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# **Should Africa Promote Stock Market Capitalism?**

by

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## **I. Introduction**

In a recent paper exploring the relationship between a country's financial system, industrialisation and economic development, I concluded that stock markets are potent symbols of capitalism but paradoxically capitalism flourishes better without them (Singh 1997). It will be argued in this paper that contrary to the international financial institutions (IFIs) who are encouraging and assisting Sub-Saharan African (SSA) countries in establishing stock markets, this conclusion is particularly applicable to economies in that region in their present circumstances. For many SSA countries stock market development would be a costly irrelevance which they can ill afford; for a number of others such an evolution is likely to do more harm than good.

These are strong conclusions which run contrary to much conventional wisdom on the subject. They therefore require careful justification. The paper does so by a detailed examination of the pros and cons of the establishment of stock markets in the current African context. Within the limitations of the space of an article, it reviews or comments inter alia on the following topics:

- (a) advantages and disadvantages of stock markets in economic theory including the most recent analytical advances in this area;
- (b) empirical evidence on the relationship between stock market development and long term economic growth for both advanced and developing countries;
- (c) the role of the stock market in financial liberalisation, and external capital flows;

- (d) historical experience of the stock market economies (such as the U.S. and the U.K) relative to those of bank-based financial systems, e.g. those of continental Europe or East Asia.
- (e) recent stock market developments in African countries in a comparative international perspective.
- (f) the current financial crisis in East Asia and its implications for stock market development and financial liberalisation in Africa.

## **II Recent Fascination with Stock Markets: Endorsement from Unexpected Quarters.**

In the years following the Great Depression of the 1930s, the stock markets were held in low esteem. Many people regarded the stock market crash on the Wall Street as an important cause of the economic slowdown. John Maynard Keynes legitimised these concerns in his analysis of stock markets in the famous chapter 12 of the General Theory (Keynes, 1936). Among other things, he likened the stock market to a gambling casino where price formation is often dominated by speculators. He thought that if a nation left its investment activities to the vagaries of such a casino, "the job is likely to be ill-done".

In the present era of the celebration of the virtues of markets such views are regarded as heretical and normally ignored. Apart from the general merits which the orthodoxy attributes to the stock markets (efficient allocation of resources, etc.- to be discussed in greater detail below), the IFIs put forward the following specific reasons for encouraging the establishment of such markets in developing countries<sup>1</sup>.

First, they suggest that the existing systems of financing long term development in developing countries are not working effectively. In many industrialising countries, including those in Africa, such finance has by and large been provided by the state controlled banks and other financial institutions which "directed" subsidised credit towards favoured industries and projects. The results in many countries have been bad loans, favouritism and corruption, and ultimately inflationary and

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<sup>1</sup>See, for example, World Bank (1989).

inefficient finance.

The second argument put forward by the IFIs is a more general one. It is suggested that stock market development represents a natural progression in the economic development of a nation. As a country begins to industrialise, it will need to have more sophisticated markets including a stock market.

It comes as no surprise that the IFIs and other orthodox economists should favour the promotion of stock markets in developing countries. But what is unexpected is that such an evolution is also being recommended by many economists and policy makers who have traditionally not been regarded as orthodox. Thus, a distinguished Study Group, headed by Sir Kenneth Berrill for the UNU/WIDER, - a generally heterodox think-tank for developing countries - recommended that these countries should encourage stock market development, in part to be able to attract non-debt-creating portfolio capital. The latter was thought to be necessary in the wake of the debt crisis of the 1980s, which it was felt, would make it difficult for developing countries to attract more debt capital. In order to obtain foreign portfolio capital, the Group suggested that exchange controls on external capital movements should be relaxed. It noted that “..... given the importance of private capital flows in mediating savings imbalances, presumptions in the article of agreement of the IMF that condones such restrictions, for example article A VI, Section 3, needs to be also reviewed”. However, the Study Group's report went on to observe that "the need to attract foreign capital in non-debt-creating forms is only one reason, and not the most important reason, why developing countries should wish to foster their emerging equity markets. Equity markets are a vital part of economic development - they encourage savings, help channel savings into productive investment and encourage entrepreneurs to improve the efficiency of investments" (Wider 1990).

Further afield, the communist government in China has established stock markets in that country and is committed to developing them further. At the thirteenth National Congress of the Chinese communist party in 1988, Zhao Zhiyang, the then secretary general of the party, justified their position on this subject in terms of Marxist analysis. He suggested that at the stage of “primitive accumulation” for a developing country, it must obey the laws of commodity production, i.e. the market, in order to develop the forces of production. Zhao asked the question that if stock markets can help capitalist countries, why should socialist countries not take advantage of such mechanisms to advance their economies? Moreover, he thought that a socialist country was, in principle, in a

better position to deal with the negative effects of stock markets (e.g. speculation) than a capitalist country<sup>2</sup>.

Notwithstanding these wide ranging endorsements of the virtues of stock markets, serious doubts abound. Paradoxically, such scepticism finds its most articulate expression in the citadels of stock markets, namely, the US and the UK. The critics forcefully argue that stock markets foster an environment in which immediate financial gain is preferred to long-term enterprise and that the markets are invariably characterised by “short-termism”. Many economists and policy makers therefore suggest that the stock market domination of the Anglo-Saxon economies puts them at a competitive disadvantage relative to countries such as Germany and Japan, where the stock market has historically not been very important. Thus, the Harvard economist, Prof. Michael Porter, reporting recently on the results of a large research project on various aspects of the US financial system: “The change in nature of competition and the increasing pressure of globalization make investment the most critical determinant of competitive advantage. Yet the US system of allocating investment capital both within and across companies is failing. This puts American companies at a serious disadvantage in global competition and ultimately threatens the long term growth of the US economy”. (Porter 1992).

In view of these conflicting assessments of the benefits of the stock markets, it is important to consider carefully whether the African countries would be wise to go further down this road. The central analytical and policy issue is - will the promotion of stock markets help or hinder the real economy at the current stage of development of African countries? Before we turn towards answering this question, it will be useful to review the recent establishment and fast growth of stock markets in several African countries in an international perspective.

### **III Stock Markets Expansion in Africa and Other Industrialising Economies**

Many African countries began to reform their financial sectors as a part of the IMF/World Bank structural adjustment programmes in the 1980s and 1990s<sup>3</sup>. As a part of this process of financial liberalisation, a number of countries have also begun to establish stock exchanges or to expand existing ones. Ducker (1996) observes that “stock exchanges had become the 1990s equivalent of

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<sup>2</sup>. For a fuller discussion of stock market in socialist economies such as China, see Singh (1990).

<sup>3</sup>. For a fuller discussion of the financial sector reforms under structural adjustment in African countries, see World Bank (1994).

National Anthems and Flags in Africa". He notes that several African countries are establishing stock exchanges despite their weak private sectors.

Tables 1-4 provide some basic information on the extent of stock market development in African countries in the 1990s. For purposes of comparison, the tables also provide information for a small number of leading emerging markets from other regions - South and East Asia as well as Latin America. To put these figures in perspective in a global context, the last two rows provide comparable data for two advanced country markets, Italy and the UK. The tables give data pertaining to the following variables: market capitalisation in absolute terms, as well as relative to GDP (Tables 1 and 2); trading value and the turnover ratio, i.e. trading value expressed as a proportion of market capitalisation (Table 3); numbers of listed companies and their average price-earning ratios.

As Table 1 shows, the aggregate African picture is overwhelmingly dominated by the South African stock market. In 1995, in terms of market capitalisation, the South African market was the tenth largest in the world. It was bigger than any of the leading emerging markets in Tables 1-4. The market capitalisation of the Johannesburg Stock Exchange exceeded by a wide margin that of the stock market of even a developed country like Italy.

The South African market accounted for more than 14% of the total market capitalisation of emerging markets in 1995 (see Table 1). However, market capitalisation of the rest of the existing stock markets in Africa together amounted to less than 1% of the emerging market's capitalisation. Some of the new African stock markets are very small indeed with literally only a handful of listed companies. Swaziland's stock market had four listed companies in 1995 - a 100% growth since 1991 when there were only two. Nevertheless, it is important to record that there were just four stock exchanges in Africa in 1990 compared with fourteen today<sup>4</sup>. Even leaving aside South Africa, the other African markets have registered a tenfold increase in market capitalisation between 1990 - 1995.

Other than South Africa, the most significant markets in Africa are those of Nigeria, Zimbabwe, Egypt and perhaps Mauritius. Compared with leading markets in other developing regions, these

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4. In addition to the twelve African stock markets listed in tables 1-4, there are two others - Zambia and Malawi. The Lusaka stock exchange was opened two years ago and has two listed companies. Tanzania is expected to initiate a stock market shortly. For a fuller discussion of recent developments in African stock markets, see further Ducker (1996) and Hartland-Peel

African markets are quite small in terms of any of the relevant variables: market capitalisation, the value of the shares traded or the number of quoted companies.

The average price-earnings ratios of companies listed on African stock markets range from 7 or 8 in Swaziland, Ghana and Zimbabwe to 12.5 in Nigeria, to 18.8 in South Africa and to 26 in Tunisia. In general, the leading markets in other regions have much higher ratios. However, as in the case of emerging markets elsewhere, the African markets display considerable volatility in share prices and returns to investors. For example, the Zimbabwe market recorded a huge average return (total annual return in US\$) of 143.8% in 1993. However, in the previous two years there were negative returns of 52.3% and 59.8% respectively. Similarly, in the Nigerian market, the average investor would have suffered a loss of 35.9% in 1992, of 11.6% in 1993, but would have made a huge total gain of 190.9% in 1994<sup>5</sup>. These enormous fluctuations in investor returns reflect volatility in both the share prices as well as the exchange rates.

#### **IV Stock markets and Long Run Economic Developments: Theoretical Considerations**

In text book economic theory, the stock markets can promote economic growth through the following channels:

- a) by increasing savings and investments.
- b) by improving the productivity of investments
- c) by raising the profitability of existing capital stock.

Stock markets may raise an economy's savings and investment rates through two different mechanisms. Firstly, the markets provide new instruments of savings which may better meet liquidity requirements or the time preferences of some households or firms, which other things being equal, may lead to more savings than before. Secondly, a stock market helps to collect together small savings of thousands of individuals and converts them into funds for large investment projects. Thus, the market provides a mechanism for risk sharing which enables economic agents to finance and own a small share of say a steel plant or a shipyard. Without such risk sharing and associated functions of screening and monitoring investment projects which stock markets perform, many such projects may not be undertaken at all.

The stock markets can help improve the productivity of investments in part through more efficient

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(1996).  
5.The figures reported in this paragraph come from IFC (1996).

allocation of investment resources and partly through technical change. If the stock market pricing system is working perfectly, it will ensure that investment funds are allocated to their most profitable uses. Less efficient corporations will be accorded a lower share price than the more efficient ones. This would reward the latter by lowering their cost of capital relative to that of the less profitable firms<sup>6</sup>.

Apart from ensuring an efficient allocation of a society's investment resources, the stockmarkets in principle, can also ensure that the existing capital stock of an economy is also most profitably utilised. This would be brought about by a take-over mechanism which would lead to corporations which are not utilising their assets well, being acquired by those who can exploit these resources more effectively<sup>7</sup>.

Recent theoretical work in this area, based on endogenous growth models, emphasises the capacity of the stock markets to promote innovation and technical progress. At a practical level, this is done by devices such as the venture capital funds. In more technical terms, the stock market provides a mechanism whereby market participants can bring to bear their collective knowledge and information on the relative merits of competing new technological inventions and innovations. It is therefore regarded as being better able to finance the most promising technologies compared with, say the banks which do not rely on the collective wisdom of large numbers of market players<sup>8</sup>.

The above is the text book story; its validity, however, depends crucially on the following:

- (a) the nature and properties of the pricing mechanism which prevails on the stock market
- (b) the nature and characteristics of the take-over mechanism.

There are widely divergent analyses on both issues. On stock market prices, the text book position is that these prices are likely to be "efficient". This is because for a typical stock or share on the market, there are a large number of well informed buyers and sellers who are dealing with a homogenous product. It is, therefore, a perfect market which can be expected to generate efficient prices.

However, an alternative view, going back to Keynes, is that since we live in an uncertain world

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6.The reader will notice that in accordance with the normal calculus of a capitalist economy, the words "profitability" and "efficiency" are used interchangeably in this exposition. The two will, of course, diverge if there are externalities.

7.See further Marris (1964); Singh (1971, 1975).



where it is difficult to know what the long term prospects of an investment project are, price formation on the stock market, is inevitably subject to speculation and may in practice be dominated by the latter. In a famous passage Keynes described the pricing of shares on the stock market in the following terms: "professional investment may be likened to those newspaper competitions in which the competitors have to pick out the six prettiest faces from a hundred photographs, the prize being awarded to the competitor whose choice most nearly corresponds to the average preferences of the competitors as a whole; so that each competitor has to pick, not those faces which he himself finds prettiest, but those which he thinks likeliest to catch the fancy of the other competitors, all of whom are looking at the problem from the same point of view. It is not a case of choosing those which, to the best of one's judgement, are really the prettiest, nor even those which average opinion genuinely thinks the prettiest. We have reached the third degree where we devote our intelligences to anticipating what average opinion expects the average opinion to be. And there are some, I believe who practise the fourth, fifth and higher degrees" (Keynes, 1936, page 156).

Which of these two views of the stock market pricing process is more accurate is an empirical question to which we would turn in the next section. In the meantime, we note that just as there are alternative theories about the stock market pricing process, there are also divergent views about the efficacy of the take-over mechanism. Recent theoretical work shows that there are a number of reasons (transactions costs; inadequate information; free rider problem), why the take-over mechanism may not work according to the text book story. It may however not only be ineffective in disciplining poorly performing corporations but may in fact produce perverse results. Stein (1988, 1989) has shown that even if there are rational markets, in the presence of take-overs, it may pay managers to be myopic, i.e. attempt to make a quick profit so as to avert the danger of a fall in share prices and hence of being acquired.

Another important issue on which again there is controversy concerns the question of liquidity of the stock market. Liquidity is normally regarded as a virtue in text book analysis, since liquid stock markets such as those which exist in advanced countries like the US and the UK enable economic agents to buy and sell their shares on the secondary market whenever they like. This reduces risk and should induce greater savings and investments. Instant liquidity is however a double-edged sword: its reverse side is that the investor has no commitment to the corporation whose shares he or

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8. See further King and Levine (1993)

she may own. This can lead to serious problems of corporate governance with important implications for the real economy<sup>9</sup>.

## V Empirical Evidence: Advanced Countries

It will be useful to consider empirical evidence on the analytical issues outlined above separately for advanced and developing countries. The former have well-organised stock markets where information about corporations is systematically gathered, rapidly transmitted and is available to all market participants. There are significant deficits in these spheres in most emerging markets.<sup>10</sup>

On the question of the efficiency of share prices generated by stock markets, Tobin (1984) has made a useful distinction between “fundamental valuation efficiency” and “information arbitrage efficiency”. The former refers to whether or not relative share prices reflect the fundamentals, i.e. the relative expected profitability of corporations. Information arbitrage efficiency on the other hand refers to how quickly information is disseminated within the market. Empirical evidence suggests that although share prices are efficient in the information arbitrage sense, they are not necessarily so in terms of fundamental values. Share prices are often dominated by the so called “noise traders” and are affected by whims, fads and contagion. There is also evidence that the market gives much greater weight in price formation to near term than to long term performance<sup>11</sup>.

The evidence on whether the stock market promotes savings is also not very promising<sup>12</sup>. The savings rates of the world’s leading stock market economy, namely the US, is considerably lower than in countries like Japan and Germany. At the disaggregated corporate level, research by Mayer (1989) and Corbett and Jenkinson (1994) shows that the net contribution of equity markets to the financing of corporate investment in the non-financial sector in countries like the US and UK is often negative. In other words, more shares are redeemed (through take-overs, etc.) than are issued to fund new investment projects. In accordance with the “pecking order hypothesis” corporations in the US and the UK appear to rely overwhelmingly on internal finance to fund their investment

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9. See further Bhidé (1994); Stiglitz (1985).

10. A few years ago the *Economist* noted with respect to Taiwan’s stock market, the largest in the third world: “(It) is a rigged casino with a phenomenal turnover...its family controlled firms equate accountancy with tax-evading creativity. Its courts react...to the nudges of the influential...it is as free-wheeling and corrupt as the Philippines, but...is a free-wheel that works” quoted in Singh (1997). See also Singh (1998).

11. For a review of the empirical evidence on share prices and for different views on the subject see 1990 special issue of *Journal of Economic Perspectives*; see also Camerer (1989); Miles (1993).

12. Theoretically, whether stock markets actually promote savings or not will depend on the utility function of the individual. To the extent that stock markets reduce the transaction costs as well as other risks involved in savings, it may lead to a fall rather than a rise in the savings rate. Pagano (1993b).

needs<sup>13</sup>.

Turning to take-overs, there is a large body of evidence for industrial countries which suggests that the take-over mechanism does not work according to the text book prescriptions. The competitive selection process via the market for corporate control does not simply punish the inefficient or the unprofitable and reward the efficient. Empirical studies show that selection in the market for corporate control takes place to some extent on the basis of profitability or the stock market valuation of the firm, but it does much more so on the basis of size. It is almost always the large firms that take over the small. Indeed, a relatively unprofitable big firm has a much better chance of survival than a more profitable small firm<sup>14</sup>.

Apart from the question of the nature of the selection mechanism represented by the market for corporate control, the evidence on post-merger profitability of amalgamating firms is also not very helpful to the proponents of the stock market. This evidence invariably shows that the profitability of merging firms declines rather than improves following take-overs<sup>15</sup>. Moreover, the critics of the stock market point to the fact that countries like Japan and Germany do not have an active market for corporate control and yet the German and Japanese corporations have been highly successful in the international market place. Indeed, it is argued that the competitive success of these corporations is precisely due to the fact that they have been spared the mercies of a market for corporate control. This enables the Japanese and German managers to ignore short-term profitability considerations, to take a long view and to aggressively bid for market share. In contrast, the Anglo-Saxon managers are obliged to give primary attention to their earnings per share figures every quarter (i.e. to short-term profits) so as not to disappoint the market and thereby suffer a fall in the share price making them vulnerable to take-overs.

## **VI Empirical Evidence: Developing Countries**

As noted earlier, compared with the highly organised as well as properly regulated stock market activity in advanced countries such as the US and the UK, most developing countries do not have such well-functioning markets. Not only is there inadequate government regulation, there do not exist private information gathering and disseminating firms of the kind found in more developed

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13. However, see further Singh (1994, 1995a).

14. For recent reviews of the evidence on take-overs, see Singh (1992, 1993a); Mueller (1992); Hughes (1994).

15. There is however an "event studies" approach to this subject which apparently arrives at rather different conclusions - it shows that the stock market valuation of merging firms increases around the time of the merger event. Singh (1992) and Charkham (1995) provide a

stock markets. Moreover, young firms in emerging stock markets do not have a long enough track record to form a “reputation.” Consequently, one expects share prices in developing country markets to be “noisy”, often arbitrary and volatile. (Tirole, 1991).

Share price volatility is a negative feature of stock markets for a number of reasons. First, it reduces the efficiency of the price signals in allocating investment resources. Secondly, it increases the riskiness of investments and may induce risk-averse corporations not to finance their growth by equity issues; it may indeed oblige such firms not to seek a listing at all on the stock market. Thirdly, at the macroeconomic level, a highly volatile stock market may lead to financial fragility for the economy as a whole.

Empirical evidence does indicate that share prices in developing country markets are considerably more volatile than in advanced country markets. (See for example, El-Erian and Kumar, 1995; Singh, 1994). However, it seems that despite this volatility, third world firms do not shun the market. The Indian stock market, for example, has 8000 firms listed on it, the highest in the world (exceeding by a small margin the US total).

In the first large scale empirical studies of corporate finance in developing countries, Singh and Hamid (1992) and Singh (1995) showed that contrary to a priori expectations, third world corporations rely heavily on (a) external finance, and (b) within external finance to a surprisingly large degree on equity finance to meet their needs for long term investment funds. Singh, (1995), outlined a theory to explain these anomalous findings.

The significant point here is that the above results indicate that third world stock markets have been useful in providing considerable funds to large corporations at least during the period covered (in the 1980s) in the Singh and Hamid, and Singh studies (the sample frame in these studies was normally the 100 largest quoted companies on the stock markets in each of the ten countries examined in this research). However, although the corporate sector clearly gained from stock market activity, this research also indicated that there was little gain to the economy as a whole. All that happened in a number of countries was a portfolio substitution from bank savings to investment in corporate shares without any increase in the economy’s aggregate savings.<sup>16</sup>

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reconciliation of the two sets of results.

16.For a detailed analysis of these issues, see further Singh (1997); Singh and Weisse (1998);

One strand of empirical research on stock markets and economic growth, involving developing countries, has consisted of international cross section studies. These studies which are based on Barro-type regression analysis show that stock markets, controlling for all other relevant factors, positively affect long term economic growth. Research by Atje and Javanovic (1993) suggested that establishment of stock markets is likely to raise a typical developing country's growth rate by a huge 2.5 per cent p.a., but that banks have little influence on economic growth. On the other hand, a methodologically similar study by Levine and Zervos (1995) suggests that banks and stock markets complement each other and both make a positive contribution to economic growth.

However as argued in detail in Arestis and Demetriades (1997), these cross-section studies have severe limitations. As they are usually based on reduced form equations, it is difficult to infer causality from them. More importantly, this research abstracts from the essential channels of transmission by which the stock market can in principle affect economic growth. It ignores altogether the deficiencies of the pricing mechanism and the take over process on the real world stock markets which have been outlined earlier.

## **VII Portfolio Capital Flows**

There has been a sea-change in the nature of external capital flows to developing countries during the last ten years. Not only has there been a big increase in these flows, they are now dominated by private capital rather than official flows (see table 5). Net direct investment and portfolio flows have replaced borrowing and debt as the principle vehicles for the inflows into developing countries. Between 1983-88 and 1989-95 net portfolio investment in these countries rose almost tenfold, and during the second period it was the largest source of external capital.

The reasons for this huge increase in portfolio capital flows lie both on the demand and the supply sides. The main force with respect to demand has been the liberal economic reforms which many countries have undertaken in the 1980s and 1990s. Financial liberalisation and stock market growth have been particularly important in attracting portfolio flows. On the supply side, the enormous increases in the resources of the pension funds and those of other institutional investors in advanced countries have obliged the managers of these funds to seek to diversify their portfolios so as to continue to maintain if not improve their risk-adjusted rates of return<sup>17</sup>.

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Nagaraj (1997).

17. For a fuller discussion of these issues see Singh and Weisse (1998); IMF (1996, 1997); Reisen (1996); Fernandez and Arias-Montiel (1996).

As noted earlier, in relation to the WIDER Study Group report in the wake of the debt crisis of the 1980s, portfolio capital was thought to have many attractions for developing countries. A recent UNIDO (1996) report sums these up in the following terms:

- Portfolio flows bolster a country's external payments position and help finance imports;
- They make an important contribution to domestic capital market development and constitute a possible source of funding for industrial development;
- They lower the cost of capital and widen the financing choices available to companies;
- They play a vital role in the privatisation process whether indirectly, by fostering the development of capital markets, or directly, by financing private-sector buy-outs of state enterprises;
- They may be the forerunner of FDI;
- They raise a country's economic profile and that of its leading stock exchange-listed corporations.

In the event, as table 5 shows, most portfolio capital flows went to Latin American and Asian countries with Africa receiving on average negative inflows for the period 1989-1995. However as disaggregated figures for the individual years indicate, the net inflows for African countries in the last four years have become positive.

Large portfolio capital inflows for many recipient countries in Latin America as well as Asia have in practice turned out to be a mixed blessing. It is, therefore, not at all obvious that African countries have necessarily lost out in not having being able to attract large amounts of foreign equity capital. This may be illustrated by considering the experience of Mexico.

Following the euphoria connected with Mexico's accession to North American Free Trade Area, it received net capital inflows of 91 billion dollars during 1990-1993 - this was one fifth of all net inflows to developing countries. The annual capital inflow between 1992 and 1994 amounted to 8% of GDP compared with a figure of 5% during the previous peak of 1977 - 1981 which is generally thought to have spawned the international debt crisis of the 1980s.

Most of the inflows consisted of portfolio capital - 67% of the total net inflows between 1990 -

1993. These inflows helped generate a stock market boom; the share price index rose from 250 in 1989 to around 2500 in 1994.

Following Rodrik (1994) and Krugman (1995), Singh (1997) notes that these portfolio flows were not responding to fundamentals but represented a misplaced euphoria and “herd” instinct. The Mexican economy expanded at a rate of only 3.5% per annum between 1990 - 1994 despite a widening current account deficit. In 1993 the current account deficit was 6% of GDP although the economy grew by only 0.6% in that year. The deficit rose to 9% GDP in 1994 as economic growth increased to 3.5% p.a. Between 1990 and 1994 Mexican private savings collapsed from 15% to 5% of GDP. Thus, foreign capital inflows largely replaced domestic savings and generated a consumption boom. The market was therefore not rewarding virtue and frugality but essentially a consumption binge.

The consequences for the Mexican economy were catastrophic when the speculative bubble burst in December 1994. The country's GDP fell by nearly 7% in 1995; other Latin American economies, notably Argentina's, suffered heavily through the contagion effect. Indeed the IMF justified its unprecedentedly large rescue package for Mexico of US \$50 billion on the grounds that it threatened the viability of the entire international financial system.

From the perspective of a developing country, much of portfolio capital inflows are literally “hot money”, which enormously increase the vulnerability of the economy not just to international economic shocks but also to domestic shocks, greatly magnifying their effects. The main reason for this is that such flows lead to an interaction between two inherently unstable markets - the stock market and the currency market. In the event of a large shock (domestic or external) these interactions generate a negative feedback, which may lead to a financial crisis. This has not only been the experience of Mexico during the financial crisis of 1994-1995, but also that of South East Asian countries in the current crisis. It is too near the events to form a definite judgement about the essential causes of the present South East Asian crisis - whether for example these are domestic or external. Nevertheless, whatever the cause of the crisis, it is clear that the interactions between the stock market and the currency market have greatly exacerbated the crisis. What developing countries need for speedy industrialisation and quicker economic growth is patient long term domestic, as well as external capital, rather than of the “fly by night” speculative variety. Stock markets in practice, particularly in the developing country context, are singularly ill-equipped to

provide such long term investment resources<sup>18</sup>.

## **VIII Stock Market v/s Bank-Based Capitalism: A Historical Perspective**

It has been suggested earlier that it is arguable whether even in advanced countries where stock markets are well-organised and fully developed, they help on balance the real economy. These markets often lead to short-termism which in turn may adversely affect a country's international competitiveness and hence long term economic growth. The effects of short-termism are compounded by the distortions to the incentive system which the stock markets generate. In the stock market dominated economies, often the highest rewards go to those who are skilled in financial engineering rather than those who create real wealth by product improvement or technological innovations.

The records of stock market dominated economies, e.g. the US and UK compared with those where stock markets do not play a significant role (Germany, Japan, Italy and other continental European countries) indicate that over the long run, the latter have outperformed the former in terms of savings, investment, international market share and economic growth.

For example, with respect to industrialisation of Italy during this century, Pagano (1993b) noted that there was a long run secular decline in the growth of the stock market relative to that of the economy as a whole. The ratio of stock market capitalization to GDP in Italy in 1906 was 23 percent compared with 12.6 percent in 1991. The numbers of listed companies do not appear to have changed much either. Pagano observes: "After a steep rise around the turn of the century, the number (of listed companies) has stagnated around the same value for over seventy years. It is striking that while the rise at the start of the century coincided with the first spurt of Italian industrialisation, no comparable increase accompanied the tremendous growth in manufacturing

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18. The underlying theoretical reason why the stock market does not conform to the text book analysis have been explored in a number of contributions in recent years. This literature by and large provides a formalisation of Keynes' "beauty contest model" of stock market pricing (discussed earlier) as well as of his other important observations in chapter 12 of *The General Theory*. See in particular Stiglitz (1983), Allen and Gale (1995), Banerjee (1993), Bikhchandani, Hirshleifer and Welch (1992), Dimaggio and Powell (1983), *Journal of Economic Perspectives* (1990) (special issue). The main analytical conclusion which emerges from this literature is that unlike other markets, financial markets are particularly prone to co-ordination failures as they are acutely subject to the problems of asymmetric information, moral hazard and adverse selection. These co-ordination failures can be improved by government intervention and indeed the economic cost of non-intervention may be huge. In practice the costs of such market failures have to be weighed against the costs of "government failure" before it can be concluded how much and where the government should intervene. See further Stiglitz (1994).



and GDP during Italy's 'economic miracle' of the 1950s and early 1960s".

Similarly, the post-war miracle of former West Germany and Japan occurred without any help from the stock markets. There is evidence that the Japanese government after the war deliberately discouraged the growth of stock markets in favour of banks in the organisation of its financial system. The extraordinary transformation of the Japanese economy in the 1950s and 1960s occurred without any assistance from the stock market. Indeed, Dore (1985) notes that in Japan the stock market has no significant economic or social role. Unlike the UK and the US, the best and the brightest young graduates of Japanese universities do not seek careers on the stock market but in the government or the corporations. In Germany, the lack of significance of the stock market is indicated in part by its very low capitalisation ratio. The number of companies quoted on the Frankfurt stock market during much of the post-war period has been about 400 of which only 25 or so are actively traded. West Germany, like Japan, as noted earlier, does not have involuntary take-overs or a market for corporate control.

Equally importantly the much bigger miracle of late industrialising countries like Taiwan and Korea over the last three decades has also been accomplished independently of the stock market. In all these countries the banks (in case of Taiwan and S. Korea, state owned ones at that) have played the central role in promoting long term industrialisation.

There are two general points which emerge from the above account which are particularly relevant for developing countries. The first, the superior long-term economic record of bank-based economies relative to stock market dominated economies is not an accident. Modern economic theory offers analytical reasons for this phenomenon. The bank-based financial systems are better able to deal with problems of asymmetric information, transaction costs, disciplining inefficient managers better than stock market based systems<sup>19</sup>. Secondly, the international financial institution's claim referred to in the Introduction that stock market development is simply a higher stage in the evolution of a market economy, is not valid. The economic history of continental Europe as well as Japan demonstrates that bank-based systems are more than adequate to permit a very high level of economic development. There is no necessary natural progression from the bank-based economy to a stock market economy<sup>20</sup>.

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19. There is a large literature on the subject. For a recent review, see Aoki & Patrick (1996).  
20. For a fuller discussion of this issue, see de Cecco (1993)

It may be objected that if the above analysis is correct and the bank-based systems are superior to the stock market economies, why have countries like Japan and Korea been expanding their stock markets in the last two decades. The reason for this is not that their existing bank-based systems have turned out to be inadequate but rather that under US pressure these countries have been obliged to open up their financial sectors. They have however done so reluctantly and as little as they could get away with. Nevertheless, even the limited financial liberalisation which these countries have implemented has caused serious difficulties for the bank-based systems and indeed many would argue that it is responsible for the present financial crisis in these countries<sup>21</sup>.

## **IX Summing Up**

This paper has reviewed analyses and evidence on the role of stock markets in promoting long-term economic growth. It has been suggested here that notwithstanding the textbook virtues of stock markets, they have important drawbacks for developing countries including those in Africa:

First, for such economies, because of the greater volatility of their stock markets, the difficulties of short-termism and distorted incentives which advanced stock market economies experience, will be greatly exaggerated.

Secondly, unfettered portfolio capital flows raise further severe problems for the emerging markets, even the most developed among them.

Thirdly, and equally importantly, most African countries have to contend with another crucial issue, namely, the lack of an adequate banking system with prudential regulation. This is what is urgently required at this stage of their economic development, rather than stock markets which are likely to divert resources away from this essential task.

If the banking system is weak and unreliable, a stock market is likely to add to the fragility of the financial system. Only in abstract economic theory can some of the inherent weaknesses of banks (e.g. “adverse selection” of borrowers due to asymmetric information -- see further Stiglitz and Weiss, 1983), be ameliorated by establishment of the stock market (Cho, 1988; 1989); see however,

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21. Mayer's (1988) prescient indicating that financial liberalisation will undermine the bank-based systems by permitting opportunism on both sides has turned out to be very much on the mark.

Singh, 1993). However, that abstraction requires both banks and stock markets to be fully developed. This is far from being the reality in most African countries and elsewhere in large parts of the third world.

For the typical African economy, even if no harm is done to the real economy, a stock market will be at best a costly irrelevance, in the sense that it would only benefit a small number of big corporations, if anyone at all. Moreover, it would not help meet the savings and investment needs of the great majority of the work force who are engaged in agriculture or informal activities. These are more likely to be met by an appropriate extension of the banking system. The allocation of the highly scarce human, material and institutional resources for the creation of stock market capitalism in the African context is therefore particularly unjustified.

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**Table 5. Capital Flows to Developing Countries.**

<b>DEVELOPING COUNTRIES</b>	<b>1983-88<sup>1</sup></b>	<b>1989-95<sup>1</sup></b>	<b>1991</b>	<b>1993</b>	<b>1995</b>	<b>1996</b>
Net private capital flows <sup>2</sup>	15.8	103.3	131.3	140.9	147.3	207.4
Net direct investment	10.3	42.5	26.9	48.8	78.2	100.8
Net portfolio investment	3.5	43.6	36.1	88.9	15.6	43.2
Other net investments	2.1	17.2	68.3	3.2	53.5	63.3
Net Official Flows	27.3	21.2	18.9	20.1	33.7	-8.6
Change in reserves <sup>3</sup>	10.1	-41.8	-46.8	-39.1	-62.3	-93.7
<b>AFRICA</b>						
Net private capital flows <sup>2</sup>	3.9	4.2	4.0	2.3	10.6	10.7
Net direct investment	1.1	2.2	2.3	1.7	2.8	5.0
Net portfolio investment	-0.9	-0.2	-1.6	0.8	1.9	0.6
Other net investments	3.7	2.2	3.3	-0.2	5.9	5.1
Net Official Flows	5.0	6.8	5.3	5.9	6.2	3.2
Change in reserves <sup>3</sup>	0.3	-1.9	-3.0	-0.7	-1.4	-5.9
<b>ASIA</b>						
Net private capital flows <sup>2</sup>	11.9	43.4	32.3	53.2	88.8	98.4
Net direct investment	3.6	25.1	12.1	34.1	49.5	58.2
Net portfolio investment	1.2	4.9	0.5	11.7	9.3	8.0
Other net investments	7.1	13.4	19.6	7.4	29.9	32.2
Net Official Flows	7.6	8.4	10.5	10.0	5.9	7.8
Change in reserves <sup>3</sup>	-2.2	-23.0	-26.7	-25.3	-28.4	-48.1
<b>WESTERN HEMISPHERE</b>						
Net private capital flows <sup>2</sup>	-2.0	33.3	25.0	62.9	35.8	79.7
Net direct investment	4.7	13.7	10.9	11.2	24.4	36.5
Net portfolio investment	-1.1	25.5	14.7	61.1	-7.2	27.8
Other net investments	-5.7	-5.9	-0.6	-9.4	18.6	15.5
Net Official Flows	9.7	5.3	3.3	-0.1	23.2	-12.6
Change in reserves <sup>3</sup>	0.4	-12.5	-16.1	-19.7	-23.6	-22.2

<sup>(1)</sup> Annual Averages

<sup>(2)</sup> Because of data limitations other net investment may include some official flows

<sup>(3)</sup> A minus sign indicates an increase.

**SOURCE: IMF (1997)**