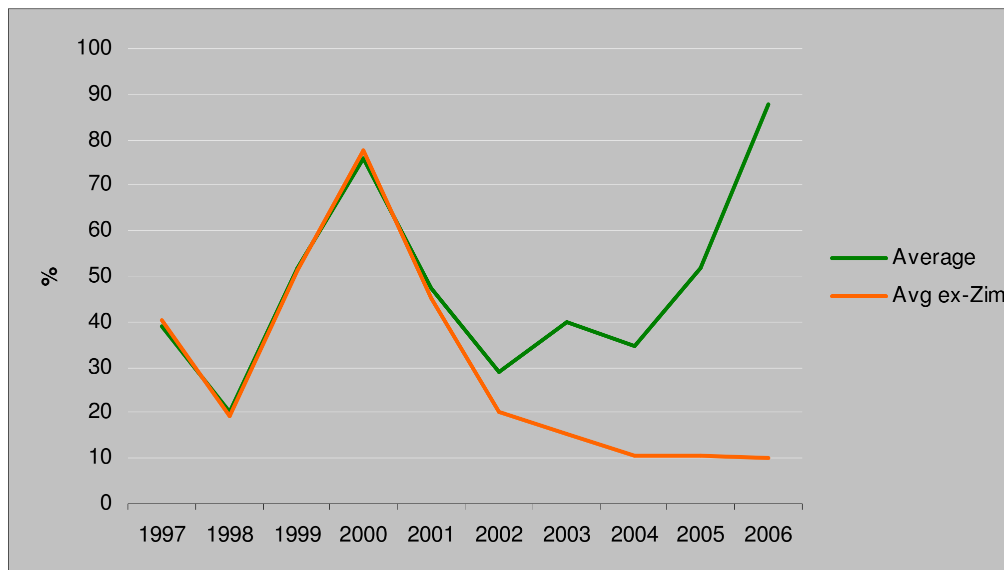
3.2.4 Inflation performance in the southern African region

Inflation performance is a fundamental macro economic measure of regional financial integration. The region's economic development and growth is affected adversely because of high and volatile inflation. There is a considerable variation in terms of inflation performance in the region, with no country attaining a single digit inflation rate in the last decade. Figure 3.3 below demonstrates the performance of SADC member states with regard to inflation from 1995 to 2006. In the region Tanzania, Mauritius and the SACU countries (Botswana, Lesotho, Namibia, South Africa and Swaziland) have lower inflation levels, and show a consistent downward trend in inflation over the period.

Angola, the DRC, Madagascar, Malawi, Mozambique, Zambia and Zimbabwe indicate high levels of inflation over 50 percent at some point in the past.

Nevertheless, even Angola and the DRC have managed to bring inflation down from very high levels very quickly. Zimbabwe has had a very high and rising inflation in recent years, with no sign of stabilisation on the horizon.

Figure 3.3: Average inflation rate in SADC, 1997-2006

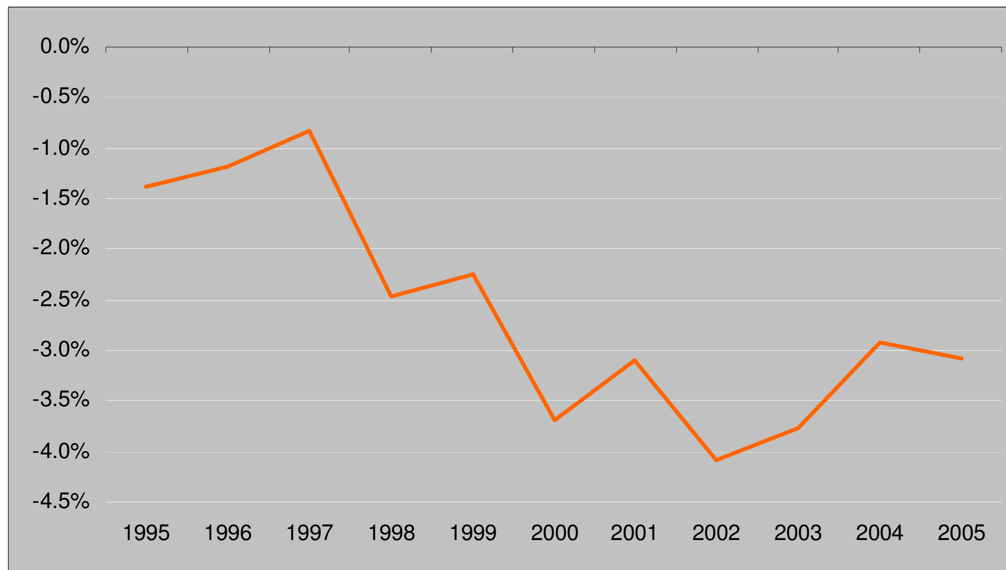


[Source: SADC, 2007]

3.2.5 Budget deficits in the southern African region

The region also suffered a setback arising from central government experiencing high level government budget deficits. Government finance dates are perhaps the poorest of all statistics for the countries of the region. Larger government deficits have undermined economic growth and development. However, in some countries structural adjustment programmes have improved the outlook and reduction in terms of deficits that have been made at a slow place, but not in all the regional member countries.

Figure 3.4: SADC average fiscal deficit, 1995-2005



[Source: SADC, 2007]

Figure 3.4 above shows the performance of SADC member states with regard to fiscal deficits. There is some volatility in budget balance, especially with Botswana and Lesotho, but generally fiscal deficits are consistently low in the range of 0-5 per cent of GDP, with some budget surpluses, with the exception of Swaziland (out) and the DRC (in).

The High Deficit was demonstrated by Madagascar and Zimbabwe. Notwithstanding the general improvement in fiscal positions, many countries remain highly dependent upon donor grants to fund public spending, especially development (investment) spending (notably Madagascar, the DRC, Tanzania, Mozambique, Zambia and Malawi).

For this reason fiscal sustainability in these countries is, in the short-to-medium term at least, dependent upon continued access to donor funds, the availability of which is in some respects beyond the control of the recipient countries. There is also a wide variation across SADC states in the ability to raise domestic revenues,

with total fiscal receipts (including grants) ranging from 17 to 50 percent of GDP in 2005.

This reflects a number of factors, including economic structures (mineral economies tend to have higher revenue/GDP ratios due to the nature of minerals taxation), policy choices (some countries may choose a low tax regime in order to attract investment) and the efficiency of revenue collection systems.

Table 3.7: Government expenditure as percentage of GDP in SADC, 1997-2007

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006	2007
Angola	58.3	46.5	43.9	38.5	33.3	37.3	37.5
Botswana	37.6	40.4	39.3	37.5	33.7	36.8	38.1
Comoros	21.4	24.1	21.5	20.1	19.9	21.8	24.1
DRC	34.1	35.5	29.3	28.6	23.7	26.5	31.2
Lesotho	49.6	49.5	44.3	43.2	50.2	44.6	45.5
Madagascar	18.4	16.4	20.2	26.0	21.0	22.3	20.9
Malawi	29.1	35.1	39.3	44.0	43.1	43.2	41.4
Mauritius	24.6	24.6	26.6	25.6	25.1	25.5	23.8
Mozambique	25.8	30.0	26.5	24.4	22.6	27.1	31.4
Namibia	35.8	34.2	35.9	34.7	34.1	35.1	37.4
Seychelles	54.2	57.5	46.6	50.7	49.2	61.4	50.1
South Africa	25.9	24.5	25.2	25.7	26.2	26.4	27.2
Swaziland	30.1	32.0	29.9	36.1	34.7	35.7	38.3
Tanzania	15.6	16.1	18.6	20.4	22.9	24.2	26.6
Zambia	29.6	31.3	30.9	26.6	25.7	22.8	24.4
Zimbabwe	34.7	20.7	25.3	41.5	49.6	53.5	66.6

[Source: IMF, 2007]

3.2.6 Degree of openness on current and capital account

There is great evidence that the region is not growing as it should because most of the regional countries are operating as closed economies with few levels of exports only few countries having a high degree of openness.

The more open the region is, the greater the region's trade output which will enhance financial sector development which will promote trade finance, investments flows, financial liberalisation and efficient regional financial integration.

The picture on the openness of capital account is misleading, because most countries in the region do not have active lending through commercial lending with the exception of South Africa and Botswana. As a result the inflows and outflows of donors and concessional capital make changes on the capital account (Economic Integration in Southern Africa, 1999).

The current account in most member countries in the region is also less open, with the exception of SACU member countries. Almost all the Southern African region countries have very low level of international reserves and this can also be illustrated by Table 3.8, which shows that there is insufficient finance to support short-term costs in enhancing investment and economic growth.

Table 3.8: Foreign exchange reserves as percentage of GDP in SADC, 1997-2007

COUNTRY	1997 - 2001	2002	2003	2004	2005	2006	2007
Angola	1.3	0.6	0.9	1.6	2.4	3.9	3.0
Botswana	30.7	30.3	23.0	18.4	20.9	21.0	23.5
Comoros	7.3	12.4	10.9	10.5	7.7	7.3	6.8
DRC	0.7	0.7	0.2	0.6	2.9	2.5	2.7
Lesotho	7.0	5.6	4.9	4.3	4.4	5.8	6.6
Madagascar	2.6	4.2	2.8	2.9	2.9	4.0	4.1
Malawi	3.7	2.0	1.7	1.5	1.4	2.1	3.1
Mauritius	3.3	5.6	6.4	5.9	4.2	3.5	2.8
Mozambique	6.0	4.9	5.3	5.9	4.5	4.5	3.8
Namibia	1.7	2.6	2.0	1.6	1.4	1.9	1.9
Seychelles	0.8	1.4	1.4	0.6	0.7	1.3	0.8
South Africa	2.1	2.3	1.9	2.7	3.3	3.3	3.2
Swaziland	3.0	2.9	2.2	1.9	1.3	2.0	2.3
Tanzania	4.6	8.3	10.1	9.3	6.4	5.3	4.5
Zambia	1.3	4.1	1.7	1.7	2.5	3.0	3.2
Zimbabwe	0.9	0.5	0.5	0.5	0.6	0.8	0.9

[Source: IMF, 2007]

Table 3.8 illustrates the level of reserves for each country expressed as months of imports. Generally all the countries have a weak reserve position with the exception of Botswana.

The countries share the same problem in the region, and this creates a barrier for financial integration because of the lack of reserves which translates into a lack of

linkage between regional economies with international open economy in a form trade and capital flow. Much cohesion and coordination in the regional financial sector needs to be done to improve the position of the region.

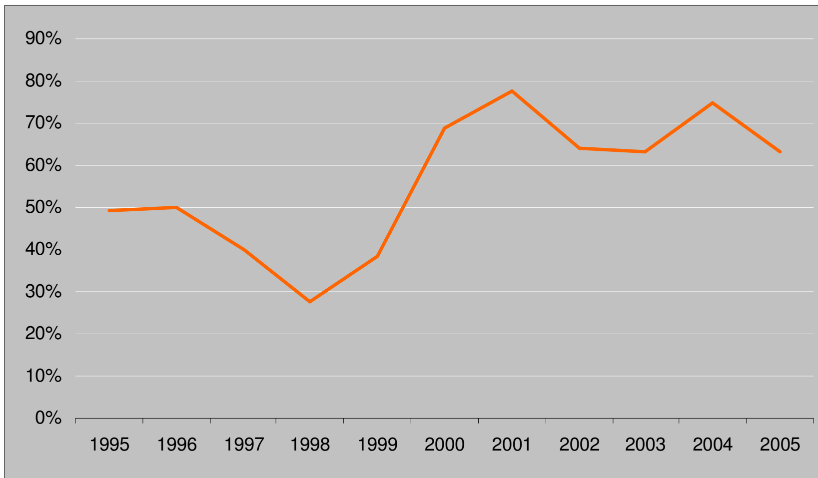
3.2.7 Level of indebtedness

The external debt situation is not positive for the region but there has been some improvement as compared to other regions. Some countries have external debt much higher than their GNP and only few countries have an external debt level of less 50 per cent of the GNP.

Botswana and Namibia have a national debt of 60 per cent of GNP and South Africa and Botswana have a lower external debt percentage of 10 per cent GNP. South Africa and Lesotho are the only two countries with external debt of less than 50 per cent of their GNP. However, Angola, the DRC and Zimbabwe are the worst performers in terms of indebtedness.

For the southern African region to succeed in terms of regional financial integration, the debt situation needs to be improved because it is also a critical macro economic convergence criterion for a monetary union for the region.

Figure 3.5: SADC average public debt, 1995-2005

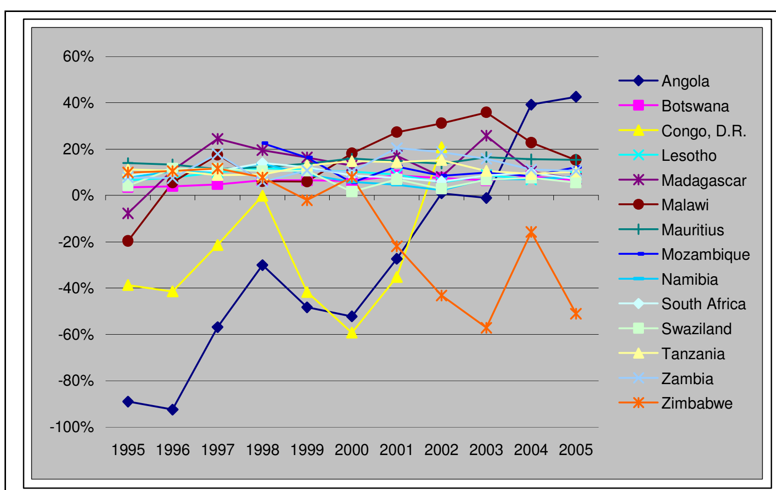


[Source: SADC, 2007]

3.2.8 Level of real interest rates

The other important macro economic parameter for regional financial integration is the level of real interest rates in the region. There is a wide spread of differences of interest rates and this arises from their inflation rate differentials.

Figure 3.6: SADC average interest rates, 1995-2005



[Source: Jefferis, 2007]

The macro economic framework is very critical and fundamental for regional economic and financial integration. However, on the one hand, the integration pace is subject to other factors, like political commitment and global developments.

Based on the broad macro economic analysis the conclusion that emerges is that there is extreme macro economic diversity, which prohibits convergence which will require substantial progression on various economic issues for regional financial integration to be realised in the foreseeable future.

3.3 The concept of regional financial integration

This concept of regional financial integration is closely related to economic integration. Apart from economic integration, other types of integration have been identified namely the preferential trade area, free trade area, custom union, common market, economic union and total economic integration. This section discusses regional financial integration as espoused mainly by Mongelli (2002:22).

As the scope of objectives for integration broadens, they also tend to include capital, financial, banking, fiscal and monetary issues, which give rise to financial integration or monetary integration. Theoretically a complete financial integration will be experienced in common markets or economic unions and total economic integration, such as the European Monetary Union.

In definition financial integration is a situation where there are open or competitive capital markets with the elimination of barriers to capital movements and a resultant gain on saving and investment. This could be categorised further into regional financial integration and international financial integration.

In many theoretical accounts, financial integration is defined and measured by applying the law of one price. Markets are well integrated when the price is the same in the whole market, which could be defined as a region.

The degree and depth of regional financial integration is weighted from diverse complementary angles which include the intensity of cross border financial flows, law of one price and also similarity in financial institutions, markets and financial system.

i. **Cross border financial flows**

Very importantly, financial integration should also illustrate a significant level of cross border financial and capital flows in the whole region. This capital and financial flow should be spread across the whole region.

The other important component for cross border financial flows is interstate risk sharing in the region. This allows risk sharing across the region which could result in the form of any capital of financial shock.

ii. Law of one price (Arbitrage test)

Concerning the arbitrage test, there is a clear theoretical understanding that financial integration could be assessed in terms of the law of one price which implies that financial and capital markets across the region are integrated if there are less arbitrage opportunities and less interest rate differential in the region.

Money markets across the euro area integrated very rapidly, after the introduction of the single currency and yield differentials among euro area government bonds have converged markedly (Mongelli, 2002: 20).

iii. Similarity in financial structures

Financial integration is also based on the extent of similarity or sharing of financial structure markets and systems. This also includes similarity or convergence on interest rates, instruments, transaction costs, legal structure, regulation, bank lending and other forms of markets.

Regional financial integration should encompass all other financial components, which will lead to convergence and less differentials in the region. The scope of regional financial integration should include fiscal, monetary and exchange rate policy and most importantly all aspects relating to banking, money and capital market, insurance equity market, regulatory, clearance and settlement issues (Irving, 2005:8).

3.3.1 Regional financial integration and capital mobility in the southern African Region

Capital flows in the emerging economies and under-developed economies has been a fundamental constraint for the economic development and economic growth for most of these countries. The OECD and other first world countries were the largest recipients of capital flows whereas Africa only benefited in the form of an aid fund.

The recent surge in global minute capital flows to developing economies has largely by-passed southern African and sub-Saharan Africa with the exclusion of South Africa. The region as a whole is not receiving as great a share and also the quality and type of capital flows are not derisible for economic development (Pigato, 2001:4).

There are constraining factors which deny southern Africa foreign capital flows which will be discussed in depth in the next section of this chapter. Regional financial integration constitutes a significant contribution for a wider influx of capital flows and for the development of the southern African region that will enhance economic growth for all the member countries.

3.3.2 Resurgence of capital flows in southern Africa

As a result of significant changes in political and macro economic management, developing countries are in upsurge for private capital flows of all kinds. Structural changes in the global and regional arena are the underlying influence of capital flows to the developing countries and southern African region.

The dynamic changes occurring at an international level are directing the progressive movement of capital flows to cross-border investment opportunities, which lead to regional and global financial integration.

The resurgence of capital flows in southern Africa is in particular borne by other factors such as deregulation and breakdown of barriers, technological change, and financial innovation which will enhance regional financial integration. Regional financial integration in southern Africa is expected to broaden and deepen over the next decade with an overwhelming inflow of net private capital flows because investment risks are declining, rates of return are improving and there is some efficiency in macro economic management in the region.

3.3.3 The structure of capital flows in southern Africa

The aggregate trend in private capital flows in southern Africa is also indicative of the difference and size in trends for different types of capital flows. An extensive analysis of these different types of flows portrays a comprehensive outlook into the factors that constrain massive private capital inflows in the southern region of

Africa. For many years after World War II, official capital flows and foreign direct investments were the only source of foreign capital available to developing countries (Pigato, 2001:2).

The composition and structure of private capital flows in the developing and emerging economics have changed quite significantly. The structure and composition of capital flows in the region will be weighed based on the four main categories of financial resources outlined by the World Bank.

- ❖ Net transfers of long-term debt or net long-term lending, are the net flows of debt disbursements with a maturity of more than one year, minus principal repayment.

- ❖ Foreign Direct Investment (FDI), defined as investment that is made to acquire a lasting management interest (normally 10 percent of voting stock) in an enterprise operating in a country other than that of the investor, the investor's purpose being to have an effective voice in the management of the enterprise.
- ❖ Portfolio equity flows which are the sum of country funds, depository receipts and direct purchases of shares by foreign investors.
- ❖ Grants are defined as legally binding commitments that obligate a specific value of funds available for disbursements for which no repayment is required (Brink, 2000:140).

3.3.4 Net transfers of long-term debt

The region has shown a low level of capital flows in the form of net transfers of long-term debt. There are underlying factors which constitute the inability to attack this type of capital flow. Unlike other developing regions, long term debts have remained either negative or very low for southern African countries. The underlying factor is that the region's creditworthiness ratings are very low because

of political risk, weak growth, poor macro economic performance and high levels of indebtedness.

3.3.5 Foreign direct investment

Despite all the negative factors constraining FDI, there have been modest improvements in the southern region of Africa and the continent as a whole. Total FDI flow grew from 4.5 billion US $ from 1990 to 8 billion US $ at the end of 1999. This reflects an increase of 44 percent of FDI, of which the southern Africa region is allocated an increase of 5 percent.

Despite all the constraints, most countries received a very modest amount of FDI, because countries in the region have addressed these weaknesses. For instance, in several countries we have experienced an end to civil instability, especially in Angola, the DRC, Mozambique, and Namibia with the exception of Zimbabwe and Swaziland which are experiencing civil conflict because of the monarchy rule structure. Similarly, all countries that improved their political and macro economic instability have enjoyed some progress in attracting model rate influx of capital flows (Africa Institute of South Africa: Africa at a Glance: Facts and Figures, 2003).

3.3.6 Portfolio equity flows

Africa is experiencing a relatively low level of portfolio investment flows as compared to other emerging economies around the world, with very small progressive signs of growing investor interest. The growing portfolio equity flows will usher more economic benefits into the region in the form of liquidity, incentives for privatisation and improvement of the financial infrastructure.

3.3.7 Grants

Apart from SACU countries, with the exception of Lesotho, the southern African region is excessively dependent on concessional resources such as grants or bilateral and multilateral credits for its external financing.

Generally, most of the countries in the region rely on bilateral or multilateral grants for external financing especially in financing economic development, for trade finance and imports.

Table 3.9: Grants received by SADC, 1997-2007

COUNTRY	1997-2001	2002	2003	2004	2005	2006	2007
Angola	1.2	0.3	0.7	0.0	0.1	0.1	0.0
Botswana	4.0	3.6	3.5	5.4	5.2	6.4	5.6
Comoros	3.3	2.1	0.6	1.3	1.9	3.6	3.3
DRC	0.3	0.2	0.2	0.0	0.0	0.0	0.0
Lesotho	16.8	16.9	15.4	19.4	20.2	24.2	20.0
Madagascar	1.0	0.2	2.6	3.8	1.3	1.2	0.8
Malawi	7.0	12.2	9.3	11.2	13.6	14.6	16.1
Mauritius	0.1	0.0	0.5	0.4	0.2	0.2	0.3
Mozambique	6.5	3.7	4.9	5.5	5.3	5.9	9.1
Namibia	11.6	8.5	9.8	11.5	10.7	13.9	16.3
Seychelles	2.0	1.8	1.5	2.0	1.6	-1.3	3.5
South Africa	-0.6	-0.5	-0.6	-0.8	-0.8	-1.0	-1.2
Swaziland	8.9	8.4	7.6	8.9	7.4	11.4	12.3
Tanzania	5.0	2.5	3.5	3.6	4.6	3.9	3.9
Zambia	1.8	2.5	1.5	0.4	1.8	1.2	1.4

Zimbabwe	1.0	0.1	0.4	0.5	0.6	1.1	0.3

[Source: IMF, 2007]

Grants also play an important role in covering for countries' budgetary expenditure since their fiscal measures are not able to generate enough revenue. Table 3.9 illustrates the increasing dependence of concessional resource for the region. Generally most member countries are experiencing an increasing trend, with the exception of Botswana, Lesotho, and Swaziland.

On the whole the region has shown a negative picture in terms of capital flows, which is the result of wide range factors which need to be addressed in order to instil a positive investor sentiment.

The southern African region must commit itself in progressively improving the economic environment through opening their economies, deregulation, infrastructural development and increasing in economic growth in order to benefit from all types of capital flows.

The region should devise a strategy of reducing dependency on concessional foreign grants which will entail progressive fiscal measures, increases in savings, promotion of domestic investment and promotion of foreign investment in productive enterprises.

3.4 Factors influencing capital flows in southern Africa

Capital flows in Africa and emerging economies have been inadequate and this also deferred the price of financial integration in the regions. Capital flows in developing countries are now accounting for 40 percent of global FDI compared with 15 per cent in 1990, and their share of global portfolio equity flows is now almost 30 per cent compared with 2 per cent before the start of the decade (World Bank, 2004).

The southern African region has also benefited from this flow, and has received modest amounts of capital flows. This improvement in terms of capital flows influx is contributed to mainly by stable political and macro economic changes and financial reforms taking place in region.

Although there is a whole basket of factors which impact on the capital flows, the influence in capital flows influx is mainly driven by structural changes in the international financial market, structural changes in the regional financial markets, growing levels of investment, deregulation in financial markets, financial innovations, technological and infrastructural development.

3.4.1 Structural changes in the international financial markets

The structural changes in the global international financial markets are directed and influenced by the effects of globalisation. This includes the economic and political changes in the global arena.

There has been continuous liberalisation of financial markets and capital accounts transactions in both industrial and developing market economies around the world.

The financial multilateral success of the European Monetary Union also triggered certain dynamics for the international financial markets. The international financial crises also triggered some structural changes which impacted on capital flows to the developing economies. Some of the financial crises are:

i. East Asian crisis in 1997
ii. Financial crisis in USA in 1998
iii. Banking crises in Japan in 1998
iv. Asset price shock in USA in 2000

v. Banking crises in Turkey in 2001
vi. Debt crises in 2001

The structural changes in the global financial scene have improved the upsurge for more capital flows and broadened the composition to developing countries and the southern African region. Consequently regional financial integration in southern Africa is expected to deepen and broaden over the coming decade and this will give a foundation to global financial integration.

3.4.2 Domestic and regional changes in southern Africa

The political and macro economic stability is growing among the member countries in the region, with the exception of Zimbabwe. This has also led to a change in perception for institutional investors to invest in the region. Notwithstanding the risks of investing in the region being high, the political and economic reforms have led to improvements to the region's creditworthiness, decline in investment risk and higher expected rates of return.

The improved economic performance of many emerging market countries played a key role in enhancing their access to international financial markets. In addition, the privatisation they have undertaken and more generally, the opening of their economies to international trade and capital flows, have also contributed to their greater access to capital markets.

Domestically and regional capital flows in the region are directly and indirectly being affected by structural change in the form of opening markets, minimal regulation, infrastructure and other macro economic factors which create incentives for international investors to invest in southern Africa.

3.4.3 Growing investment opportunities

Although the risks of investing in emerging markets remain relatively high, investors have begun to respond to the relatively higher expected rates of return in southern Africa, based on the progressive decline in risks resulting from improvements in political and macro economic policy reforms. The second factor behind the growing investment in the region is the investor's incentive and desire for portfolio risk diversification.

3.4.4 Deregulation in the financial sector

Deregulation and liberalisation of the financial service sector around the world has also opportuned a flow of capital to emerging economies in our region. Globalisation has contributed to the general abolishment of restrictions of capital accounts and also capital flows in the form of exchange controls. Regional initiatives, in deregulating our financial markets, have facilitated the increase in capital flows in our region.

3.4.5 Financial innovation

New instruments and market developments in the region, have also contributed to the increase in capital flows. Most African countries have always been behind, regarding financial developments. Regional cooperation is supporting the development of new financial instruments, activities, systems and market structures in line with international financial innovations. This could include option, treasury instruments and new markets and indexes. The innovation is relatively slow in the region, but is mainly driven by information from financial houses exploring business opportunities in the region and also cross border investments by South African financial institutions in Africa.

3.4.6 Technological and infrastructural development and advances

Technological and infrastructural development is crucial for positive investment, and influx of capital flows in Africa and the southern sub-region. Although progress in terms of technology and infrastructural development is mainly visible is South Africa, gradual development is influenced by the progressive cooperative projects in the financial sector though SADC, MMA and COMESA.

The most important success is the development and harmonisation of the payment, clearance and settlement system. The southern region of Africa requires technological and infrastructural developments to facilitate the influx of capital flows in the region, to facilitate regional and global financial integration. Communication and information technology can help southern African countries to lower costs and increase productivity. The rising use of cell phones, for example, facilitates access to financial services and the deepening of financial markets. While access to these technologies in the region is still below the world average, the region is slowly catching up (Amponsah, 2001:14).

CHAPTER 4: THE CONSTRAINTS, COSTS AND BENEFITS OF REGIONAL FINANCIAL INTEGRATION IN SOUTHERN AFRICA

4.1 Introduction

The effect of globalisation on the world financial system is evident and poses a challenge to most emerging African economies and regions. Globalisation has been a key underlying factor for the upsurge and increase in integration of financial markets at regional and international level.

Many developing countries around the world are also positioning themselves by dismantling restrictions, deregulating their markets and improving the macro economic and political environments by increasing the degree of financial integration.

The potential for achieving the substantial benefits of regional financial integration is unlikely to be realised if all the barriers for integration in southern Africa are not reduced. This chapter will focus on the constraints, costs and benefits associated with financial integration in southern Africa. It looks at all domestic and international constraints, costs and benefits for the region and finally the degree or measurement of regional financial integration is also discussed (Mongelli, 2002:33).

The recent surge and pace of regional financial integration in southern Africa has been curtailed by a number of factors. The constraints are the underlying factors for poor financial market development, capital flows and most importantly for poor regional financial integration. These barriers have been classified into two main categories by nature, which are domestic or regional and international constraints.

These factors together had made it difficult for the region to develop progressively in terms of financial integration, with the exception of South Africa, Botswana and Mauritius.

The main factors constraining financial integration in the region are the political and macro economic environment which could be simplified into political instability, lack of market openness, regulation and liberalisation of markets, infrastructure, economies of scale, low economic growth, slow privatisation, low reserves, low investments, capital flows and poor macro economic performance in terms of inflation, public deficits, public debt, balance of payments and exchange rates.

With many Asian and Latin American countries growing rapidly and moving far ahead of most African countries in terms of putting in place the financial infrastructure needed to enhance regional financial integration, most African regions and most importantly the southern African region, will have to undertake speedy financial sector policy and structural reforms to foster sound regional financial integration.

Some benefits associated with regional financial integration

There are many countries in the world, especially in Africa, the Caribbean and the Pacific, which are too small to justify having their own markets with all the paraphernalia of support facilities as well as the liquidity, width and depth that financial markets need in order to function properly (Teunissen, 1998:94).

The need for and benefit of regional financial integration is paramount because regional capital, banking and financial markets would make the region more competitive, efficient and cost-effective than any singular national financial market, in the financial global arena.

The possible benefits of regional financial integration are twofold, firstly in the form of real economic growth and secondly in the diversification of capital and asset markets, which would reduce the risks and costs of investment. Apart from boosting growth with increased opportunities for risk diversification, financial integration could bring gains in the form of investment, which would increase growth and more capital flow that will afford the southern African region more economic muscle to compete in the global financial markets.

The risks of regional financial integration

Financial markets and private capital flows are becoming intra regionally concentrated, particularly in Europe, East Asia and more recently, increasingly in Latin America. Furthermore, as Africa is still in its infancy in financial integration, much attention has to be paid to dealing efficiently with macro economic and financial issues in order to prevent or contain currency and capital market crises in the region.

Sound and stable financial integration is needed to avoid any contagion effects, and the real economic and financial costs that might have negative spill over effects on the southern African region. The degree of risk associated with regional financial integration would depend mainly on the strength of macro economic policies, the soundness of the banking sector and the strength of institutional arrangements in the region.

The main, profound risks of regional financial integration, according to Coleman (1999:9) could be in the form of serious adverse private capital flow reversals which could be attributed to international investors becoming more discerning about the region and by the authorities' attempts to restrict capital flight by exerting more controls leading to the loss of investor confidence.

The other important risk (Mills, 1998:25) is the greater volatility which could be experienced by the national economy emanating from the other regional member

countries. Financial integration could therefore magnify shock or the costs of policy mistakes and lead to greater instability in the region.

Proper planning and coordination by means of a regional institutional policy framework is unavoidable, because most of the member countries of the southern African region lack a strong macro economic banking sector, and institutional underpinnings to contain vulnerability or potential instability and reversals of private capital flows.

The failures in financial regional integration have a damaging long term regional effect in terms of regional trade and investment interests, according to Teunissen (1998:87).

Constraints on regional financial integration in southern Africa

Most African and developing economies still lag behind in the establishment of the rigorous preconditions needed for successful regional financial integration. A number of factors are seen as constraints to financial integration, ranging from political instability to poor micro-and macro economic fundamentals.

First generation regional integration arrangements among developing countries failed to raise efficiency because of relatively low demand elasticity, relatively large differences in production costs and income levels, divergent rates of industrial development, low levels of infrastructural integration or intra regional trade, non-complementary production resources and divergent macro economic factors (Teunissen, 1998:87).

Teunissen (1998) lists other important impediments such as shaky banking systems, poor financial infrastructure, undeveloped financial markets, a weak regulatory framework, poor human capital, slow privatisation and corruption. Macro economic factors could be the broad policy issues such as the exchange

rate, monetary issues, fiscal issues and trade, which could pose problems for efficient financial integration if they are not properly managed.

Overcoming the constraints to financial regional integration in southern Africa

With the emergence of capital markets developing into continental blocks in Europe, America and Asia, it is most likely that the future relationship between African countries and these blocks would be based largely on commercial and economic competitiveness. It is important therefore that Africa should consider that the most important response would be an effective mobilisation of Africa's own regional and sub regional economic and financial integration to achieve rapid structural transformation and high levels of productivity and competitiveness.

In Africa, regional financial integration is the only viable strategy for the optimal development of all the countries of the continent as well as in the world as a whole (Asante, 1997:32). The African continent is encountering various obstacles that erode the integration process of smaller nations into sub regional blocks.

Integration effects could be achieved if policy harmonisation and coordination were properly managed. These also include transforming and aligning the existing integration units, such as COMESA and SADC. Regional infrastructural cooperation should be promoted to enhance productivity and growth. The development of commodity markets and capital markets is very important for regional consumption and investment respectively. This has to be supported by a good regional banking and financial system. Financial integration in developing countries could be improved by efficient macro economic management. Continued good performance in this area would be crucial for the southern African region to retain strong integration and interdependency with world capital markets (Hansohm, 2002:4).

Institutional integration arrangements have to be reinforced in order to overcome the difficulties of financial integration. A strong supra national institution would

allow the implementation and monitoring of integration. This would in fact sanction authority on compliance with policies and non-implementation of treaties by regional member countries. Political commitment is important by member countries and this would allow them to implement treaty provisions (Bourenanc et. Al., 1992:174).

Proper integration strategies should be implemented to overcome constraints to realising the benefits of regional financial integration. The achievement of regional financial integration would drive medium and long-term development strategies consistent with increasing the participation of the southern Africa region in the world economy.

4.2 Regional constraints to financial integration in southern Africa

The economic health of the southern African region has been troubled with a significant number of illnesses and has been marked by short-lived recoveries, and to some extent this has constrained the region in its efforts for regional financial integration.

The regions' member countries have, in the past few decades, moved from stagnation to declining economic growth with inflation reaching triple and double digit levels. Poor performance in terms of public debt, public deficits and most importantly adverse situation on balance of payment accounts are common.

The sub regional efforts through PTA / COMESA, SACU, MMA and SADC have done a sterling job in responding to the challenges of regional financial integration and have given rise to some development strategies to overcome these regional constraints.

Notwithstanding the robust positive performance of South Africa, Botswana, Mauritius and the other member countries of MMA, Lesotho, Namibia and Swaziland, also responded positively to the challenges facing the region.

The fundamental barriers in the region for financial integration (Pigato, 2001:4) are outlined, as:

- Macro economic instability
- Poor political environment
- Closed market structures
- Poor agricultural development
- Over regulation of markets
- Slow privatisation pace
- High country risk rating for member countries
- Dependence on donor funds as a source of capital flow
- Lack of financial innovation
- Technological development
- Exchange rate risk
- Non- convertibility of currencies.

4.2.1 International constraints to regional financial integration

Recent developments in the international arena indicate that the new world order revolves around the theme of globalisation and calls for emerging economies and the southern African region to pull nations together politically and economically by positioning themselves for the pressures and globalisation problems which might be prohibitive to regional development. The southern African region has to commit itself collectively by enhancing regional financial integration arrangements, which would result in a regional economic block with a common currency.

Despite the surge in regional economic cooperation and integration, the region is confronted with a whole basket of international constraints, which creates structural problems impacting on the pursuit of regional financial integration. The most important international factors which constrain regional financial integration (Pigato, 2001:6) are:

- Financial crises
- Liberalisation of financial markets and capital accounts
- International political instability
- Investors' perception about Africa and the region
- Risk profile
- Financial innovation
- Capital flows
- Less international financial integration.

In summary, the international structural changes are impediments for regional financial integration in southern Africa. Although less progress has been made, much more concerted efforts need to be instilled to transcend the region into a sound financial integrated block like the Euro. This will enhance access to international financial markets by southern Africa as a unit.

4.3 The costs for regional financial integration in southern Africa

The arrival of EMU has sparked a new wave of interest in cooperation and integration in the continent of Africa. The increase in regional financial integration attempts is indicative of some positive prospects towards the formation of an African Economic Union.

As a result, financial integration is perceived as an appropriate vehicle for sound regional economic development, which could advance to a full economic integration for the continent. Regional financial integration could contribute as a

building block towards a continental, African Economic Union. The study has identified a number of costs which needs to be sacrificed in netting the benefits of regional financial integration and resulting in a formidable regional economic integrated block. These costs are discussed in depth in this chapter.

The costs of attaining regional financial integration in southern Africa cannot be ignored and are taken into consideration in the development of regional economic integration.

Regional financial integration involves some costs especially during the various formation phases and these factors force member countries to take proactive initiatives by adopting strategies which would maximise benefits and reduce costs.

4.3.1 Macro economic instability

The size of the integrated financial markets will increase costs in terms of controlling or aligning the macro economic benchmarks of inflation, economic growth, deficits, public debt, interest rates and the balance of payments, unless some market control measures are marshalled uniformly in the whole region. This could be done through a supranational institution or through a country agency in scaling down asymmetric disturbances in the region.

Regional financial integration could also result in transferring the responsibility for setting monetary policy, exchange rates and national accounts to some agency. This implies that the domestic monetary authorities loses control of macro economic issuing, affecting the national economy which can also create some macro economic instability.

4.3.2 Volatility and capital flows

Despite the large potential benefits, there is widespread concern among policymakers that growing financial integration and increased reliance on capital flows might render emerging markets more susceptible to volatility, including large reversals in capital flows (World Bank, 2004).

Regional financial integration also brings about costs in the form of volatility and capital flows because of the financial market risks shared by the region. Dominant economies like South Africa, Botswana and Mauritius will lose their financial market sovereignty and also inherit the adverse credentials of other regional member countries like Angola, the DRC and Zimbabwe through association or affiliation.

International confidence and investor confidence may plummet and every member country would suffer in this scenario, particularly those that previously had reasonably stable economies.

Capital flow reversals could also be experienced during the various phases of regional financial integration. Although there has been some improvement in terms of capital flows in the region this could be reversed in the short-term. Regional financial integration can give rise to greater volatility through new sources of shocks in the regional economy. It could also magnify the effects of domestic shocks.

The main international sources of volatility are changes in asset return and contagion effects, whereas on the domestic side the volatility is generated mainly from real and policy shocks. Regional financial integration can enlarge the size or the costs of policy mistakes, leading to greater instability for the southern African region as a whole. The southern African region must progress vigorously in

establishing stable macro economic conditions that will attract more capital flow and reduce the risks associated with volatility and large reversals.

4.3.3 Regional financial contagion

The other important cost related to regional financial integration in southern Africa is referred to regional contagion. Regional financial contagion occurs when an economic or financial shock occurs in one country in the region and has spill over effects to the other regional member countries because all the countries share similar regional economic fundamentals or are exposed to common external shocks.

Regional financial contagion will affect all the regional countries because the shocks will be transmitted through trade or financial channels since all the member countries in the region share similar fundamental economic conditions and policies.

Experience suggests that such contagion will be either short-lived or lasting depending on the reaction and intervention of the regional economic authorities and the possible change in investor sentiment in revaluating the whole regional economic outlook and performance.

Financial contagion may occur when a country suffers massive capital outflows triggered by a perceived increase in country risk by international investors. This brings forth vulnerability of a country's currency, or more generally, a loss of confidence in the country's economic prospects, as a result of developments elsewhere in the region (Agenor, 2001:16).

4.3.4 Increase in depth of systemic risk

The banking and financial system plays an important role in the process of regional financial integration and is one of the main channels through which the benefits of financial integration materialise. Banks are dominant pillars in financial intermediation in developing countries and therefore they influence intermediation of a large proportion of private capital flows directly or indirectly. The transition towards greater financial integration also involves risks for the regional economy in general in southern Africa.

The southern African regional banking sector will be adversely affected by increased macro economic volatility and by structural changes in the banking system, resulting from competition and exposure to new sources of risk.

The process of regional financial integration will expand and increase the size and nature of the systemic risk which could result in serious financial distress and crises in the southern African region. Prudent bank regulation and supervision should be centred on proactively. Capital adequacy, supervision and recapitalisation, which are outlined in the Basle II. Systemic risks will pace itself with the speed of financial integration in the region.

Regional financial integration exposes the domestic country to more sources of external disturbances and increases the speed at which the shocks are transmitted across the whole regional banking sector. The activities and associated risks in the region create an increase in the depth of the systemic risk in southern Africa.

National or regional regulatory authorities must proactively reduce all these risks and challenges which pose a threat to a regional banking sector to be exposed to greater depth of systemic risks. Regional regulators must also cooperate with

international regulators and other regulatory agencies in an endeavour to reduce the transaction costs and systemic risks and to promote regulatory convergence.

According to Borio (2003), there are two commonly held views of systemic risk. The first prospective systemic risk arises from widespread financial distress developing primarily from the failure of individual institutions, spreading though a variety of contagion mechanisms and affecting the whole financial system more generally.

The second view point on systemic risk is seen as vulnerability of the financial system with an uprising of a sudden shock, which is amplified by the endogenous response of market participants precipitated mainly by structurally illiquid portfolios, liquid liabilities and the threat of deposit runs (Borio, 2003:5).

4.3.5 Loss of national financial sovereignty

Regional financial integration is also normally characterised with a loss of national financial sovereignty. Generally, in the build up process of regional financial integration, national financial sovereignty is transferred to some agency or supranational body, but by the same token the poor financial countries will benefit by inheriting the new regional financial status, which is highly dependant on the success of the various phases of integration.

These countries, like Angola, the DRC, and Zimbabwe will also inherit credibility from other financially credible countries like South Africa or from the new regional financial integration scheme. The financial sovereignty includes a number of financial aspects; *inter alia*, convertibility of currency, the structure of the various financial markets, exchange rate policy, tax systems, bond market rating and monetary policy strength.

Even during the formation of the European Monetary System, some countries, for example Germany, lost status as one of the leading financial powerhouses to a trade-off for a supra regional financial sovereignty. By the same token, countries that performed well in the financial sector would also forsake that national financial sovereignty in the wake of financial integration. South Africa, which acted as the model in the southern African region on various multilateral arrangements like MMA, is a likely candidate for such a trade-off.

4.4 The benefits of regional financial integration in southern Africa

This section focuses on the long term benefits derived from a well-managed regional financial integration; with the emphasis on the best-case scenario. Generally speaking the virtues of regional financial integration include a wide range of macro economic and financial benefits, which are sometimes difficult to distinguish because of their interrelatedness.

On the macro economic level, the benefits of regional financial integration are summarised as benefits arising from trade, production and consumption, growth, transfer of technology and managerial know-how.

The other benefits arising from regional integration are closely associated with the financial sector, and include increases in investment, savings, enhanced financial systems and financial sector development, competition, mobilisation of financial resources; currency convertibility, reductions in transaction costs, risk diversification and price stability, increases in savings and investment, financial system efficiency and stability and mobilisation of financial resources.

4.4.1 The macro economic benefits of regional financial integration

The macro economic benefits of regional financial integration will be discussed against the macro economic virtues, which will deliberately result in macro economic stability and economic growth and development for the region as a whole.

Fundamentally, these benefits include the following macro economic variables; trade, production, consumption, economic growth and transfer of technology and managerial skills.

4.4.1.1 An increase in trade

Regional financial integration enhances gain in terms of an increase in trade, be it at a cross-border level or at an international level. At the regional level intra regional trade will expand because of the free flow of goods and services resulting from a total removal of tariff and non-tariff barriers for a regional trading block. Greater intra regional trade will occur, because of sector cooperation in the region in the form of investments, infrastructural development, communication, transportation, and agriculture, industrial and mining cooperation, which will make progressive improvements in terms of production capacity. This will result in greater regional trade.

Short-run adjustments are usually less costly because the multiplier effect of the disturbances on output and the price level are smaller. With increased international trade arising from integration, the economies of participating countries become more open in terms of the share of its exports in GNP. The more open the economy, the larger the export and import elasticity and the

smaller the induced charges in domestic spending because of the leaks to the external sector when an exchange rate is fixed.

Table 4.1: Trade balance as percentage of GDP in SADC, 1997- 2007

COUNTRY	1997-2001	2002	2003	2004	2005	2006	2007
Angola	35.9	38.7	28.9	38.6	48.0	41.9	37.6
Botswana	11.8	11.9	10.8	8.5	17.3	15.2	14.5
Comoros	-15.9	-12.5	-12.4	-17.1	-20.8	-22.7	-22.4
DRC	46.6	52.0	50.2	53.3	60.2	65.6	48.0
Lesotho	-65.5	-56.4	-47.7	-44.2	-40.1	-36.5	-39.8
Madagascar	-3.2	-2.6	-3.5	-10.1	-11.3	-8.8	-8.1
Malawi	-3.7	-14.7	-14.5	-16.3	-27.2	-19.0	-15.6
Mauritius	-8.3	-4.4	-5.8	-6.3	-11.3	-13.2	-15.3
Mozambique	-16.7	-17.9	-14.5	-9.0	-10.9	-6.4	-10.7
Namibia	-5.7	-6.6	-10.3	-5.1	-4.4	0.4	-0.5
Seychelles	-31.5	-20.0	-13.0	-22.2	-41.4	-35.6	-55.2
South Africa	2.8	4.3	2.1	-0.1	-0.5	-2.5	-3.0
Swaziland	-8.2	7.6	5.4	5.9	2.8	2.5	1.8
Tanzania	-8.0	-7.1	-6.3	-7.6	-9.0	-13.3	-15.0
Zambia	-5.0	-6.9	-7.0	-0.5	0.1	10.7	8.4
Zimbabwe	1.3	-0.1	-1.0	-6.5	-8.6	-0.8	0.0

[Source: IMF, 2007]

Table 4.2: Exports as percentage of GDP in SADC, 1997-2007

COUNTRY	1997-2001	2002	2003	2004	2005	2006	2007
Angola	75.2	6.3	69.6	69.7	77.7	74.1	70.1
Botswana	50.1	47.8	44.2	45.7	52.6	55.3	53.3
Comoros	15.1	15.7	15.7	12.7	12.5	11.7	12.3
DRC	76.4	81.5	79.3	84.3	86.4	91.0	77.6
Lesotho	31.1	55.3	49.6	54.3	49.3	50.6	46.0
Madagascar	25.5	16.0	23.1	32.6	26.5	27.7	26.0
Malawi	27.2	23.9	26.6	28.4	26.7	23.0	21.6
Mauritius	60.8	63.1	58.4	55.5	57.3	60.5	58.4
Mozambique	17.9	29.0	28.2	30.9	32.6	38.6	36.8
Namibia	45.4	42.9	37.2	41.0	40.9	46.6	47.4
Seychelles	71.0	77.8	95.1	97.8	98.7	115.8	137.7
South Africa	26.7	33.0	28.1	26.7	27.5	29.8	30.8
Swaziland	79.7	94.9	82.9	82.7	80.8	80.1	80.5
Tanzania	14.4	15.3	16.7	20.4	22.2	24.2	24.6
Zambia	29.0	28.6	29.0	38.2	34.3	38.4	42.3
Zimbabwe	33.5	6.5	17.6	42.6	42.7	34.5	9.9

[Source: IMF, 2007]

Table 4.3: Imports as a percentage of GDP in SADC, 1997-2007

COUNTRY	1997-2001	2002	2003	2004	2005	2006	2007
Angola	74.1	62.2	63.1	53.7	51.7	52.5	54.4
Botswana	41.9	36.3	33.5	37.6	35.5	40.6	39.4
Comoros	35.0	30.8	31.8	32.6	34.7	37.3	38.0
DRC	57.8	53.9	53.7	57.3	50.1	45.2	48.9
Lesotho	97.7	114.7	100.8	100.7	94.9	90.6	84.4
Madagascar	32.4	22.6	32.1	47.5	40.2	39.4	37.1
Malawi	38.4	51.4	49.7	53.5	63.7	50.9	45.4
Mauritius	63.0	58.7	57.4	55.0	61.6	67.3	66.8
Mozambique	35.7	47.8	44.0	39.2	42.6	42.6	46.9
Namibia	54.2	48.1	48.1	43.8	44.5	445.2	46.5
Seychelles	84.3	84.1	84.0	95.8	125.7	136.5	176.1
South Africa	24.3	29.1	25.8	27.0	28.4	33.2	34.5
Swaziland	97.4	95.2	80.9	84.3	84.8	86.1	86.8
Tanzania	25.1	22.6	23.5	26.2	30.4	36.6	39.5
Zambia	40.0	42.0	41.5	42.6	37.4	30.2	36.8
Zimbabwe	33.8	7.2	20.7	51.3	53.7	37.0	10.2

[Source: IMF, 2007]

Table 4.4: Principal exports as percentage of total export earnings in SADC, 2001/2

Angola	Petroleum 88, diamond 12
Botswana	Diamond 79, copper/nickels
Lesotho	Manufactures 75, food 4
Malawi	Tobacco 62, textiles 10, tea 9
Mozambique	Prawn 24, electricity 23, cashew nuts 12
Namibia	Diamonds 33, fish 26, metal ore 13
South Africa	Manufactures 57, mineral / metal 30
Swaziland	Beverages 25, sugar 11, wood pulp 10
Zambia	Copper / cobalt 57, electricity 40
Zimbabwe	Tobacco 34, manufactures 32, gold 10

[Source: Africa Institute of South Africa - Africa at a Glance: Facts and figures, 2003]

Southern African regional integration will enhance intra trade in the region as indicated by the expected product output of the various member countries. Regional financial integration will enlarge and expand the domestic market and create more export and import trade with other international countries. For example, South Africa's trading partners are mainly Germany, the US, and the UK in terms of imports and exports. These markets will be exploited by other regional member countries the in event of an integrated southern African region. Already SACU and COMESA / PTA countries are enjoying the benefits of trade arising from these regional trade initiatives.

Table 4.5: SADC trading partners by share of imports and exports, 2001/2002

Country		
Angola	Imports Exports	Portugal 16, SA 10, US 10 US 49, China 14
Botswana	Imports Exports	SA 77, Switz. 7. UK 3 UK 67, Switz. 18 SA 10
Lesotho	Imports Exports	SA 90 SA 65, US 33
Malawi	Imports Exports	SA 43, Zim, 14, UK 5 SA 16, Germany 16, US 15
Mozambique	Imports Exports	SA 35, US 4, Japan 4 SA 16, Zim 15, Spain 13
Namibia	Imports Exports	SA 80 SA
South Africa	Imports Exports	Germany 15, US 14, UK 10 UK 9, Germany 7 US 7
Swaziland	Imports Exports	SA 84, EU 15 SA 65, EU 12 Mozambique 11
Zambia	Imports Exports	SA 55, Zim 9, UK 6 S. Arabia 13, Japan 10
Zimbabwe	Imports Exports	SA 41, UK 7 Germany 5 SA 13, UK 10 Germany 9

[Source: Africa Institute of South Africa - Africa at a Glance: Facts and figures, 2003]

Table 4.5 shows that the industrial countries of Europe continue to be southern Africa's main trading partner. South Africa's role in the region, especially as a supplier of trade, is evident in the sense that all member countries import from

South Africa and export to South Africa with exception of Botswana, Zimbabwe, Malawi, Swaziland, Namibia, Lesotho and Mozambique.

Regional integration will enhance, facilitate and encourage more regional sharing of trading partners as is already the case with the SACU and MMA members.

4.4.1.2 Production

On the production side, integration permits greater specialisation and allocation of production resources to their most cost effective uses independent of location, thereby improving regional sectoral cooperation. Production gains from regional financial integration occurs as a result of rationalisation of production sectors, which expands and maximises investment flows and integrates regional production to achieve economies of scale. ‘A regional market has to establish stable prices for raw materials and manufactured goods; this cannot be achieved without monetary stability and exchange rate certainty’ (Nellis, 1983:89).

4.4.1.3 Consumption

Regional financial integration will also increase and spread consumption across the region as a whole through the openness of their economies. Consumption will be enhanced by free movement of production resources, which in turn creates the free mobility of goods and services across regional borders.

OECD examines the degree of similarity in the structure of consumption across EU area countries. An index of similarity in consumption is compiled based on the correlations of various components of real consumption in each country, which shows a very high similarity in most countries except for Spain. The structure of consumption has increased in virtually all EU countries (Mongelli, 2002:22).

For this reason, regional financial integration will subject all member countries in southern Africa to similar asymmetric disturbances because the member countries' economies will converge into homogenous macro economic structures which will induce similar consumption structures in the region.

4.4.1.4 Economic growth

The most important contribution of regional financial integration is higher economic growth, which should contribute positively to the development of the southern African economy. Regional financial integration has the ability to draw upon the regional pool of resources that financial openness accentuates and turns into economic growth.

Another channel through which regional financial integration affects the rate of economic growth is through its impact on the total factor productivity. The openness of the region's economies and more liberalisation will enhance capital flow. This should lead to an increase in economic growth that tends to accentuate the development of domestic and regional equity markets. This in turn enhances factor productivity in the region.

A further growth benefit outlet would be experienced when the region has aligned the exchange rates, reducing the risks associated with currency movements. This should contribute to economic growth and help to avoid any misallocation of resources. It could also help the single market to function smoothly and benefit producers and consumers.

4.4.1.5 Transfer of technology and managerial skills

Regional financing integration has the capacity to increase capital flows, which in turn paves the way for the attainment of the mobilisation of human capital in the form of technological and managerial skills.

According to Prasad et al. (2003), southern Africa's estimate including South Africa's enrolment of engineers in 1995 was only 12 per cent, compared to 9 per cent for Korea and 22 per cent for Philippines. Asia accounts for 86 percent of RED scientists and engineers in the developing world and only 0.3 per cent of sub-Saharan Africa.

Financially integrated economies seem to attract a disproportionately large share of FDI inflows, which have the potential to generate technology spillovers and to serve as a conduit for management skills transfer, which results in an increase in productivity, in turn boosting economic growth (Prasad et al., 2003:25).

4.5 The financial sector benefits of regional financial integration

Fundamentally, regional financial integration is always associated with benefits for the financial sector's development and stability. This section summarises the discussions of the financial sector gains arising from sound regional financial integration.

The financial sector benefits associated with regional financial integration are, *inter alia*, price stability, increases in savings and investment, efficiency and financial system stability, financial sector development and enlargement, mobilisation of financial resources and finally enhancing financial sector competitiveness.

4.5.1 Price stability

An important benefit of regional financial integration is price stability, which ensures the realisation of macro economic and other financial benefits. The full benefits of regional financial integration will be realised only if appropriate stability-oriented policies are deployed in the macro economic and financial sector.

Price stability in a financially integrated region will enhance access to broader and more transparent financial markets and increase the availability of external financing, realising negative reputation gains for those members with a history of high inflation that benefit from an anti-inflationary anchor (Mongelli, 2002: 33).

Monetary policy will make its contribution towards the attainment and maintenance of price stability, while other economic policies must be implemented to ensure that the opportunities of an integrated southern Africa are fully realised.

4.5.2 Increase in savings and investment

Most developing countries and regions are under-performing with regard to the level of savings and investment; this of course contributes to various financial set backs for these economies. The southern African region suffers from an acute shortage of savings and investment which is fundamental for the development of regional financial systems and increasing the possibility of regional financial integration and linkages to global financial markets.

Chapter two of the study has exhibited the adverse reactions of low savings and investment in southern Africa. The restoration of macro economic stability throughout the region will rectify the current instability and financial distress and this will eradicate the probability of escaping the vicious cycle of low savings and investment. In a financially closed economy, investment must be funded by domestic savings. The two variables are matched by movements in the real interest rate which is the cost of borrowing and return on savings.

Financial integration, whether on the national or the international level, serves as the link between local savings and local investment, allowing savings to run as surely and instantly where it is most wanted, and where there is most to be made of it, as water runs to find its own level.

4.5.3 Efficiency and financial system stability

Regional financial integration reduces financial disturbances through the various financial and macro economic policies with the eventuality of enhancing efficiency and financial system stability in the region. The region will instil discipline in the various financial markets and other financial sectors of the region that will reduce the accentuated weaknesses and financial shocks in the southern African region.

Regional financial integration leads to a greater increase in financial openness, which contributes to efficiency and stability in the financial sector. Financial openness may increase the breadth and depth of domestic markets and lead to an increase in the degree of efficiency of the financial intermediation process, by lowering costs and excessive profits associated with monopolistic markets, thereby lowering the cost of investment and improving resource allocation (Agenor, 2001:11).

4.5.4 Financial sector development and enlargement

Financial sector development and enlargement is created automatically through regional financial integration. The region's financial markets will develop in order to attract international financial integration attempts by the rest of the world.

A deepening regional financial system in the wake of financial integration also enhances growth through the efficient allocation of resource which translates into further financial deepening. More innovation in terms of markets and financial instruments will develop, which will create access to international financial institutions.

Empirical evidence indicates that regional financial integration is strongly associated with greater financial deepening of investments and faster productivity growth as the resultant benefits.

4.5.4.1 Mobilisation of financial resources

The region's financial resources will foster and increase financial efficiency in the wake of financial integration in southern Africa. The EU can bear testimony to this fact. Various member countries' resources are under-utilised especially in terms of market and skills development. Only South Africa is regarded as the main financial sector which is integrated with the global world. Financial integration will create more opportunities for the mobilisation of financial resources in these under-developed economies of the region.

4.5.4.2 Enhancing financial sector competitiveness

Another potential source of benefit for financial integration can be found in the financial sector competitiveness of all financial markets across the region. This could result from a stable currency, reduction in transaction costs and risks, alignment of exchange rates, a common pool of foreign reserves and a sound regulatory and financial market environment.

The southern African region needs to rectify its credit rating, which is normally based on a number of factors like political risk, weak growth, export performance, macro economic instability and high levels of indebtedness.

This chapter analysed the constraints, costs and benefits of regional integration in southern Africa and recommended some measures and approaches in dealing with these barriers and costs. It also illustrated the significant benefit for the southern African region and took some evidence from the European Monetary Union.