Comments to Ajit Singh on Stock markets in low-income countries

It is an honour to comment on this paper: another excellent piece by Ajit Singh. It is also a bit of an embarrassment, as I can hardly call myself a specialist on stock market development. Hence, I will focus my comments on some broader issues related to the role of stock markets in financing development in the low-income countries (LICs) and Africa in particular.

Let me start from a quote from within the UN of a couple of years ago. In 2003, Mark Malloch Brown, then UNDP administrator, told investment managers and heads of African stock exchanges that: "The future of Africa's stock markets is the future of the poor in Africa." And further that: "The jobs, the businesses, the prosperity and the future of the region lies in its stock markets." At that same meeting, in Wall Street of all places, the head of the Nigerian stock exchange echoed these remarks indicating that "African stock exchanges help create wealth and the long-term capital needed for development and through that will contribute to poverty reduction."

Well that was then and Mr. Brown is no longer heading UNDP. Prof. Singh's paper concludes to just about the opposite when he concludes that for capitalism works better when stock markets do not have a major role in the economy. Since growth is mainly driven by market forces in Africa and most other LICs, one could translate that as to saying that development is better served with a minor role for stock markets. I am inclined to agree with Prof. Singh, but with some caveats.

The paper gives a clear view of opposing views about the role of stock markets could play in both mobilizing resources for growth and development and in enhancing market efficiency, especially through its effects on corporate governance. The analysis says relatively little about financial market conditions in LICs as such, but basically builds on broad lessons from the functioning of stock markets in developed and the more developed emerging market economies to conclude we should not be overly optimistic about the role stock markets can play on both counts: mobilizing resources for long-term development and enhancing financial market efficiency and corporate governance. While I broadly agree with these notions, we need not be too pessimistic either and there may be an important role for stock markets to play.

On the role of stock markets in the financing for development

It is well known that stock markets hardly play any role in mobilizing resources for investment and there is also little correlation between stock market growth and domestic savings mobilization. Table 5 of the paper shows as much and we only need to look at the US to see what stock market booms can do to your generation of savings. Actually, it is remarkable to see both a great variety of patterns in the role of stock markets relative to GDP (Table 1 below) and financial structures (Table 2) no matter level of income per capita or rates of economic growth.

Potentially stock markets could attract more equity financing from abroad, but until other important constraints are lifted they unlikely will become major sources of finance. Stock markets in Sub-Saharan Africa loose out because of their small size and very low liquidity (as matter of speaking: the NYSE trades more before tea time than all of Africa in one year). According to experts a stock exchange must have $50 billion in market capitalization and $10 billion in value traded to attract any interest from global emerging market funds. Only South Africa's market is large enough and hence absorbs just about all of equity financing going into Africa. The barriers to improve are huge. Few companies are in the formal sector and when they are moving into the formal sector they will face structural development bottlenecks, such as the lack of infrastructure, human capital, and diversity in economic structure, which tend to keep them small and non-dynamic. Developing a stock market will not change this by anything much and because of their small size foreign investments into that market should also be expected to be quite volatile. One should also expect that a much bigger role must be given to the development of domestic bond markets and improve mechanisms for those countries to issue bonds on international capital markets in order to provide for the finance needed for long-term development.

Stock markets and financial market efficiency

So, then isn't there a role at all for stock markets to play? I think there is for two reasons. First, banking reforms in Africa have been slow and banking sectors are still very weak in playing a major role in savings mobilization and financial intermediation. The development of stock markets could help with the maturation of the banking sector, among others by making information flows about companies more transparent and by pricing risk. But clearly this would be a complementary role rather than the key to financial development.

Second, while acknowledging all the caveats mentioned by Prof. Singh regarding the implications for corporate governance, in African countries there could be positive implications, in the sense that they could also create some positive incentives to company managers by making company valuation more transparent.

In sum, I agree with the notion that the developmental role of stock markets for African and low-income countries in general will (and, in the words of Prof. Singh, *should*) be limited. Promoting the stock market should therefore not be the main priority of financial sector development. But, as said, most likely there is a positive complementary role stock markets can play in enhancing financial market transparency and helping mature and strengthen weak banking and other corporate sectors. This role, however, should not be defined in isolation or as a goal in itself, but rather it should be defined as an integral part of wider reforms of the financial sector and its regulatory framework.

Table 1

Financial Depth Worldwide, 2003

As shares of GDP	Stock Market	Debt Sector			Bank Assets	Total Capital
		Public	Private	Total		
World	0.86	0.56	0.88	1.44	1.12	3.42
EMU*	0.60	0.67	0.97	1.64	1.60	3.84
US	1.30	0.46	1.46	1.91	0.52	3.73
Japan	1.14	1.43	0.53	1.96	1.45	4.54
UK	0.37	0.29	1.05	1.34	2.22	4.93
* of which						
Germany	0.45	0.48	1.20	1.68	1.20	3.33
France	0.71	0.60	0.88	1.47	1.99	4.17
Spain	0.86	0.53	0.74	1.27	1.09	3.22
Portugal	0.42	0.72	0.81	1.53	1.18	3.14
Greece	0.60	1.29	0.12	1.41	1.02	3.03
EMs	0.47	0.23	0.15	0.37	0.78	1.63
LA	0.76	0.21	0.24	0.45	1.12	2.33
Asia	0.35	0.37	0.12	0.49	0.45	1.29
ME	0.12	0.01	0.02	0.03	0.85	1.00
Africa	0.30	0.13	0.05	0.18	0.60	1.08
Europe	0.09	0.27	0.03	0.30	0.27	0.67

Source: IMF *Financial Stability Report 2005*

Table 2

Financial structure worldwide

As shares of total assets	Stock Market	Debt Sector			Bank Assets	Total Capital
		Public	Private	Total		
World	0.25	0.16	0.26	0.42	0.33	1.00
EMU*	0.16	0.17	0.25	0.43	0.42	1.00
US	0.35	0.12	0.39	0.51	0.14	1.00
Japan	0.25	0.31	0.12	0.43	0.32	1.00
UK	0.28	0.06	0.21	0.27	0.45	1.00
* of which						
Germany	0.13	0.15	0.36	0.50	0.36	1.00
France	0.17	0.14	0.21	0.35	0.48	1.00
Spain	0.27	0.16	0.23	0.39	0.34	1.00
Portugal	0.13	0.23	0.26	0.49	0.38	1.00
Greece	0.20	0.43	0.04	0.47	0.34	1.00
EMs	0.29	0.14	0.09	0.23	0.48	1.00
LA	0.33	0.09	0.10	0.19	0.48	1.00
Asia	0.27	0.28	0.10	0.38	0.35	1.00
ME	0.12	0.01	0.02	0.03	0.85	1.00
Africa	0.28	0.12	0.04	0.16	0.56	1.00
Europe	0.14	0.40	0.04	0.45	0.41	1.00

Source: IMF *Financial Stability Report 2005*