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A Comparative Study of Financial Market Development Indicators in Africa

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ABSTRACT

Financial markets in Africa have been experiencing growth in its market development indicators in recent years. Evidence of growth is seen in market capitalization of stock exchanges, level of liquidity in the stock market, bank credit made available to the private sector, etc. This growth is attributed to market development policies introduced to enhance economic growth as postulated by the finance – growth proponents. However, despite the recorded growth, African financial markets lag behind in development measures when compared with markets in Asia and South America. This study discusses the various development measures introduced in four (4) African financial markets (Egypt, Kenya, Nigeria and South Africa) and compares the level of development recorded in each of the markets. The study concludes that South Africa outperforms the other countries in most of the indicators. This lends credence to the fact that South Africa is an exception in the region. The comparative analysis also supports the classification of both Egypt and South Africa as emerging markets and that of Nigeria and Kenya as frontier markets in the region. The Stock market and banks in Egypt and South Africa had been in existence before those in Kenya and Nigeria; so we may argue that this factor contributed to their level of development. Based on these findings, the study recommends the introduction and implementation of relevant institutional and regulatory framework to complement financial market development policies.

Keywords: Financial market, Growth, Development, Domestic credit, Institutional, Regulatory

1. INTRODUCTION

The importance of a well-developed financial market in any economy cannot be overemphasized.

Extant literature shows that well-developed financial markets have a positive and significant effect on the economy of such countries (Beck & Levine, 2004; Hassan, Sanchez & Yu, 2011; Levine, 2005; Murinde, 2012; Saci & Holden, 2008). As postulated by the finance-growth proponents, a well-developed financial system enhances economic growth through the functions performed by the financial system. Such functions include mobilization of deposit of savings for productive purposes, easing the exchange of goods and services, monitoring of investments and implementation of corporate governance, trading, diversification and management of risks and provision of information on viable investments. These functions when combined, influence the resource allocation process to productive units in the economy (Levine, 2005).

Financial markets are able to carry out these functions through the intermediary role they play. Theoretical literature shows that in well-developed financial markets, the intermediation role played by financial markets leads to reduction in information asymmetry, reduction in the level of adverse selection, lowering of moral hazard, reduction in the cost of external financing, channelling of resources to productive use and an improvement in monitoring and corporate governance (Murinde, 2012). In the same vein, it is noted that developed financial markets create wealth and opportunities which leads to efficient re-allocation of resources from lenders to borrowers. This creates a conducive environment for

efficient risk diversification (Chami, Fullenkamp, & Sharma, 2010). Furthermore, studies also show that in developed financial markets, there is little information asymmetry thereby promoting the capital allocation process that stimulates productivity which, in turn, increases investments and translates into growth of the economy (Dahou, Omar, & Pfister, 2009; Fisman & Love, 2004; Wurgler, 2000).

Due to the benefits identified in having a well-developed financial market, African economies in the early 1990s introduced a series of economic and financial reforms to liberalise and develop the domestic markets (Dahou et al., 2009). As a result of these policies, the financial markets are increasingly playing important roles in the provision of external finance to borrowers. Financial market development indicators used in this study show that some level of improvement was recorded in the domestic financial markets over the years. Some authors also point out that some of the financial market development measures (an example is the recapitalization of deposit money banks in Nigeria) put in place by some of these countries reduced the contagion effect of the 2007/2008 global financial crisis on the domestic markets unlike what was obtained in developed countries (Boorman & Christensen, 2010, Murinde, 2009). However, despite the measures introduced, African financial markets still lag behind when compared to financial markets in Asia and South America (Afful & Aseidu, 2014; Allen, Carletti,

Cull, Qian, Senbet & Valenzuela, 2012; Standley, 2010). The reasons behind the slow development of the African markets include the low level of liquidity, small size of the financial markets, high transaction costs present in the markets, stringent listing requirements for companies wishing to go public, ineffective, inefficient legal and regulatory institutions to complement market development policies amongst others (Beck, Maimbo, Faye, & Triki, 2011).

This paper discusses the various market development policies put in place by emerging and frontier markets in Africa for the period 2003 – 2012 and makes a comparison between the developments in the markets studied. Section two briefly reviews selected literature on financial market development. Section three discusses the various financial market development measures introduced in the four selected African countries while section four compares selected financial market development indicators in the countries. Section five concludes the study with relevant policy implications drawn out.

2. BACKGROUND ON FINANCIAL MARKET DEVELOPMENT

Allen et al. (2012) identified that one of the challenges facing African financial markets is the existence of an inadequate / underdeveloped financial system. This could be because of the low level of financial intermediation in the system and other essential functions required of financial markets that are lacking. For example, capital accumulation process

which plays a major role in the development of markets in underdeveloped and emerging countries as identified by Papaioannou (2007), still needs to be improved upon. In addition, Moss, Ramachandran and Standley (2007) assert that in order for financial markets in Sub-Saharan countries to improve equity investment, there is the need to develop the financial markets by increasing the liquidity level and size of the markets. These two indicators of financial market development are necessary ingredients needed to improve investments in the domestic financial markets as postulated by the finance – growth proponents.

However, it is also noted from extant literature that in order to develop the financial system and promote growth, some of the African economies especially in the early 1990s, introduced a series of financial and economic reforms. This was done to make the domestic markets more open to international capital inflows and integration with the rest of the world as well as remove imperfections identified in the market (Hassan et al., 2011). The various measures were able to put in place some level of development in the markets which covered both the banking sector and capital market. In the banking sector, some of the developments recorded include expansion in banks network within the domestic market and across the continent, the strengthening of commercial banks capital base, improvement in risk management and corporate governance practices, the privatization of state controlled banks, an increase in credit to the private sector and

adoption of a technology based banking system.

Most of the African countries primarily rely on bank financing for external finance but the capital market in recent years have begun to play a more significant role. This is because of the market development policies that were introduced. Some of the developments in the market include increase in the number of stock exchange in the continent¹, increase in the total value of market capitalization of the existing stock markets², relaxation of the restrictions placed on foreign investments in the domestic markets, adoption of an automated trading system from a manual based one, enhanced investor protection laws and corporate governance codes and a cross listing of shares of different companies in the various exchanges (Beck et al., 2011; Mlachila et al. 2013).

Despite the developments recorded as mentioned in previous sections, financial markets in Africa are still small when compared to other markets in Asia and South America. Existing markets are characterised with low level of liquidity and small size. A few large firms who have majority of the total market capitalization usually dominate these markets. Institutional investors form a minority in the market. The illiquidity of the markets implies

thinness of trading and low business volume. This effectively discourages investors who are interested in the markets and thus prevents the deepening and enlargement of the market.

Standley (2010) submitted that the process of developing a financial market is a long - term project and because of this, he proposed that that the institutional policy, legal and regulatory environments in which the markets operate be made conducive to enable the development of the markets. Putting in place this framework will accordingly set up structures that better define property rights, enforcement of contracts and investors protection.

The focus of this study is on selected financial markets classified as emerging³ and frontier⁴ markets in Africa. Dow Jones Index country classification defines emerging markets as markets that "generally have less accessibility relative to developed markets but demonstrate some level of openness" while frontier markets are defined as markets that "are typically much less accessible to foreign investors, exhibit notable limitations in their regulatory and operational environments and support a smaller investment landscape. These markets tend

³ African financial markets classified as emerging are Egypt, Morocco and South Africa.

⁴ Financial markets in Africa classified as frontier includes Botswana, Ghana, Kenya, Mauritius, Nigeria and Tunisia.

¹ An increase from 5 in 1960 to 29 in 2012

² Market capitalization of the 29 stock exchanges increased from \$250 billion to over \$1 trillion between 2002 and 2007.

to be less robust and are in their earlier stages of development". The focus on African emerging⁵ and frontier markets⁶ is due to the renewed interest in these markets by international investors. These economies are reported to have recorded growth rates higher than those obtained in developed economies. Sub-Sahara African countries were reported to have had an average growth rate of 5.4%, North Africa had 5.5% while a third of African countries had an average growth rate of 6% or more. The figure for the ten largest developed economies was put at 1.4% for the year 2012 (Chuhan-Pole, Angwafo, Buitano, Dennis, Korman, & Sanoh. 2012; Kearney, 2012). This reportedly makes the region an investment haven for international investors.

3. OVERVIEW OF FINANCIAL MARKET DEVELOPMENT IN SELECTED AFRICAN ECONOMIES

The discussion on financial market development in this study is on stock market and the banking sector. This is due to the relative underdevelopment and difficulty in obtaining data on other sectors of the markets such as the foreign exchange market, the derivatives market and the bond market in the countries studied.

South Africa

Compared to other financial markets in the continent, South Africa is

considered the most developed whose development indicators can be compared with those of developed countries. According to the 2012 / 2013 World Economic Forum competitive survey, South African banks were rated 2nd in 144 countries for soundness and 3rd in the area of financial sector development. This success is attributed to the various reforms introduced in the area of consolidation, technology and innovation. For instance, the banking sector was opened to allow for foreign participation in local banking business in 2005. Local banks were also allowed to spread their reach outside of South Africa. The early implementation of the Basel II accord in 2001 enabled the risk management system of the banks to be robust to the implementation of Basel III in 2013⁷.

The Johannesburg Stock Exchange (JSE) is one of the oldest (founded in 1887) and largest markets in Africa. It is a member of the World Federation of Exchanges (WEF) and ranked 17th as at 2012. As at the end of 2012, its market capitalization was \$903 billion⁸. In 2001, the JSE had an agreement with London Stock Exchange (LSE) to allow cross dealings between the two exchanges in order to open up the market and increase participation by investors. The JSE market trading system is fully automated and called the JSE TradeElect which is operated under

⁵ www.banking.org.za

⁶ <http://www.african-exchanges.org/members/jse-ltd>

license from the LSE. The system is adjusted to work with the specific needs of the JSE. In order to improve transparency in the market and gain investors' confidence, the real time stock exchange and news service were launched in 1997. The JSE is one of the three stock markets in Africa classified as an emerging market by Morgan Stanley Capital International (MSCI) and the International Financial Corporation (IFC) emerging market indices. It (the JSE) plays a key role in the African Stock Exchange Association with plans to create a pan-African exchange to enable investor's trade in shares from Ghana, Namibia, Zimbabwe and Zambia and later expand to other parts of Africa.⁹

Egypt

The Egyptian banking sector is one of the oldest and largest in Africa. Although the reforms here started as early as the 1970s, modern financial sector reforms did not begin until the 1990s which was aimed at fully liberalizing the sector to make the banks to be more competitive and efficient. These reforms included deregulation and privatization of state owned banks, bank mergers, recapitalization, modernisation of the payment system, enhancement of corporate governance policy and an overall overhauling of the legal and regulatory framework. In addition, the Financial Sector Development Policy Loan to enhance the investment

environment was introduced in 2005 (Murinde, 2009). For instance in 2002, banks were required to shore up their capital in order to meet the capital adequacy ratio under Basel II standards. This was raised to a minimum of about \$87 million. Owing to these reforms, foreign banks have no restrictions in entering into the local market. This has enabled several foreign banks to have majority shareholdings in Egyptian Banks while others have registered branches instead of subsidiaries in Egypt.

The Egyptian Stock Exchange (EGX) is unarguably one of the oldest stock markets in the Middle East and Africa. Its origin and existence can be traced back to 1883 just a few years ahead of the JSE and ranks second largest to it. It consists of two exchanges; namely, the Cairo and Alexandria Stock Exchange (CASE). The Alexandria Stock Exchange was established in 1883 while the Cairo Stock Exchange came into existence in 1903. The EGX in its efforts at strengthening its position in the international capital market with the aim of developing the quality and depth of the EXG joined a number of international stock exchange associations and signed memorandum of understanding with a few. Some of these international associations include WEF, African Stock Exchange Association, (ASEA), and Union of Arab Stock Exchange and the International Organization of Securities Commissions (IOSCO)¹⁰. In 2007, the

⁹ <http://www.african-exchanges.org/members/jse-ltd>

¹⁰

<http://www.egx.com.eg/english/homepage.aspx>

transaction cycle for the clearing of securities was reduced from T+3 to T+2 cycles.

The EGX was severely affected by the socialist reform policies that occurred between the 1960s and the 1990s. This era saw a drastic reduction in market activities because of the nationalization law that was enacted. It was not until the early nineties when policies that were aimed at freeing up the market and geared towards privatization was introduced that market activities once again picked up (Bolbol et al., 2005). In 1992, as part of the reform measures, a new capital market law was passed to encourage private investments and increase investors' protection. This had the objective of strengthening financial disclosures, allowing investors full access to the market and increasing investors' right (Bolbol et al. 2005). The purpose of enacting the law was achieved because of the remarkable increase witnessed in market activity between 1991 and 2002. This was evidenced by the various performance measures that all showed increased activities. For instance, market capitalization expressed as a percentage of GDP rose from 7.8% to 30.1%, value traded increased from 0.4% to 7.4%, the number of listed companies increased to 1,150 from 627 while the value of shares traded rose to \$832.9 million from \$22.7 million (Bolbol et al. 2005).

Nigeria

Prior to the reforms in the Nigerian financial sector, the banking sector was seen to be weak, fragmented and mostly financing short-term credits. Many of the banks were engaged mainly

in short term and limited lending to the private sector. Thus, in order to correct this anomaly and improve credit granted to the private sector, reforms were introduced. Most notably of the reforms was the 2004 "consolidation exercise" where the banks were required to increase the minimum capital from \$15 million to about \$192 billion. These requirements set in motion a series of mergers and acquisitions in the industry as banks that could not meet up with the requirement had to either merge with other banks or were acquired by stronger banks to prevent their license being revoked. This consolidation exercise saw a reduction in the number of the banks from about 89 to 24. Other reforms include the strengthening of the regulatory and supervisory powers by the Central Bank of Nigeria to have a risk-based approach as required by the Basel II accord and the implementation of corporate governance policies. Some of the leading banks also opened up branches in other African countries.

Activities in the Nigerian capital market (known as the Nigerian Stock Exchange, (NSE) began in 1961 when the law establishing the market was enacted. Most of the reforms in the market started in the 1980s with the liberalization of the market. One of such reform is the second – tier market for securities which was introduced in 1985 to enable medium and small scale enterprises have access to finance from the market. Also in 1992, the Central Securities Clearing System was established to facilitate transactions regarding the payments and settlements in the market and the slow manual call over

system was upgraded to automation in 1999. In order to enhance integration with other exchanges in the continent, the NSE partnered with the exchanges in Kenya, Ghana and South Africa in 2002. In 2006, the foreign listing sector was revived. Other reforms introduced in 2006 included the recapitalization of capital market operators, reduction in transaction costs and the granting of concessions to firms to enable them to raise new funds from the market in addition to facilitating mergers and acquisitions¹¹. The NSE is a member of the World Federation of Exchanges. According to the NSE 2012 market review report¹², the market capitalization of listed equities grew by 37.36% from N6.54 trillion to N8.98 trillion, while the number of listed companies and the number of listed equities at the end of 2012 were 191 and 198 respectively. To improve market participation, the market making programme was introduced in 2012.

Kenya

In East Africa, Kenya has the largest and most developed banking system when compared with other countries in the same region. Prior to the reforms and like most of the other countries, the sector was not liberalized with most of the banks being under state control. Liberalization of the interest rate was introduced in 1991 and in 1998; capital adequacy ratio was increased for the banks. In recent years, there has been

measures taken to improve corporate governance, risk classification and risk management. There has also been an increase in liquidity due to recapitalization of the banks which has made the banks to be less prone to crisis / shocks¹³. Kenya has been able to improve on financial inclusion in recent years as seen in the strong growth in bank branch expansion and the adoption of technology based banking services (Alien et al., 2012). This has contributed immensely to its success in East Africa banking system.

The Nairobi Stock Exchange (NSE) was established in 1954 but dealing in shares was restricted only to the resident Europeans in the community. It was not until 1963 when Kenya obtained independence that trading was opened to resident Africans and Asians. Structural reforms began in 1984 with the International Finance Corporation (IFC) and Central Bank of Kenya's implementation of a blueprint titled 'Development of Money and Capital Markets in Kenya'. The purpose of the blueprint was to create a conducive environment for the growth and development of the country's capital market. The exchange operates an electronic system of clearing and settlement which was introduced in 2004. Amongst other key reforms are the introduction of corporate governance policies and the strengthening of regulatory bodies charged with supervisory powers. In 2012, the NSE signed a memorandum of understanding

¹¹ <http://www.nse.com.ng/>

¹² <http://www.nse.com.ng/MarketNews>

¹³ <http://www.centralbank.go.ke/>

with the Somali Stock Exchange Investment Corporation with the purpose of establishing a working relationship in the exchange of securities which involves the trading, settlement, delivery and other stockbroking activities¹⁴.

4. INDICATORS OF BANKING SECTOR DEVELOPMENT AND STOCK MARKET DEVELOPMENT

The indicators used in this study are selected from financial market indicators as identified by Beck, Feyen, Ize and Moizeszowicz (2008). The indicators for banking sector development are the domestic credit provided by the banking sector to the private sector expressed as a percentage of GDP (this is an indicator of the role played by banks in the provision of long-term financing to private companies) and broad money expressed as a percentage of GDP (this indicates the size of the banking sector in relation to the economy as a whole). The indicators for stock market development are the market capitalization of listed companies expressed as a percentage of GDP (an indication of the size of the market) and stocks market turnover expressed as a ratio of the value of traded shares for the period and the average market

capitalization for the period (an indicator of the liquidity of the market).

Banking Sector Development

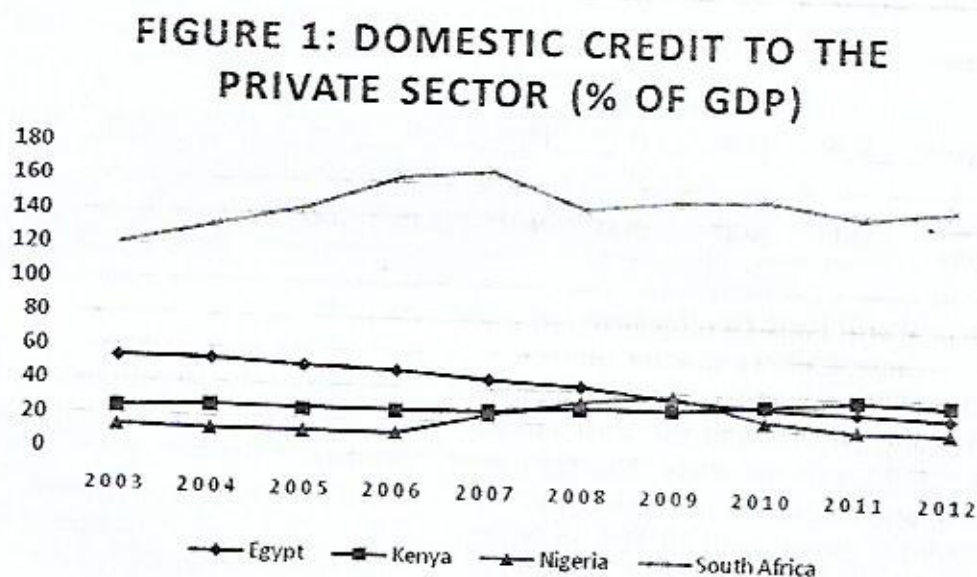
Domestic credit to private sector ratio indicates the role of banks in providing long-term financing to private sector and the extent to which savings are transferred into investments. This is done through the process of information evaluation and identification of profitable investments (Beck & Levin, 2004; Saci & Holden, 2008). Higher levels of the ratio suggest that transaction costs are low and an increased level of financial intermediation (Saci & Holden, 2008).

¹⁴ <http://www.african-exchanges.org/members/nairobi-se>

Table 1: Domestic Credit to the Private Sector % of GDP

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
<i>Egypt</i>	53.9	54.04	52.17	49.29	45.52	42.80	36.09	33.07	31.15	29.11
<i>Kenya</i>	24.60	26.79	25.93	26.08	26.93	29.90	30.29	33.83	38.15	36.59
<i>Nigeria</i>	13.82	13.14	13.24	13.18	25.25	33.75	38.49	24.84	20.94	20.85
<i>South Africa</i>	120.71	132.43	144.15	163.37	167.54	147.35	152.08	153.95	144.68	151.07

Source: World Bank Development Indicators (2013)



Source: Data taken from World Bank Development Indicators (2013)

Table 1 and Figure 1 respectively show that over the ten-year period, South Africa has the highest ratio which implies that transaction costs are lowest in South Africa and that there is a high level of

financial intermediation. A rising trend is seen in the four countries from 2003 to 2007 except Egypt. The ratio for Nigeria initially rose from 25.25% in 2007 to 38.49% in 2009 but declined to 20.85%

in 2012. South Africa had a ratio of 167.54% in 2007 which declined to 147.35% in 2008 and rose to 152.08% in 2009. However, as at the end of 2012, it had risen to 151.07%. Egypt had a ratio that consistently declined all through the six-year period from 45.52% in 2007 to 29.11% as at 2012. We suggest that this decline may be because of the contagion effect of the 2007 / 2008 global financial crisis.

The ratio of broad money as a percentage to GDP is an indicator of the size of the banking sector in relation to the economy as a whole and shows the level of liquidity provided by the banking sector. Unlike the domestic credit to the private sector, it does not show how savings are allocated to investments and does not exclude private sector credits (Saci & Holden, 2008).

Table 2: Broad Money (% of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
<i>Egypt</i>	96.98	96.63	97.10	97.35	96.17	88.37	83.13	80.72	75.77	74.08
<i>Kenya</i>	39.02	39.33	38.91	39.71	42.32	42.54	44.14	50.08	50.98	50.62
<i>Nigeria</i>	20.20	18.26	17.73	19.04	27.97	36.42	40.77	32.80	33.68	36.51
<i>South Africa</i>	63.17	64.27	69.88	76.17	82.75	84.83	80.95	78.33	77.30	75.18

Source: World Bank Development Indicators (2013)

Table 2 shows that for the period 2003 to 2008, Egypt recorded the highest ratio while Nigeria had the least out of four countries in the study. Nigeria rose from a ratio of 27.97% in 2007 to 40.77% in 2009 but closed with 36.51% in 2012. South Africa had a ratio of 82.75% in 2007 which rose to 84.37% in 2008 and declined to 75.18% in 2012. These figures indicate that the liquidity provided by the banking sector in Egypt and South Africa is relatively high when compared

to Kenya and Nigeria. This may be because of the larger banking sector size in both countries (Egypt and South Africa).

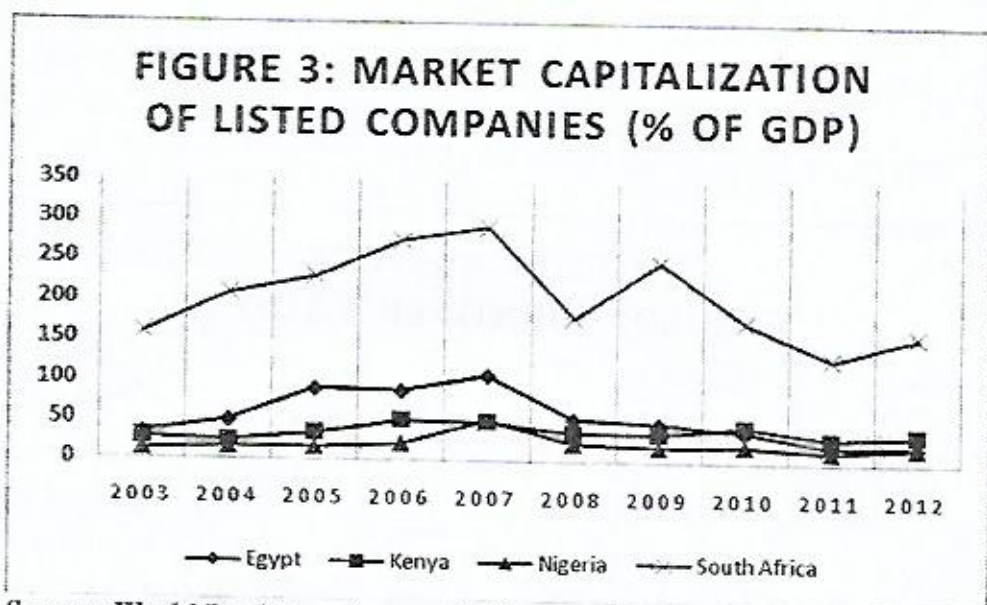
Stock Market Development

The stock market capitalization ratio indicates the size of the stock market and it is expected that it will positively associate with the ability of the market to allocate capital and manage risks (Rajan & Zingales, 2003; Saci & Holden, 2008).

Table 3: Market Capitalization of Listed Companies (% of GDP)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
<i>Egypt</i>	32.65	48.85	88.83	86.97	106.75	52.75	47.60	37.69	20.63	22.07
<i>Kenya</i>	28.03	24.17	34.07	50.56	49.15	35.83	35.17	44.91	30.35	36.34
<i>Nigeria</i>	14.03	16.47	17.24	22.57	51.88	23.44	19.66	22.17	15.98	21.47
<i>South Africa</i>	159.16	48.85	88.83	86.97	106.75	52.75	47.60	37.69	20.63	22.07

Source: World Bank Development Indicators (2013)



Source: World Bank Development Indicators (2013)

Table 3 and Figure 3 both show that South Africa consistently is the most capitalized market in the group with Nigeria and Egypt being the least capitalized. Figure 3 also shows a rising trend in the capitalization ratio from 2003 to 2007 for all the countries. However, a decline is noticed from 2008 with none of

the countries able to attain its pre-2007 level as at 2012 (period of the study). It should however be noted that the size of the market is also related to the size of the country's economy¹⁵.

¹⁵ This is because the size of a market is expressed as a ratio of the economy

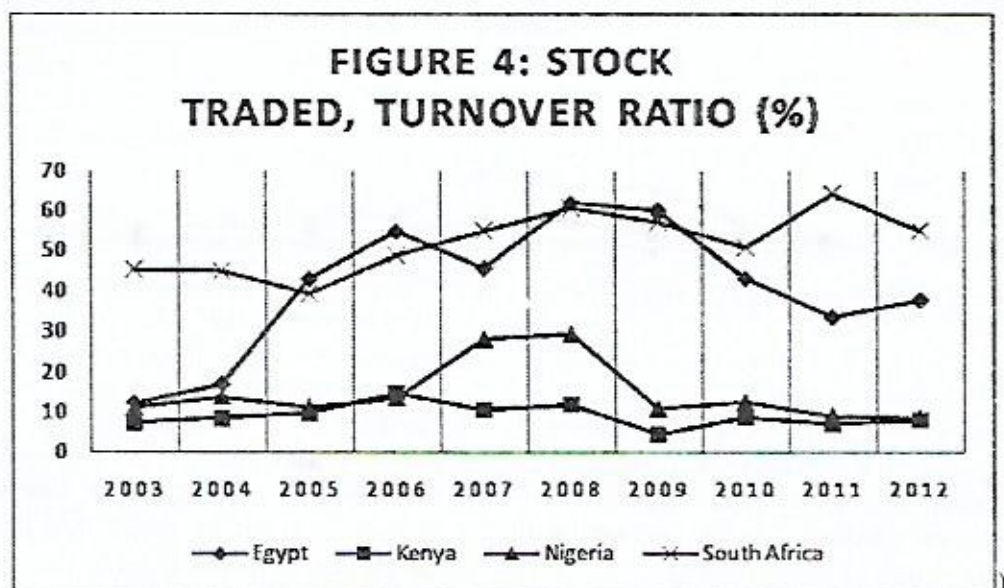
The stock market turnover ratio which is an indicator of the level of liquidity in the market shows the significance and reliability of information that is available in the market. An increase in this ratio in emerging markets suggests developments

in the market, low transaction costs (which facilitates transfer of funds) and an increase in the number of firms in the market (Rousseau & Wachtel, 2000; Saci & Holden, 2008).

Table 4: Stock Traded, Turnover ratio (%)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
<i>Egypt</i>	12.33	17.1	42.97	54.82	45.61	61.85	60.07	43.04	33.53	37.79
<i>Kenya</i>	7.46	8.54	9.83	14.63	10.64	11.83	4.59	8.6	7.12	8.07
<i>Nigeria</i>	11.27	13.91	11.46	13.64	28.15	29.3	11.01	12.54	9.21	8.79
<i>South Africa</i>	45.45	45.03	39.32	48.8	54.99	60.61	57.27	50.74	64.26	54.93

Source: World Bank Development Indicators (2013)



Source: Data from World Bank Development Indicators (2013)

Table 4 and Figure 4 both give evidence that South Africa just like in the

market capitalization ratio is the most liquid in the group followed by Egypt.

Generally, a rising trend is seen for the countries up to 2007 -2008 when a decline is noticed. This implies that liquidity in the markets was generally on the rise in the markets until 2007 -2008 when it fell.

In summary, it is seen from the Tables and Figures above that South Africa outperforms the other countries in most of the indicators. This lends credence to the fact that South Africa is an exception in the region. The comparative analysis also supports the classification of both Egypt and South Africa as emerging markets and that of Nigeria and Kenya as frontier markets in the region. The Stock market and banks in Egypt and South Africa had been in existence before those in Kenya and Nigeria, so we may argue that this factor contributed to their level of development.

CONCLUSION AND RECOMMENDATIONS

This study examined the various financial market development policies introduced in in selected African economies and makes a comparison between the countries. Financial development indicators used in the study show that financial markets in Africa have relatively developed over the years as seen in the rising level of financial intermediation, reduction in transaction costs, increase in the liquidity level, increase in credit made available to the private sector and size of the markets. This development can be attributed to the need to develop the economy as submitted by finance -growth proponents. However, it is noted that

there is the need for improvement to further develop the market in order to make the financial markets a haven for investors and to be able to compete with markets in South America and Asia. Development policies that will put in place institutional and regulatory policies which will complement and bring out the effectiveness of the various development measures undertaken should be implemented. This will go a long way in further strengthening the market and improve investors' confidence in the financial markets to bring in the much needed capital inflow.

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