Σrsa
Economic
Research
Southern
Africa

ERSA Research Brief
January 2017

## Financial Development and Economic Growth in SADC: Cross Country Spatial Spill-Over Effects

By Alex Bara, Gift Mugano and Pierre Le Roux

The study bridges a knowledge gap regarding the relationship between financial innovation and economic growth in SADC. The study also carries out panel Granger causality tests to evaluate empirically the direction of causality between financial innovation and economic growth in SADC. Financial innovation has, generated increased economic activity in the SADC region over the years, mainly faster and more efficient financial transfers, increasing the volume of trade and remittances, and increases access to finance for the unbanked populace. SADC countries such as Lesotho, Swaziland and Tanzania have higher mobile phone usage for payments and transactions than the financially developed countries in the region, despite the underdeveloped financial sectors.

Literature reviewed indicated that financial innovation has been an integral component of economic activity for several millennia. Innovation is a double edged-sword with a 'good' side, which includes of driving economic growth, and a 'dark' side. The right kind of innovation spurs banks to invest in new technologies that would help the financial system fulfill its intermediation role and, consequently, deliver growth. Financial innovation mobilizes financial surpluses from ultimate savers and channel them into most productive investment avenues - thereby raising the rate of capital accumulation, and hence, the rate of economic growth. Financial innovation can contribute significantly to infrastructure investment; financial inclusion, for example, mobile banking in Kenya and Philippines and mobilization of funds; - which support balanced economic growth. Financial innovation is crucial, indeed indispensable, for sustained economic growth and prosperity.

On the "dark side", financial innovation is associated with higher growth volatility among industries more dependent on external financing and on innovation. Financial innovation can introduce complexity to exploit uninformed investors and can be used as tools of economic destruction. Too much or inefficient innovation can have serious consequences for the overall economy. There is limited empirical evidence of the relationship between financial innovation and economic growth.

The study uses a reduced form of the extended Aghion, Howitt, and Mayer-Foulkes' (AHM) model developed by Laeven, Levine and Michalopoulos (2012) and ustilised the Autoregressive Distributed Lag (ARDL) model estimated using Pooled Mean Group and Dynamic Panel Fixed Estimation. Growth in Banking Sector Credit to Private Sector as a proportion of GDP and ratio of Broad Money to Narrow Money were used as proxies for financial innovations.

The empirical estimations show that financial innovation has a negative, but weak, relationship with economic growth in both the short and long run. Netting off the impact of financial development in the estimation, in line with the extended AHM model, does not have any effect in changing the relationship between financial innovation and economic growth. In addition, the panel Granger causality tests results suggest that there is no causality, in either direction, between financial innovation and economic growth in both the short and long run. The obtained results are in line with some studies and in contrast with other studies. Overall, the obtained results are not consistent with theory, a priori expectations and recent developments in the SADC countries. A number of reasons could explain the relationship:

a. There is likelihood that the underdeveloped financial sectors of SADC countries played a role in the negative impact of financial innovation on economic growth in the region.
b. Some innovations, such as mobile money, and money transfer platforms, are occurring outside the banking sector and the data on economic activity driven by such innovation is not captured under the banking sector.
c. The results could possibly be a reflection that innovations are slowly and gradually substituting and taking over the intermediation role of banks. In other words, financial innovation results in the activities of the financial sector being replaced by innovative strategies resulting in failure to explain growth.
d. Lack of data also limit the use of variables that closely reflect financial innovation, in the process affecting the results.
e. Furthermore, lack of enabling conditions may also be affecting the development of financial innovation across SADC countries.

The implication of these findings is that the on-going innovations in financial sectors of most countries are insignificant to have an impact on economic growth. Implicitly, there is potential to increase financial innovation in SADC without being constrained by the country’s growth.

Notwithstanding the results, SADC countries need to enhance development of their financial sectors in order to promote financial innovations. In framing policies, SADC governments have to balance the distinctive priorities of promoting financial sector development, financial innovation, and financial inclusion. SADC countries should promote regional financial integration in order to enhance the development of infrastructure and technology that support innovations, as individually, the countries are too small to support or attract huge investment in financial infrastructure.