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ABSTRACT

This paper considers the pros and cons of establishing stock markets in Sub-Saharan African economies at the present stage of their development. It provides theoretical analysis and empirical evidence from both developing and advanced countries to argue that for many African countries such a development would be a costly irrelevance which they can ill afford; for a number of others, it is likely to do more harm than good. The African countries would do better to use their scarce human, material, and institutional resources to improve their banking systems than to promote stock markets.

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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). This paper will be argue that contrary to the international financial institutions (IFIs) which are fostering stock market development in Sub-Saharan Africa (SSA), this conclusion is particularly applicable to economies in that region in their present circumstances. For many of these countries such a development would be a costly irrelevance which they can ill afford; for a number of others it is likely to do more harm than good.

These are strong conclusions which run contrary to conventional wisdom and therefore require careful justification. The paper does so by providing theoretical analysis and empirical evidence from developing (DCs) and advanced (ACs)

countries.

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, being regarded by many as an important cause of the economic slowdown. Keynes (1936) legitimised these concerns by likening 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 a casino, "the job is likely to be ill-done".

In the present era of celebrating the virtues of markets, such views are regarded as heretical. Apart from the efficient allocation of resources and other general merits which orthodoxy attributes to stock markets, the IFIs provide some specific reasons for encouraging them in DCs ¹.

First, they suggest that the existing systems of financing long term development in DCs, including African ones, are ineffective. Such finance has generally been provided by state controlled financial institutions and banks which "directed"

subsidised credit towards favoured industries and projects. The results have often been bad loans, corruption, inefficient finance and inflation.

Secondly, the IFIs suggest that stock markets represent a natural progression in the economic development of a nation. As a country begins to industrialise, it needs more sophisticated markets including stock markets.

It is unsurprising that the IFIs and economic orthodoxy should promote stock markets in DCs. However, unexpectedly such an evolution is also being recommended by many practitioners who have traditionally not been regarded as orthodox. Thus, Sir Kenneth Berrill's distinguished Study Group for the UNU/WIDER, - a generally heterodox think-tank for DCs - recommended that DCs should encourage stock markets, partly to attract non-debt-creating foreign portfolio capital. The latter was thought necessary in the wake of the 1980s debt crisis, which would make it difficult for DCS to attract more debt capital. To obtain foreign portfolio capital, the Group suggested that restrictions on external capital movements should be lifted. However, the Group observed that "the need to attract foreign capital in non-debt-creating forms is only one reason,..... ,to fosteremerging equity markets. (These).....are a vital part of economic development - they encourage savings, help channel savings into productive investment and encourage entrepreneurs to improve the efficiency of

¹ See, for example, World Bank (1989).

investments" (WIDER 1990).

Further afield, Chinese communist government is committed to developing stock markets. In 1988 the then Party Secretary General, Zhao Zhiyang, justified this position on this subject in Marxist terms, suggesting that at the stage of “primitive accumulation” for a DC , it must obey the laws of commodity production, i.e. the market, to develop the forces of production. Zhao asked if stock markets can assist capitalist countries, why should socialist countries be deprived of such mechanisms? A socialist country was, he thought, better placed to deal with the negative effects of stock markets (e.g. speculation) than a capitalist country².

Notwithstanding these wide ranging endorsements of stock markets, serious doubts abound, paradoxically in the stock market citadels, e.g. the US and the UK. The critics argue that stock markets foster an environment of “short-termism” in which immediate financial gain is preferred to long-term enterprise. Many scholars suggest that the stock market domination of the Anglo-Saxon economies puts them at a competitive disadvantage with Germany and Japan, where the stock market has historically been less important. Porter (1992) has observed “The change in nature of competition and the increasing pressure of

globalisation 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”.

In view of these conflicting assessments of the benefits of the stock markets, African countries should consider the wisdom of this path. The central analytical and policy issue is - will the promotion of stock markets help or hinder the real economy at the current stage of African development? Before answering this, it is useful to review the recent stock market experience of African countries from 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 1990s³ and

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

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

as a part of this process, some countries established stock exchanges or expanded existing ones. Ducker (1996) observes “stock exchanges had become the 1990s equivalent of National Anthems and Flags in Africa”. He notes several African countries are establishing stock exchanges despite their weak private sectors.

Tables 1-4 provide information on the stock market development in a) African countries in the 1990s; b) for comparative purposes on some leading emerging markets from other regions; c) to obtain a global perspective two advanced country markets, Italy and the UK. Data is provided on 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 (Table 4).

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, 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 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 markets' capitalisation. Some of the new African stock markets are very small, e.g.. Swaziland's stock market had only 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 today⁴. 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 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.

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 (1996).

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. Generally, 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 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 large total gain of 190.9% in 1994⁵. These enormous fluctuations in investor returns reflect volatility in both share prices and exchange rates.

IV Stock markets and Long Run Economic Development:

Theoretical Considerations

In textbook economic theory, the stock markets can promote economic growth through:

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

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

Stock markets may raise an economy's savings and investment rates through two different mechanisms. Firstly, the markets provide new savings instruments which may better meet liquidity requirements or the time preferences of some households or firms, which *ceteris paribus*, 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 e.g. 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 partly through more efficient allocation of investment resources and partly through promoting technical change. A perfect stock market pricing system will allocate investment funds to their most profitable uses, according lower share prices to the less than the more efficient corporations; the latter being rewarded by the relative lowering of their cost of capital ⁶.

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.

Apart from ensuring an efficient allocation of a society's investment resources, the stock markets can also ensure that the existing capital stock of an economy is most profitably utilised. This is brought about by a take-over mechanism which leads to corporations which are not utilising their assets well, being acquired by those who can exploit these resources more effectively⁷.

Recent theoretical work in this area, based on endogenous growth models, emphasises the capacity of the stock markets to promote innovation and technical progress. This is done practically by devices such as venture capital funds. In more technical terms, the stock market provides a mechanism whereby market participants utilise their collective knowledge to assess competing new technological inventions. The market is therefore better able to finance the most promising technologies compared with, say, the banks which do not have the collective wisdom of numerous participants⁸.

This is the textbook story; its validity, however, depends crucially on :

- (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. The textbook position on stock market prices is that they are probably “efficient”. This is because for a typical company share on the market, there are many well-informed dealers in a homogenous product. It is, therefore, a perfect market which can be expected to generate efficient prices.

However, an alternative Keynesian view is that since we live in an uncertain world where it is difficult to ascertain what the long-term prospects of investment projects are, price formation on the stock market is inevitably subject to speculation and may actually be dominated by it. In a famous passage, Keynes (1936 p.156) described the pricing of shares on the stock market thus:

”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

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

8. See further King and Levine (1993)

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 intelligence 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".

Which of these two views of the stock market pricing process is more accurate is considered in the next section. 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 problems), why the take-over mechanism may not work according to the textbook story. It may not only be ineffective in disciplining poorly performing corporations but may also in fact produce perverse results. Stein (1988, 1989) has shown that even if there are rational markets, because of take-overs, it may pay managers to be myopic, i.e. attempt to make a quick profit to avert the danger of a fall in share prices and hence of being acquired.

Another important controversial issue is concerns the question of stock market

liquidity which textbook analysis regards as a virtue since liquid stock markets as in the US and the UK enable economic agents to trade on the secondary market at will. This reduces risk and should induce greater savings and investments. Instant liquidity is however a double-edged sword in that the investors have no commitment to the corporation whose shares they own. This can lead to serious problems of corporate governance with important implications for the real economy⁹.

V Empirical Evidence: Advanced Countries

It is useful to consider empirical evidence on the analytical issues outlined above separately for ACs and DCs. The former have well-organised stock markets where reliable information about corporations is systematically gathered and rapidly transmitted to all which is not the case in most emerging markets.¹⁰

On the efficiency of actual share prices, Tobin (1984) distinguished between “fundamental valuation efficiency” and “information arbitrage efficiency”. The former refers to whether relative share prices reflect the fundamentals, i.e. the

9. 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 (1998a).

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 may be efficient in the latter sense, they do not necessarily conform to fundamental values, being often dominated by “noise traders” and affected by whims, fads and contagion. The market also evidently gives much greater weight in price formation to near- than to long-term performance¹¹.

Since insurance companies and pension funds with long-term liabilities play a major role on the stock markets, that should arguably discourage short-termism. Unfortunately, evidence shows that it does not. The main reason is that the fund management industry is highly competitive and the fund managers’ own performance is judged over relatively short time intervals. One result of this situation is the much greater “churning” of portfolios by pension fund managers than by individuals, i.e. the former typically hold the stock for considerably shorter period than ordinary investors [for a fuller discussion of this issue, see Cosh, Hughes and Singh (1990)].

The evidence on whether the stock market promotes savings is not very

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

promising¹² . The savings rates of the world's leading stock market economy, namely the US, is considerably lower than in 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" US and UK corporations appear to rely overwhelmingly on internal finance to fund their investment needs¹³ .

There is a large body of evidence for industrial countries suggesting 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 only partially on the basis of profitability or the firm's stock market valuation, but much more so on the basis of size. It is almost always the large firms that take over the small. A relatively unprofitable big firm has a much

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).

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

better chance of survival than a more profitable small firm¹⁴.

Further, the evidence on post-merger profitability of amalgamating firms also does not assist stock market proponents. It invariably shows that the profitability of merging firms declines rather than improves following take-overs¹⁵. Moreover, the stock market critics pinpoint Japan and Germany which do not have an active market for corporate control and yet their corporations have been highly successful in the international market place; their competitive success is precisely because of the absence of hostile take-overs, thus enabling managers to ignore short-term profits, take a long view and 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 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 and properly regulated stock market activity in the US and the UK, most DCs do not have such well-

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

functioning markets. Not only is there inadequate government regulation, private information gathering and disseminating firms as found in more developed stock markets do not exist. 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 DC markets to be “noisy”, often arbitrary and volatile (Tirole, 1991).

Share price volatility is a negative feature of stock markets for several reasons. First, it reduces the efficiency of the price signals in allocating investment resources. Secondly, it increases the riskiness of investments and may discourage risk-averse corporations from financing their growth by equity issues and indeed from seeking a stock market listing. Thirdly, at the macroeconomic level, a highly volatile stock market may lead to financial fragility for the whole economy.

Empirical evidence indicates that share prices in DC markets are considerably more volatile than in AC markets. (See for example, El-Erian and Kumar, 1995; Singh, 1994). However, despite this volatility, DC 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).

Charkham (1995) provide a reconciliation of the two sets of results.

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, DC 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.

Nevertheless what these results indicate is that DC stock markets have been useful in providing considerable funds to the large corporations (normally the 100 largest) in the Singh and Hamid, and Singh studies in the 1980s. However, although the corporate sector clearly gained from stock market activity, this research also indicated that the economy as a whole gained little. All that happened in many countries was a portfolio substitution from bank savings to investment in corporate shares without any increase in the economy's aggregate savings or investments.¹⁶

One strand of empirical research on stock markets and economic growth, involving DCs, has been international cross section studies, based on Barro-type regression analysis which show that stock markets positively affect long term

economic growth. Research by Atje and Javanovic (1993) suggested that establishment of stock markets is likely to raise a typical DC's growth rate by a huge 2.5 per cent p.a., but that banks have little influence on economic growth. Conversely, a methodologically similar study by Levine and Zervos (1995) suggests that banks and stock markets are complementary in making a positive contribution to economic growth.

However, Arestis and Demetriades (1997) suggest these cross-section studies have severe limitations, being usually based on reduced form equations, makes it 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 outlined earlier.

VII Portfolio Capital Flows

There has been a sea-change in the nature of external capital flows to DCs during the last ten years. Not have these flows increased greatly, they are now also dominated by private capital rather than official flows (see Table 5). Net direct

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

investment and portfolio flows have replaced borrowing and debt as the principle vehicles for the inflows into DCs. 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 on both the demand and 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 important in attracting portfolio flows. On the supply side, the enormous increase in the resources of the pension funds and those of other institutional investors in advanced countries have obliged the fund managers to seek to diversify their portfolios to continue to maintain or improve their risk-adjusted rates of return¹⁷

b.

As noted earlier, in the WIDER Study Group report following the 1980s debt crisis, portfolio capital was thought to have many attractions for developing countries. UNIDO (1996) report specifically notes the following benefits:

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

- strengthening a country's external payments position;
- contributing to domestic capital market development and providing funding for industrial development;
- lowering the cost of capital;
- assisting the privatisation process indirectly, by fostering capital market development, or directly, by financing buy-outs of state enterprises;
- encouraging FDI;
- raising a country's economic profile and that of its leading stock exchange-listed corporations.

In the event, (see Table 5), 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.

Table 6 provides information on private capital flows to individual African countries during the 1990s. Since only a small number of African countries have

stock markets, the table shows, unsurprisingly, that most African countries did not attract any portfolio capital flows. Further, South Africa received most of the region's portfolio flows. SSA's record as regards the FDI inflows is relatively much better, both in terms of the aggregate amount of investment, as well as its distribution among countries. Nevertheless, it has been estimated that between 1990 and 1997 the SSA countries received a cumulative FDI flow of \$23 billion, less than 5 per cent of this total for all DCs. Moreover seventy percent of the region's FDI went to oil producers (Angola and Nigeria) and to Ghana, Uganda and South Africa. (See Financial Times, June 1998).

In the wake of declining official aid flows to SSA countries during the last decade they clearly need to seek more capital from private sources. SSA economies received official development assistance of \$13 billion in 1997 - \$3 billion less than in 1990. The important question is, should the African countries make a determined effort to attract more portfolio capital to compensate for the official aid shortfall? Should they, for example, establish stock markets and institute capital account liberalisation to induce fund managers in advanced countries to invest in SSA securities?.

The experience of many Asian and Latin American countries with portfolio capital flows during the last decade indicate that the African countries would benefit from using their efforts and institutional resources to attract FDI rather than portfolio flows. The difficulties of portfolio capital flows for DCs may be illustrated by the case of Mexico - one of the largest recipients of such flows since the late 1980s. Following the euphoria connected with Mexico's accession to the North American Free Trade Area, it received net capital inflows of \$91 billion during 1990-1993 - one fifth of all net inflows to DCs. 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 1980s international debt crisis.

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% p.a. 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, suffered heavily through the contagion effect. Indeed the IMF justified its unprecedentedly large rescue package for Mexico of \$50 billion on the grounds that it threatened the viability of the entire international financial system.

From the perspective of a DC, much of portfolio capital inflows is 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 being 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, or greatly worsen, a financial crisis. This has not only been the experience of both Mexico during the financial crisis of 1994-1995 and 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 external (as well as domestic) capital, rather than the “fly by night” speculative variety.

It has been suggested that the 1994 Mexican crisis was due to volatility of short term capital flows rather than being caused by the stock market *per se*. It can thus be argued that regulating short term capital flows is the appropriate solution instead of limiting the development of the stock market. However, the important point is that even though the *tesobonos* may have been the immediate trigger for the crisis, the withdrawal of portfolio capital flows greatly contributed to the spread and propagation of the crisis. It is not clear that taxation of short term portfolio flows of the Chilean kind would have been enough to stem the outflow once a crisis had occurred. The essential point of the argument made above is that if stock markets, together with capital account liberalisation, are used to

attract foreign portfolio capital it makes the economy much more fragile because of the interactions that it leads to between two inherently unstable asset markets. Since African countries are more likely to be prone to internal (e.g. political) and external (e.g. terms of trade) shocks, such market interactions are likely to lead to much greater economic and financial instability. These countries are therefore better advised to encourage foreign direct investment rather than to establish stock markets in order to attract portfolio capital flows¹⁷.

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

As suggested earlier it is arguable whether stock markets even in advanced countries help the real economy on balance. These markets often lead to short-termism which 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

17b. It is argued that encouraging stock markets may also encourage FDI through the sale of state-owned enterprises on the stock market. However, the existence of a stock market is neither a necessity nor a sufficient condition for such sales. The government can auction such enterprises more directly to suitably qualified domestic or foreign buyers rather than to leave

to those who are skilled in financial engineering rather than those who create real wealth by product improvement or technological innovations.¹⁸

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 stock market growth relative to that of the economy as a whole. The ratio of stock market capitalisation 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 observed that the

it to the vagaries of the stock market.

18. The underlying theoretical reasons 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

tremendous growth in manufacturing and GDP during Italy's 'economic miracle' of the 1950s and early 1960s occurred without any increase in listed companies or total stock market capitalisation .

Similarly, the post-war miracle of former West Germany occurred without any help from the stock markets. With respect to Japan, there is evidence that after the war, the Japanese government 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 also occurred without any assistance from the stock market. Indeed, Dore (1985) notes that in Japan the stock market is viewed socially with some suspicion as a gambling den. 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 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.

Equally importantly, the much bigger miracle of late industrialising countries like Taiwan and Korea over the last three decades has also been accomplished

should intervene. See further Stiglitz (1994).

independently of the stock markets. In all these countries the banks (in the case of Taiwan and S. Korea, state owned ones) 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 DCs. Firstly, 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 and disciplining inefficient managers than stock market based systems¹⁹. Secondly, the IFIs 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 economy²⁰.

If the above analysis is correct and the bank-based systems are superior to the

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)

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 countries²¹.

IX Summing Up and A Perspective on African Banking

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

21. It has become common place among Western commentators to blame the so-called Asian model for the present financial crisis in East and South East Asia. Singh (forthcoming) provides detailed a analysis of the issue and concludes that precipitate financial liberalisation has been the main reason for the economic and financial crisis, rather than the specific model of capitalism that these countries followed.

market economies experience, will be greatly exaggerated.

Secondly, the establishment or the encouragement of stock markets together with capital account liberalisation in order to attract foreign portfolio capital raises further 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 simply 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 the establishment of the stock market (Cho, 1988; 1989); (see however, Singh, 1993). However, that abstraction requires both banks and stock markets to be fully developed.

This is far from reality in most African countries. The serious shortcomings of the African banks have recently been reviewed by World Bank (1994). Most African banks are state or foreign owned. The latter tend to be very conservative and generally serve only the needs of large firms and multinational enterprises. The state-owned banks, on the other hand, are inefficiently managed and lend a large part of their resources to government parastatals and neglect the credit needs of domestic small enterprises. In response to these gaps in domestic financial intermediation during the last decade or so, a number of local private sector banks have emerged in countries like Kenya, Uganda and Zambia. Since the mid-1980s they have gained a significant share of banking and financial markets in these three countries and in Nigeria where the local banks have a longer history. However, despite their many clear advantages (e.g. providing competition to state-owned banks, filling the gaps in financial intermediation) the local banks have not been successful. A substantial number of them have failed due largely to non-performing loans. Brownbridge (1998) notes that “arrears affecting more than half the loan portfolio were typical for failed banks”.

Data on assets and deposits and available estimated loan losses of the failed banks in the four countries are given in Table 7. Failed banks accounted for a

significant proportion of total bank assets, particularly in Zambia and Kenya. It is difficult to estimate the cost of these bank failures to the depositors and/or the governments because very little public information is available on the subject. Nevertheless, Brownbridge (1998) notes that a Kenyan parliamentary statement in October 1995 reported that the Central Bank of Kenya (CBK) lost a sum equivalent to nearly 4% of the 1993 GDP from frauds connected with the “political banks”. The CBK gave liquidity support to three of the failed banks in 1992-93 which amounted to 6.6 % of GDP. Brownbridge (1998) further notes that “the provision of (this) liquidity support was the major cause of the loss of monetary control and the subsequent inflation in the country”.

Turning to the state-owned banks in Africa, the World Bank (1994, pp 116-117) observed: “Restructuring and recapitalising insolvent or undercapitalised banks has been another important part of adjustment programs...Bank recapitalisations in Africa - without corresponding changes in the real sector, such as restructuring the parastatals - have generally failed. In the Central African Republic, one bank has been restructured three times. In Mauritania, five major state-owned banks were recapitalised at a cost of nearly 15 percent of GDP in 1988, but they are again suffering large losses of up to 50 or 60 percent of total loans. In Kenya in 1989, eight failed institutions were merged into a “turnaround” bank,

Consolidated Bank Limited, now in difficulty. The recapitalisation operations have also been expensive. The fiscal cost in some cases was between 1 and 2 percent of GDP - 1.5 percent of GDP in Ghana, 2 percent in Guinea, and 1.5 percent in Madagascar; in other cases it was much larger. In Senegal the cost came to about 15 percent of GDP...In Tanzania the cost of a partial restructuring is estimated at roughly 40 percent of GDP.”

The African countries, therefore, have quite a way to go before they can be regarded as being established, well-functioning and competitive banking systems let alone a banking system of the Japanese/German type with superior developmental potential. World Bank (1994) rightly notes for African countries the general scarcity of skilled and qualified managers and regulators in this area. Moreover, many countries still need to devise a regulatory and legal framework for the adequate operation of a modern banking system.

X. Conclusion.

When the banking systems are seriously inadequate, as is evidently the case in a large majority of SSA economies, it suggests a perverse order of priorities to use scarce human and institutional resources for the establishment of stock markets

rather than for the improvement of the banking systems. Moreover, 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 urban corporations, if anyone at all. 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. Further, it has been argued here that DCs , particularly in Africa, would be better advised to encourage foreign direct investment of the appropriate kind rather than foreign portfolio capital. The latter, it is suggested, is not conducive to long term economic growth as it engenders economic and financial fragility.

In the light of the considerations outlined in this paper, the allocation of the scarce human, material and institutional resources to the creation of stock market capitalism in the African context would therefore seem to be particularly unjustified.

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