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Spatial Externalities, Openness and Financial Development in SADC: Beyond the Multilateral Monetary Agreement

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Economic variables tend to exhibit variation not only over time, but also across space. Space influences the way an economic system works and is a source of economic advantages or disadvantages. Proximity brings agglomeration to industries and enhances knowledge spill-overs and transfers. In trade it promotes integration, enhances cross-border trade, reduces transport costs and reduces non-economic barriers. In development, it has a pulling effect. It is however, not clear if proximity matter in services, more so in finance and financial development. Two critical issues arise: first, whether being close to a financially developed economy is advantageous for financial sector development. Second, whether financially less developed economies realise any externalities from their proximity to, and linkages with, a financially developed economy. Given the evident discrepancy between South Africa and the rest of the countries in the region in terms of financial development, spatial theory suggests that proximity to South Africa should drive financial development in other SADC countries.

This study empirically evaluates spatial externalities in financial development in SADC, in line with spatial proximity theory, which asserts that externalities increase with proximity. Precisely, the study tests the nature of spatial externalities that comes from financial development in South Africa to their financial sectors as a result of their proximity to, and linkages with, South Africa. The study also evaluates spatial effects in SADC beyond the monetary union in the region by controlling the effects of the Multilateral Monetary Union. Furthermore, the study also evaluates whether trade and financial openness matter in enhancing spatial externalities of financial development in SADC countries.

Literature reviewed show that proximity takes many forms including spatial, cultural, organisational and vocational. Diffusion of ideas depends on physical proximity, technological specialisation, the stage of economic development, labour mobility, and other factors. Financial geography emphasises that location remains important in the conduct of financial transactions and markets. One of the salient features of a nation's financial development is its ability to generate positive spatial externality to neighbouring countries. The financial sector has a contagion effect beyond a country to other economies, in other words, geographical closeness to a more financially developed country may generate spatial externality to the neighbours. Spatial proximity and inter-connectedness of markets are the central transmission channels of the global financial crisis and financial linkages that contributed to the spread of these financial stresses across borders. Literature suggests that the financial system in Sub Saharan Africa are geographically sensitive and not immune to spatial externality.

The Spatial Durbin Model estimated using GMM and Dynamic Panel Estimations, establishes that there is a spatial externality effect on financial development in the region where in spatial externality among the countries are either positive or negative. Financial development in South Africa is responsive to spatiality although the responsiveness vary with the specific aspect of financial development. Precisely, proximity to South Africa brings spatial externalities which crowds out domestic credit but are positive in the money markets. Implicitly, the spatial variable has a substitution effect in the local credit market and a complementary effect in the money market.

Estimations that controlled for effects of monetary union also confirms that financial development is affected by spatiality in the money market and is not responsive to spatial effects in credit. In other words, beyond the monetary union, South Africa's credit is consistently not affected by spatial externalities, implying that countries in the monetary union are too small to induce spatial effects on credit. In addition, the money market in South Africa is affected by spatial externalities even beyond the monetary area, indicative of 'centripetal' force of money and money markets in South Africa.

Furthermore, findings also indicate that financial openness offers greater scope for advancing financial development than trade openness in the SADC region. In SADC, financial openness is a necessary condition for financial development.

The findings points that SADC countries needs to extensively develop their financial sectors in order to counter the crowding-out effects of credit from South Africa. Implicitly there is more scope and potential for SADC countries to utilise financial development in South Africa to enhance development of their financial sectors through the money markets. Inevitably, financial integration in SADC could be of benefit to small countries as they can have increased access to South Africa's financial sector. Furthermore, countries close to South Africa needs to have in place mechanisms of linking their monetary sectors with that of South Africa to benefit from positive spillovers. In the same vein, neighbouring countries also need to have in place mechanisms of dealing with vulnerabilities that could emanate from South Africa's monetary sector since they are equally exposed to any negative spatial externalities.

Lessons for the South African Economy:

- a. South Africa's credit can easily replace domestic credit of neighbouring countries reflective of high preference of South Africa's credit. In that case, South Africa has an avenue to further develop and expand its financial sector by extending credit in deficient areas in the region.
- b. South Africa needs the region especially neighbouring countries to strengthen its currency.
- c. South Africa remains a dominant economic in the region and has opportunity of expanding its own credit market by developing credit market for other SADC countries.
- d. Financial integration is important for the SADC region, but more importantly for the South African Economy as it anchors financial development in the region.
- e. South Africa needs to drive region financial integration agenda as it has the stronger financial sector.