The Development of Capital Markets in Africa: Constraints and Prospects*

By

Lemma W. Senbet
The William E. Mayer Chair Professor of Finance
University of Maryland
The Maryland Business School
College Park, MD 20742
USA

(301) 405-2242; fax (301) 405-0359
LSENBET@BMGTMAIL.UMD.EDU

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I. Introduction: Africa Left Out

Africa was left out of the massive flows of international investment capital to
developing countries resulting from the opening up of the world economy in the 1980s.
Indeed, while the decade of the 1980s was a period of virtually uninterrupted expansion of
economic activity in Western economies, it was considered "the lost decade" for the Sub-
Saharan Africa. During this same period many Asian countries, such as Malaysia,
Thailand, and Indonesia, achieved startling real economic growth rates that often exceeded ten per cent per annum. Most African countries, by contrast, faced desperately poor economic performance, with low or negative real growth rates and deteriorating per capital income levels.

The typical explanations for the dismal economic performance, particularly of Sub-
Saharan African countries in the last decade, are exogenous shocks, such as famine,
drought, military conflicts, and unfavorable terms of trade. This report takes a view that there are also internal structural reasons, particularly the absence, or ill-functioning nature, of African financial markets and institutions. African countries tend to have financial sectors dominated by ill-functioning banks which are often state-owned and protected from outside competition. Moreover, securitized debt is non-existent, and the existing stock markets are utterly thin and illiquid.
Fortunately, there is a growing recognition of the role of the financial sector, and
the region has undergone extensive economic and financial reforms of similar proportions
as those countries in Latin America and East Asia. These reform measures seem to have
began yielding positive results in terms of economic performance and increased attention
by international investors. According to the ADB statistics, the real GDP growth rate in
Africa reached 3.0% in 1995, markedly higher than the year before (1.9%) and the
average for the 1990-93 (less than 1%). At the dis-aggregate level, there are countries
which have posted exceptional performance (Uganda, Ghana, Benin, Botswana,
Mauritius, Cote d'Ivoire, Kenya, etc). Figure 1 depicts the general positive trend for the
region. Another encouraging new development is that international investors have began
looking at Sub-Sahara Africa, with the establishment of over a dozen investment funds
since 1993. These Africa investment funds are now trading in New York and Europe.
Thus, a careful examination of constraints and prospects for the development of capital
markets in Africa is timely and imperative.

Insert Figure 1

A compelling case can be made for the development of capital markets in Africa.
Well-functioning financial markets, along with well-designed institutions and regulatory
systems, foster economic development through private initiative. The linkage between
finance and economic development is of great interest to Africa, since it suggests an
indirect linkage between financial sector development and poverty alleviation, along with
employment creation. There is empirical evidence strongly suggesting that well-functioning capital markets promote long-run economic growth. In particular, Levine and Zervos (1995) find that indicators of stock market development (market liquidity, capitalization, turnover, efficiency of pricing of risk, etc) are correlated with current and future economic growth, capital accumulation, and productivity improvements. The previous literature focussed almost exclusively on banking development and growth, but Levine and Zervos find that stock market development provides different functions as an engine of economic growth. In what follows, we take this functional approach in discussing prospects for capital market development in Africa. The link of capital market development to growth is particularly important, given positive linkage between growth and poverty alleviation.

Thus, the focus in rebuilding Africa should not just be reconstructing physical infrastructure but also developing legal and financial infrastructure that fosters the growth of a well-functioning financial economy. This report provides a forward looking perspective on the development of capital markets in Africa. Although financial markets are presumed to include markets for debt, equity, and a variety of services by financial institutions, this report uses equity markets as an anchor in discussing the development of capital markets in Africa.

We take a functional perspective in discussing the constraints and prospects for capital market development in Africa. At a broader level, we regard that the functions of capital markets in an economy could be categorized into one of allocation of capital and governance. It should be recognized that the broad functions of capital markets extend
beyond mobilization of domestic financial resources to risk pooling and sharing among market participants as well as facilitation of international capital inflows. Equally important, though, are the governance functions of capital markets, and they manifest themselves in the form of information processing and aggregation, monitoring, and facilitation of efficiency-based takeovers of companies. Indeed, in the context of advanced economies, the markets for corporate control function through active capital markets.

Unfortunately, the prevailing policy perspective has been to view the financial sector as a mere conduit for capital mobilization and allocation. Financial liberalization/reform programs are inspired by this perspective which in turn is inspired by dominant economic thinking on the subject, such as the "McKinnon-Shaw paradigm" [see McKinnon (1973) and Shaw (1973)]. Since the function of capital mobilization can be readily performed by depository institutions (say savings mobilization), the focus has been on the development of the banking sector. However, this is short-sighted. First, the focus does not go beyond conditions of complete certainty, and hence the effects of liberalization targeted only to capital mobilization. Second, there is general lack of appreciation of the deeper roles of financial sector under conditions of uncertainty. Under uncertainty, there is not just capital allocation (supply-side) that is the sole issue, but the issue of risk allocation (demand-side) is also paramount. Third, in an environment characterized by a host of imperfections and incentive problems, there is a crucial role played by the capital markets for efficient contracting among conflicting parties and for disciplining of corporate insiders through markets for corporate control.

Thus, it is the policy premise of this report that the capital market policy-making
functions in Africa should focus on enhancing, rather than inhibiting, the *multiple* roles of capital markets. The depth of the capital market infrastructure has to be judged on the basis of the efficiency with which these various functions are carried out. For instance, the mere erection of *stock exchanges* is inconsequential, if the environment is hostile against opportunities for risk-sharing and liquidity provision and transformation. Moreover, the mere existence of banks is of little value, if their existence is merely to purchase government securities at the expense of commercial lending. In fact, the demise of commercial lending prevents banks from serving as *informed* agents or intermediaries on behalf of the society, and hence building vital information capital for efficient allocation of resources. Unfortunately, this pattern of *financial dis-intermediation* or dysfunctional intermediation is widely observed in many emerging economies, particularly in Africa.

The rest of the report is organized as follows. Section II elaborates on the functional perspective as a conceptual framework for guiding policy efforts in developing capital markets. Section III looks at current African experience in capital market developments and highlights a growing international investor attention to the continent. The discussion is presented in the context of forces impacting development of emerging markets in general and African emerging position in this important and competitive movement. Major challenges and impediments in capital market development in the region are critically examined under Section IV, and Section V outlines the prospects in this development effort, emphasizing the key roles of public policy.
II. Functional Perspective for Capital Market Development

We take a view that policies for capital market development should take functional perspective. This immediately implies that policies should be put into place with the objective of laying financial infrastructure that promotes the multiple functions of capital markets. This view has important implications for sequencing of financial markets and products, banking and equity markets, and insurance and derivatives in emerging economies, such as in Africa. The financial market development path should also be anchored by this functional perspective and not necessarily guided by the path of the advanced economies. For instance, African economies are replete with extensive risk exposure and informational problems, and if they follow an identical path of the developed economies, they may become even more unstable for certain regulatory regimes and for certain sequencing schemes.

A. Capital Mobilization

At the heart of capital mobilization is the need to finance investments with long-term outlook. The problem is that people who own capital in the economy may not be those with entrepreneurial and managerial talent with investment opportunities. Thus, a key function of capital markets is one of transferring capital from savers to borrowers with investment needs.

Capital markets provide a wide range of mechanisms through which individuals can pool or aggregate their wealth into larger amounts of capital for use by firms with large-scale investment projects. This, in turn, provides individuals an opportunity not only
to participate in the fortunes of the investment projects but also to diversify their risk exposure. Moreover, capital providers may often desire liquidity (ability to exit on short notice), along with attractive returns commensurate with the underlying risk exposure, while firms need to commit capital on long-term investments. Capital markets resolve this divergence through pooling. Thus, capital markets provide a mechanism for the pooling of funds to undertake large-scale indivisible enterprises, for the subdividing of shares in enterprises to facilitate diversification, and for maturity transformation.

Capital markets also facilitate an efficient allocation of financial savings to their most productive use in the real economy. Through provision of economic signals (such as share prices and interest rates), they direct economic resources to the activities with the highest returns. In general, capital markets provide ways to transfer economic resources through time, across geographic regions, and among industries. Moreover, capital markets make it possible for an efficient separation of ownership from management, thereby enabling specialization in production according to the principles of comparative advantage.

**B. Risk Sharing and Allocation**

When providers of capital are risk averse, high return yet risky investment projects may not be undertaken simply because it could be too risky for any one investor to bear.

1. Recently, some have questioned the validity of the allocation role of equity markets based primarily on the relatively small size of capital historically raised in the developed world from issuance of equity in the primary markets (see Stiglitz (1993) and Hellman and Murdock (1995)). It is true that new equity issue has had relatively minor contribution to the capital needs of firms. While, for example, U.S. firms have raised a mere 2% of their capital requirements from new equity issues over the post-war period, internal financing (internal equity) accounted for 73%. It is important, however, to recognize that the equity market plays an important role in the allocation of internal equity through providing managers signals in the form of prices in their selection of investment projects and financing.
A well-functioning capital market allows multiple investors to share risk enabling high-risk, high-return projects to be undertaken. Through a menu of complex securities, capital markets provide risk-pooling and risk-sharing opportunities for both investors and firms. Moreover, financial markets allow the separation of providers of real investment from the providers of risk capital who bear the financial risk of those investments. This separation between real investment and risk bearing, in turn, permits specialization in production activities according to the principle of comparative advantage [Merton and Bodie (1995)].

Thus, capital markets help allocate risk on the basis of preferences. Investors trade risk based on their comparative advantage - with an expanded menu of risk sharing opportunities provided by markets, they can shed unwanted risk and acquire preferred risks. A richer market, composite of options and other derivatives, allows to create positions in a wide variety of shapes catering to diverse clienteles. If markets are truly perfect and complete, of course, there is no need to have explicit options and other derivative markets (such as the Chicago Board of Options and Exchange and the Chicago Mercantile Exchange), since such financial instruments can be replicated dynamically from the spot markets. The absence of organized and over-the-counter markets for derivatives is a manifestation of either extreme market failure (via barriers to opening markets) or extreme completeness. While the latter is unlikely anywhere on this planet, the former is widely prevalent (e.g., Sub-Sahara Africa). In well-functioning, but imperfect environment, such as in the U.S., there has been explosive growth of the derivatives markets in recent periods. For instance, there are now a number of formal exchanges for
trading options on a wide array of assets including individual stocks, stock indices, government debt securities, commodities, and foreign exchange. In addition, there are customized options traded over-the-counter. The growth in the markets for other derivatives such as futures, forwards, swaps and other exotic financial instruments is equally spectacular.

The following are the commonly used risk-allocation mechanisms supported by well-functioning capital markets offering a wide array of financial instruments.

1. **Diversification**: This is a mechanism for reducing risk to a target level through a strategic combination of securities with imperfectly correlated risks. The market compensates only for undiversifiable risk in a capital market environment with rich diversification opportunities. Diversification can be achieved across companies, industry sectors, geographic locations, and even across national boundaries.

2. **Hedging**: This is a mechanism for eliminating risk exposure altogether through an offsetting (hedging) transaction. Hedging mechanisms/markets include forward, futures, swap, and even spot markets (e.g., selling risk via short selling) and other structured arrangements.

3. **Insurance**: This is a mechanism to limit the downside in exchange for a premium (e.g., deposit insurance, insurance for home owners, automobile, life, health, and retirement, etc.). Insurance is analogous to a put option, and buying insurance is tantamount to buying a put option. Holding a put option along with a risky asset transforms the combined position into an *insured* investment. If the risky asset has unlimited potential, the purchase of put (insurance) limits the downside while maintaining
the upside potential. If the upside is limited, such as in a fixed obligation contract, the
insured position becomes totally riskless. Indeed, there is an *implicit* insurance component
in any risky debt, so that loan guarantee transforms it into riskless debt. Thus, loan
guarantee is isomorphic to a put option.

The above dimensions of risk allocation, namely, *diversification, hedging*, and
*insurance*, are not the only features of risk management desired by market participants.
There may be middle ground strategies, and we can see this by the mere existence of
certain financial products which are perhaps demand-driven (e.g., floating rate mortgages,
collateralized mortgage obligation [CMOs], leasing, social security, pension plans). These
securities and transactions offer features that are not directly isomorphic to diversification,
hedging, and insurance, but provide important mechanisms for risk allocation. For
instance, floating rate mortgages reallocate risk from the lender to the borrower.

C. *Globalization: Promoting Inflow of International Capital*

An efficient financial structure is critical not only for domestic capital mobilization
but also for gaining competitive advantage in the global markets for capital. Domestic
financial systems are fast merging into international capital markets, irrespective of the
wishes of government policy makers. The need for foreign aid is increasingly lessened for
countries with improving economic policies, since they can compete directly for capital in
the global capital market. The competition for international capital is devoid of "hand-
outs" from rich countries but of "self-help", since wealthy-country investors also benefit
from portfolio diversification that includes emerging economies.
Thus, the benefits from international portfolio diversification can be thought of yielding mutual gains akin to the traditional gains from trade in the goods markets. These potential benefits are untapped opportunities particularly for African countries if they wish to play globally by liberalizing the institutional environment and putting forth an appropriate legal and financial infrastructure. It is, therefore, critical that the development of financial infrastructure be conducive not only for domestic resource mobilization but also for accessing the services of international financial markets as a means of attracting international capital.

In this regard, African countries should take serious note of a new and radical shift in the pattern of external financial flows to developing countries in the early 1990s. According to the 1993 World Bank report on developing economies, the non-bank private sources, in the form of bonds, equity portfolio flows and foreign direct foreign direct investments have accounted for nearly all the recent growth in financial flows to developing countries. In particular, there has been explosive growth in private portfolio flows, both bonds and equity, to Latin American and East Asian countries. According to the 1996, IMF study, total net private capital flows (net direct foreign investment net portfolio investment, and bank lending) to developing countries grew about four-fold from $45.4 billion in 1990 to $173.1 billion in 1993. On the other hand, net portfolio investments grew five fold between 1990 and 1993 (from $18.6 billion to $89.6 billion) and then declined to $50.4 billion in 1994 following the Mexican crisis. By contrast, net portfolio investments to Africa have been negative during the same period (peak negative of $0.9 billion in 1993).
Actually a new pattern of external finance emerged between late 1980s and early 1990s until it got tampered by the Mexican crisis, with bank being loans being dramatically replaced by bond and equity portfolio flows. For instance, bank-related loans actually declined from $88.5 billion (58% of total private capital flows) in 1991 to $34.6 billion (20% of the total) in 1993, but jumped dramatically to $72.9 billion in 1995 following the Mexican crisis. However, bank loans are still proportionately lower (40%) even in the current period than they used to be before the emergence of the new pattern of external finance.

It is striking that African countries, particularly of the Sub-Saharan African region, have had virtually no access to the growing external private capital markets. The dearth of portfolio investments is particularly noticeable in the 1980s into early 1990s, while countries of Latin America and East Asia have been virtually sole beneficiaries of the explosive growth in this category of private capital flows. Yet, the advantages of these new sources of external finance are abundant, and they arise in the form of reduced cost of capital, establishment of a diversified investor base, and technology transfers, and ultimately economic prosperity.

There are encouraging signs, though. Africa has began participating in the global portfolio capital beginning in 1993, and this shows up in the IMF data. Africa moved from a negative portfolio inflow of $0.9 billion in 1993 to positive inflow of $1.1 billion in 1994, although levels of portfolio investments stagnated as of 1995 with a net inflow being only a tenth of the 1993 counterpart. These positive developments have partly to do
with the reforms undertaken in recent years, in particular with respect to stock exchanges.

D. Governance and Control

While the role of financial markets in mobilizing capital, particularly in the context of developing countries, has been a focus of public policy, there is now a growing recognition that capital markets do much more than transferring resources from savers to users of capital. Indeed, the preceding discussion has already underscored the vital role of capital markets in risk sharing and globalization functions. In addition, there are governance and control functions that we wish to discuss. How well capital markets perform these other functions could be a determinant of not only the extent to which they mobilize capital but also the overall efficiency of the economy.

1. Information Production and Price Discovery: Trading activity among market participants (speculators, arbitrageurs, liquidity seekers, etc.) produces information and enhances pricing efficiency. The processing of this information allows for deviations from fundamental values to dissipate through the arbitrage process. Even the previously uninformed market participants get informed through trading activity regarding the true security value. In addition, the capital market provides sufficient signals for firm productive and investment decisions, and hence allocational efficiency is enhanced.

2. Monitoring and Control: In an environment of incomplete contracts, contractual relationships are prone to severe agency problems owing to potential conflicts.

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2 At the outset, though, it should be recognized that capital will not flow into Africa just because stock exchanges are set up! Almost a third of African countries have already erected stock exchanges, but as will be discussed below, they are now keenly aware that there are deeper ingredients for capital mobilization than mere erection of exchanges.
of interest among parties to an organized firm. The problems arise because parties to
contracts cannot easily observe or control one another, and because contractual
enforcement mechanisms are costly to invoke. Potential conflicts exist between
management and shareholders (owners of capital), between shareholders and creditors,
and between private capital contributors and the society at large, and between political
operators and taxpayers. Left alone, each group seeks to maximize its own interests.
Conflicts of interests are endemic to a market economy. They can be mismanaged to the
detriment of the economy, or control mechanisms can be put into place to manage these
conflicts so as to achieve allocational efficiency. It turns out capital markets provide an
important function in controlling and monitoring sub-optimal behavior on the part of those
who manage resources.

In advanced economies capital markets are used to provide powerful control
mechanisms and help correct inefficiencies that arise from distortionary incentive conflicts
between decision-makers and other stakeholders. Inefficient management is typically
thrown out of office through takeovers which allow unfriendly raiders to accumulate
shares in the open market and take control of the firm. The very threat of such takeovers
is actually a powerful mechanism for disciplining management.

A well-functioning economy allows for active contests for corporate control so
that resources are controlled by those who create the most value for the stakeholders, and
ultimately for the society at large. The takeover mechanism is one way to facilitate
competition in markets for corporate control. Well-functioning capital markets have
become crucial in the conduct of markets for corporate control ooth through the delivery
of price signals in uncovering target firms for takeover and provision of active trading that allows for actual transfer of control.

The existence of well-functioning capital markets can also allow for efficient resolution of bankruptcy or financial distress. Financially distressed firms, which are otherwise economically viable, can be reorganized in private workouts and informal reorganization through financial markets. This allows for avoidance of deadweight costs associated with bankruptcy proceedings and the court system. Indeed, "privatization" of bankruptcy has been a major innovation in advanced capital markets. [See Haugen and Senbet (1978, 1988) and Senbet and Seward (1995) for a more elaborate discussion of these issues]. This suggests that a design of a bankruptcy code should take full account of its role in facilitating private workouts among participants and the use of financial markets in recapitalizations of the firm's balance sheet for a smooth transfer of ownership to new claimants to the firm.

3. Contractual Efficiency: The conflicts of interest that pervade a private economy extend beyond the tension between management and shareholders to the tension between shareholders and creditors. Creditors contract for fixed payoffs, while shareholders obtain the residual cash flows. Consequently, shareholders have incentives to undertake riskier projects hoping for big, even unlimited payoffs, when economic conditions turn out to be favorable. Of course, they walk away (declare bankruptcy) when conditions are unfavorable. This risk incentive problem makes it difficult for a corporate firm to raise debt capital in a credible fashion.

Insert Figure 2
It turns out that well-functioning capital markets facilitate incentive contracts for alignment of diverse interests between management, shareholders, and bondholders. In the case of managerial agency conflicts, capital markets facilitate the design of incentive contracts and optimal compensation structure that aligns management with capital contributors. Such incentive features include equity participation by management, executive stock option plans, retirement plans that allow for participation in capital markets and fortunes of companies that are being managed. An active capital market serves as a valuation benchmark in evaluating these incentive schemes as well as the impact of these incentive contracts on corporate investments through observed price signals.

Likewise, capital markets provide mechanisms for controlling bondholder-stockholder conflict by providing opportunities to design debt contracts with incentive features, particularly those with option characteristics, such as conversion privileges (giving creditors the right to convert into equity at a predetermined price), call provisions (giving the firm to retire its debt at predetermined). These incentive features of debt contracts can align the interests of shareholders and bondholders so that they both seek value maximizing investment strategies. For instance, conversion privileges allow for bondholders to participate in the upside cash flow fortunes of the firm and create a disincentive for shareholders to engage in excessive risk-taking at the expense of bondholders. A well-functioning capital market, which has both equity and options markets, provides appropriate pricing signals for valuation of these incentive (option) features and their impact on the investment behavior of corporate decision-makers. Thus,
capital markets promote contractual efficiency in an environment characterized by incentive conflicts and hence lead to allocational efficiency. Overall, capital markets provide a number of mechanisms for firms to overcome agency problems and achieve their full potential in creating value or shareholder wealth, which ultimately impacts the societal wealth. Barnea, Haugen, and Senbet (1985) summarize these to be (1) provision of financial unification, (2) informal reorganization and takeover and (3) contingent claims contracts.

III. The African Experience: Pre-emerging Markets and Some Encouraging Developments

Historically, African financial systems have been dominated by bank finance often shouldered by the public sector. In recent years, most African countries have undergone unprecedented economic and financial reforms of similar proportions as the emerging countries in Latin America and East Asia. There is new emphasis on private sector development, deregulation, liberalization, and privatization, along with improvements in governance and democratization. As part of the reforms sweeping the continent, there has been a gradual shift away from bank-based capital markets to accommodate non-bank institutions in particular in favor of stock markets. There are currently fifteen stock exchanges in African countries, namely, Botswana, Cote D'Ivoire, Egypt, Ghana, Kenya, Malawi, Mauritius, Morocco, Namibia, Nigeria, South Africa, Swaziland, Tunisia, Zambia and Zimbabwe.

The recent enthusiasm in stock market development has also been accompanied
by unprecedented well-meaning financial and regulatory reforms. Measures have been taken ranging from placing appropriate regulatory infrastructure, such as market supervisory bodies to streamlining of existing operational and settlement procedures for smooth and efficient execution of market transactions. In many countries, there have been tax reforms that suspend and even abolish capital gain taxes, reduce dividend withholding tax rates and mitigate effects of multiple taxation. Other areas of reforms include such market competitive measures as reduction of official costs of transactions, listings and new issues; and removal of barriers to international capital flows in the form of elimination of rules that discriminate against foreign investors and legal reforms governing repatriation of capital.

In fact, African markets are increasingly displaying greater openness to foreign investors. Recently, over half of these markets have posted spectacular returns, at levels at least competitive with other emerging markets on a risk-return tradeoff (Cote d'Ivoire, Mauritius, Namibia, Nigeria, Ghana, Egypt, Zimbabwe, Swaziland). Indeed, a growing evidence is that investments in Africa have produced returns higher than in Latin America.

Investors on Wall Street and in Europe have began including Africa in the global investment opportunity set as manifested vividly by floatation of funds targeting Africa, beginning with the funds created by the New York brokerage firms: Morgan Stanley Africa Investment Fund, Alliance Capital Management's Southern Africa Fund, and Robert Fleming's New South Africa Fund. The New York Times (April 3, 1994) declared that, "Africa, particularly that part of the continent south of the Sahara, has become a hot new target for international investing". Currently over a dozen African funds, with total
investment level of $1 billion, are trading in New York and Europe. Mind you; there were none in 1990 (an infinite rate jump!). Why this development and surge of interest?

Fundamentally, there is an investor motive for diversifying risk globally. While industrial countries have become more integrated and the benefits from diversification among industrial countries have declined, developing countries offer significant diversification benefits and competitive rates. This was a fundamental motive for a dramatic flow of capital to emerging economies to begin with. Although emerging markets are characterized by high real or perceived risk or volatility, they have posted high returns during those periods when the US market conditions were not favorable. There is also empirical evidence supporting low correlation among emerging markets and developed markets. These features are shown to improve risk-return tradeoffs for industrial country investors according to many studies, including a study by Diwan, Errunza, and Senbet (1994). In other words, the addition of emerging markets to a well-diversified global portfolio increases reward-to-risk ratios.

Why is this relevant to Africa? As the newly industrialized and emerging markets become more integrated with the advanced economies, and hence exhibit higher correlation, pre-emerging regions, such as countries in Africa, are bound to be more attractive in terms of the benefits of international diversification. The apparent correlation between African markets and those of the developed countries is low, and hence generating potential for beneficial international diversification. This is what is likely motivating Wall Street and European investors. Moreover, given the principle of international investment allocation, the potential for growth of capital flows to emerging
markets is very high, since the emerging markets portfolio represents only 10% of the
global capital. Expectedly, the allocation of global funds targeted to emerging economies
has continued to increase, and Africa has the potential to be part of the growing flow of
global capital, if countries get their “houses in order”. Why? While emerging markets are
under represented in the global portfolio, Africa is grossly under-represented even in the
emerging markets portfolio (by some estimates about 4% of emerging markets portfolio).
Thus, with increasing economic and financial reforms, Africa is bound to participate in the
growing allocation of global investments to emerging economies. Indeed, Africa is now
being viewed as the “last frontier” for international portfolio investments. These positive
developments point to Africa’s growing status toward marching into an emerging markets
club. Notwithstanding the bright prospects of African financial systems, however, the
current status of capital markets is far from satisfactory. This is a subject that the next
two sections will turn to.

IV. Constraints for Development of Capital Markets in Africa

There are serious challenges and impediments to the development of capital
markets in Africa. While it is difficult to generalize about the disparate financial systems
of a continent comprising over fifty countries, we wish to highlight certain challenges that
are applicable in many country cases, particularly of the Sub-Saharan region. (Also see

A. Microstructure of Stock Markets

Despite the positive and encouraging developments in the restructuring of African
financial systems, stock market development in Africa is way far from complete - not satisfactory even by the standard of what has been possible in the region itself.

Except for the South African stock market, mainly owing to their fledgling nature, many of the stock exchanges are small, with few listed companies and low market capitalization at an alarmingly low liquidity. The emerging stock markets in Africa are by far the smallest of any region, both in terms of number of listed companies and market capitalization. Only four companies were trading in Swaziland in 1995, 12 in Botswana, 56 in Kenya, and 181 in Nigeria compared to over 7000 in the U.S. Moreover, the listed companies consist mostly of foreign firms, a reflection of the weak private sector in these countries. The lack of listed indigenous companies is usually attributed to indigenous entrepreneurs' hesitation to going public for fear of losing control, and generally to shortage of entrepreneurs with resource and experience to float a kind of company of the size traded in other parts of the world (Emenuga (1996)). To encourage listing by indigenous companies, Nigeria launched a second-tier stock market with the result of more participation (181 listed companies) without significant gain in market capitalization.

Market capitalization (measured as a percentage of GDP) is also low ranging from 4.8% in Cot d'Ivoire to 43.6% in Kenya compared to 64% in the U.S. The exception is South Africa with a capitalization ratio of 185%. In absolute terms, market capitalization as of December 1995 ranged from $189 million in Namibia to $397 million in Botswana, $2,033 million in Nigeria and $2,038 in Zimbabwe. Again the exception is South Africa with market capitalization of $208,526 million, a testimony of what is possible even in
Africa. Moreover, in many of the countries, the average listed company has a size of less than $40 million except in countries like Ghana where the market is dominated by a few large companies (e.g., Ashanti Goldfields in Ghana), compared to a size of $539 million and $438 million in Taiwan and South Africa respectively.

Insert Table 2

Most disturbingly, African stock markets suffer from an extremely low liquidity by comparison to the standards of other countries. Market turnover ranges from 0.1% to Swaziland to the maximum of 10% for Botswana (see Table 2). Others are: Nigeria (0.8%), Kenya (2.8%), Cote d'Ivoire (2.2), Namibia (1.6%) and Ghana (1.6%). In contrast, U.S. and Germany achieve turnover ratios of 68% and 147% respectively with Korea 93%, Thailand 70% and Mexico 56%. The low liquidity, more than of the size of the markets, should be of great concern to African light of emerging evidence linking market liquidity to economic growth [see Levine and Zervos (1995), Demirguc-Kunt and Maksimovic (1996), and Rajan and Zingales (1996)].

The lack of liquidity is attributable mainly to barriers to foreign portfolio flows that are still in place in many countries. Share holdings in these markets are typically distributed among the original direct investors of the listed foreign firms, the public sector and local institutional investors. As a case in point, Emenuga (1996) describes the Ghana Stock Exchange where original direct investors hold 69.4% of market value with 30.6% left for the public sector, local institutional investors and the public. With a buy and hold attitude to investing, these three shareholder classes do not usually engage in trading.
except for terminal disinvestment. In the absence of free flow of foreign investment, therefore, little trading occurs. In Nigeria, for example, only 0.8% of market value trade hands in a year; only 3% in Kenya and 1% of market value in Ghana. More interestingly, even the South African market, as advanced as it is in all other respects, suffers from an extreme illiquidity with a turnover ratio of a mere 6.5% in 1995.

Still, regulatory infrastructure in many countries is extremely fragile with weak or absence of company disclosure requirements and accounting rules. Partly owing to problems in the design of market microstructure and lack of quality personnel, there are poor brokerage services and slow settlement and operational procedures where, in some countries (e.g., Nigeria) it takes months to execute a single transaction. As a result, transaction costs are still very high with some barriers to trade and tax anomalies in place that discourage foreign participation in the stock markets.

The settlement (share transfer) process in transacting on stocks in Africa is too long. Aside from Nigeria, in Kenya and Zimbabwe, for example, clearing and settlement takes up to two months. Emenuga (1996) considers this transaction delay a significant source of unsystematic risk in African stock exchanges and attributes it to the manual-based clearing operations (combined with poor postal system), incompetent personnel and fraudulent practices.

Transaction costs in African markets are the highest in the world. Investors get charged for brokerage fees, stamp duty and, in some cases, special charges by the regulatory bodies. Nigeria has the highest brokerage fees of 3%, with Ghana and Zimbabwe, each having 2%. The stamp duty varies, with 0.35% in Zimbabwe to 2% in
Ghana. Total transaction costs range from 2% in Kenya to 4.75% in Nigeria (see Table 2). For a round-trip transaction in Nigeria, it costs a minimum of 9.5% of the share price, with a typical additional brokers' unofficial charge of 10% of price. This is also true to the firms that raise capital through going public. In official fees alone, it costs 2.3% and 2.5% respectively to raise equity capital of $1 million in Ghana and Nigeria (Emenuga 1996). With administrative and advertising costs, it takes up to 4% to raise $1 million equity capital in Nigeria, 5.5% in Cote d'Ivoire. Moreover, in most of these countries, issue costs do not qualify for tax deduction.

In the world of international capital mobility where capital flows respond to the investment climate of host countries, the role of tax policies in promoting or retarding the development of capital markets can not be overemphasized. Tax policy retard development if taxes are heavy, discriminatory and levied in multiple stages. African countries seem to have recognized the role of sound tax policy in promoting capital markets. Many countries, including Botswana, Ghana, Kenya, Mauritius, Namibia and Swaziland, have recently abolished or suspended capital gains taxes. Dividend withholding taxes are cut to 5% from 10% and 15% in Kenya and Nigeria respectively. The rest of Africa has also fared well in the area of dividend taxation, which appears to be a common practice all over the world. The highest rate charged by any African country is 15% (with Mauritius having 0% taxes) compared to a worldwide average of about 15%. In terms of multiple taxation, while in the past, equity was subject to taxation at multiple stages, including corporate income tax, dividend withholding tax, personal income tax and remittance tax on foreign investment, recent measures have virtually eliminated the
remittance tax and attempted to remove all other discriminatory taxes against foreign capital.

B. Weak Banking Systems

In many African countries, lending rates are often divorced from the credit risk of the underlying borrower with the base lending rate often fixed by the central bank as the (primary) monetary policy tool. Moreover, the allocation of credit often has been biased towards soft loans to government owned or controlled sectors rather than the private sector. In particular, small firms are often completely rationed out of the formal bank loan market in the absence of explicit or implicit government guarantees and formal bankruptcy laws and priority rules. Banking systems often adopt cartelized structures regarding interest rates, fees, and services. The "gross" rationing of the private-sector versus the public sector and the failure to use the price (interest rate) mechanism to discriminate among large corporate and public-sector borrowers can result in significant inefficiencies in the allocation of resources and a highly oligopolistic and inefficient banking system.

Thus, common African government policies, such as limiting the size of foreign banks, limiting foreign investments and/or requiring a separation between banking and commerce and banking and insurance (universal banking) can all be viewed as implicit barriers to the efficient provision of financial services. Moreover, policies that require banks and offer financial institutions to make large-scale loans to public sector backed projects or to invest in publicly issued bonds, limit the ability of financial institutions to diversify and offer (sell) credible contracts to investors.
On a related note, government policies that deter the growth of non-bank financial institutions have serious consequences to the overall health of the financial system. These non-bank institutions that complement stock markets and banks include insurance companies and pension funds. Nurtured appropriately, these institutions, with their rich reserve savings, could play an important role in capital mobilization, providing long-term finance to firms, cheap source of personal loan to households (in U.S. one-fourth of outstanding mortgage backed securities is held by these institutions), and even alternative source of funds to governments helping avoid money creation and inflation. The growth of these institutions has been inhibited in many African countries. Emenuga (1996) attributes this to financial instability and repression which discourages long term savings; government interference in the management of the assets of the institutions; and the weak, legal, regulatory and prudential control.

C. Weak Enforcement, Prudential Control and Supervision

In general, accounting standards are often weak and disclosure poor. Capital standards for banks and other financial institutions are rarely enforced and the power to close banks prior to explicit failures is often diffused and rarely used. This has often resulted in implicit forbearance being granted towards the weakest banks and large bailout and resolution costs having eventually to be paid by the government or the bank's depositors. The absence of credibility and rationality in the financial sector is a deterrent to savings in the formal sector and economic development stemming from channeling savings to the most productive firms and sectors.
The activity of financial intermediation, such as banking, involves monitoring of the activities of borrowers and hence enhancing the efficiency of resource use. In a failed financial system borrowers are extremely hard to monitor as a result of poor enforcement of collateral and foreclosure. The lack of enforcement of lender's rights for fuller disclosure of financial information about borrowers would make it impossible for lenders to enter into certain types of financial contracts. In a broader context, firms are unable to raise funds to finance projects at favorable terms, since creditors demand unduly high interest rates, relative to an environment characterized by effective bankruptcy or limited liability laws with effective enforcement of debt contracts, covenants and/or collateral.

Equivalently, adequate disclosure and sound accounting standards are essential ingredients for stock market development. Financial information disclosure and accounting rules in many African countries are mandated by law. Compliance, in many cases, require publication of an annual report, often containing only summary figures and usually due with a lag of about a year. Some stock exchanges publish investment information, such as the annual Handbook of the Ghana Stock exchange and the Factbook of the Nigerian Stock Exchange which also suffer from lack of detail and timeliness. In the developed world, financial information is also provided through brokers' forecast and credit rating agencies. Only in Zimbabwe and Botswana, brokers provide financial forecast on listed firms. In many African countries, the brokerage industry did not develop the institutional capacity to provide this service due to lack of qualified manpower and investment in informational technology.

D. Illiquid and Thin Securitized Finance
There is a dearth of securitized finance, particularly securitized debt, in Sub-Saharan Africa. In addition, derivative markets are virtually non-existent. The absence of securitized debt market in Africa may be a reflection of extreme financial system underdevelopment characterized by severe agency and information costs, and the problems of contract enforceability. African financial systems are not only in a failure category, but government policies typically limit the size and scope of financial service activities, particularly of foreign banks. Also as discussed under subsection A, stock markets in Africa suffer from a dearth of liquidity, with the most advanced of African stock exchanges, the South African market recording a trading volume of only 6.5% of market value.

The major form of financial contracting in Africa is through financial institutions, such as banks. However, the ability of financial institutions to expand and diversify in a competitive financial market, in which they are free to enter and exit, is often constrained. While many governments issue treasury bills or bonds, these are usually directly held until maturity by domestic financial institutions. As such, they take on the characteristic of forced loans, with formal secondary markets in such instruments notably absent. Thus, those capital markets that do exist are extremely thin or informal in nature.

E. Risk Factors

1. Macro-economic and Political Risk: High macro-economic and political instabilities lead to high volatility in the financial markets. Research has shown that country risk, by implication, macro-economic risk, is the predominant source of variation
in stock returns across countries (as opposed to industry-specific shocks). Further, international investors are concerned about political risk associated with the odds of adverse changes in government policies. They manifest in the form of expropriation, restrictions on repatriating capital and returns, differential treatment of domestic versus foreign-owned capital, taxation, etc. It is often said that the best policy is no change in policy! In addition, policies are as effective as they are credible. Thus, stability is valuable, both domestically and internationally.

2. **Foreign Exchange Risk**: Hard currencies are readily hedged. High currency exchange volatility is endemic to African economies, creating an impediment to foreign investments. In view of the dearth of hedging mechanisms through derivative markets (forward, futures, and options), an indirect approach would be to increase the number of export-oriented companies on the stock exchanges. In particular, those with exposure to hard currency exports should be targeted, so as to provide substantial hedging against local currency devaluation.

**F. Resistance to Financial Innovation**

There are concerns about the impact of financial innovation even in the advanced economies. These concerns stem from the potential adverse impact of financial innovation on the stability of the financial system through increased systemic risk. At the outset, it should be recognized that the financial system (and financial innovation), per se does not add risk to the economy. It merely facilitates the efficient allocation of existing risks associated with physical and human capital. However, in an imperfect world, these reallocation mechanisms can change investor trading and consumptive behavior on the
demand side and firm productive behavior on the supply side. It is important to understand this channel in assessing the welfare implication of financial system and the role of innovative mechanisms in this system. Resistance to financial innovation may be due to this channel contributing to greater market volatility and the associated misconceptions about market volatility. This, of course, raises a fundamental question about the optimal level of social risk.

At any rate, it is misleading, and at best incomplete, to assess the efficiency of capital markets based solely on volatility. Volatility is produced by market activity and production of new information that impacts prices. Indeed, the most inactive markets, with negligible volatility, are perhaps the most inefficient. That includes virtually all the stock markets in Africa. Market efficiency is judged by the speed of adjustment to new information, and in this context, it is possible for markets to be more volatile as they become more informationally efficient. In other words, increased market volatility may be reflecting increased informational efficiency and even allocational efficiency.

G. Weak Governance and Political Agency

There is inherent conflict between the private interests of policy-makers and the public at large, and the adverse consequences of this conflict are quite detrimental when the policy-makers grossly intervene in the private management of the economy. It is important to recognize that the conflicts of interests and agency problems that pervade the private sector are endemic to the government sector as well. One should reject the notion of the government as benevolent social guardian, with selfless bureaucrats and technocrats carrying out government policies and deciding upon investment and production plans. The
reason is simple; the government is made up of groups and individuals with diverse interests often in conflict with each other.

Unfortunately, the notion of a benevolent social guardian appears to be the underlying assumption for development economists who advocate active government role in the event of perceived imperfect markets. The irony is that economists assume that agents or individuals in the private sector act in their *self-interest*. How come that the same economists continue to assume that individuals in the public sector are motivated merely by social justice? Undoubtedly there are selfless civil servants and politicians concerned only with the public good; however, it is more realistic to assume that individual actors within the public sector are as concerned with their self-interest as those in the private sector. It is important to recognize that the conflicts of interest and agency problems that pervade the private sector are endemic to the government sector as well.

The reason is simple; the government is made up of groups and individuals with diverse interests often in conflict with each other, or with the taxpayers.

Unfortunately, the public sector lacks the discipline supplied in the private sector by capital markets, corporate governance and control mechanisms to curtail the inefficiencies that arise from self-interested decision-makers and corporate insiders. In particular, agency conflicts arise from opportunistic behavior of government decision-makers for expansion of span of control, promotion, survival, re-election, etc. For instance, to limit this managerial conflict between outside investors and corporate insiders, financial contracting in the advanced countries includes restrictive covenants on the actions of insiders, requiring collateral backing to debt, as well as designing incentive
compatible contracts, such as executive stock options and performance-based compensations, provisions for conversion privileges and callability in the debt contracts. In addition, management may be disciplined by the threat of takeover through markets for corporate control.

V. Prospects for Developments of Capital Markets in Africa

This section will outline an agenda facing Africa in the continent’s attempt to develop capital markets. In particular, we will specify major areas of attention in alleviating the aforementioned challenges and impediments. The basic premise here is that capital knows no borders. The very ingredients that steer foreign capital into Africa are also those that help retain “domestic” capital. The dramatic anecdotal evidence for this premise is considerable reversal of flight capital into Latin America and East Asia, as these countries liberalized and put into place proper ingredients for capital accumulation. Africa stands within the top tier of regions in terms of flight capital stock per GDP, but has yet to see significant reversal of flight capital. According to a recent World Bank estimate, the stock of flight capital from the Sub-Sahara African countries is staggering: 80% of GDP, more than twice Latin America. To put it simply, capital is *Darwinian*. It migrates to wherever its chances to survive and multiply are highest. Given the growing globalization of markets, it has a wide range of choices. Africa’s basic challenge is to position itself competitively in this choice set.

We challenge the existing regulatory approaches and suggest alternative mechanisms that rely on the collective wisdom of the market place and contractual
efficiency arising from informational efficiency and enforceability of contracts.

A. Developing Public Confidence and Informational Efficiency

The government has a vital role to play in ensuring enforceability of private contracts, and hence appropriability of investment returns. The mere existence of legislation, which declare and grant inalienable property rights, is insufficient. Indeed, there is no shortage of such legislation in Africa. There ought to be an independent judiciary strongly enforcing and protecting these rights. Thus, accounting and legal standards are vital ingredients of financial market development.

While there has been an impressive growth of stock exchanges in Africa, they are utterly deficient in terms of informational and operational efficiency. This greatly detracts from public confidence and efficiency in the pricing of stocks, as well as liquidity and turnover. This failed financial environment has also hampered the development of institutional funds and unit trusts, which are critical in attracting small investors to risk capital. Another reason that stock market development requires institutional development is that institutions, such as pension funds and insurance funds, are presumed to take a long-term view. One way to bring energy in the institutional development process is to employ capital market approaches to the process of privatization of state-owned enterprises. This may well be an important arena in experimenting with the development of pension funds through employee participation.

B. Promoting Financial Market Development through Regionalization

There is a positive trend emerging for the development of regional stock markets. Since the stock markets are currently thin and balkanized, there is a talk about pooling
resources and harmonizing securities and investment laws, as well as banking and financial regulations. Cross-border monitoring and enforcement of laws may enhance competition on among the member countries in the region and enhance public confidence in the markets. It is my expectation that the trends in currency regions will take the form of the Rand zone (anchored by the Johannesburg Stock Exchange), the Franc/CEFA zone (anchored by the Abidjan Stock Exchange), the Schilling zone (anchored by the Nairobi Stock Exchange), and the Arab Mahgreb zone. Already, there is some cross-listing of securities between Namibia and Zimbabwe, and Ghana and Zimbabwe (e.g., the Ashante Goldfields). Regionalization or sub-Regionalization should be an essential element of an facing the continent in its effort to develop financial markets. The sooner the better, though. The recent launching of the African Capital Market Forum is an hopeful sign in this endeavor.

C. Human resource and Infrastructure Development

Sub-Saharan African countries face not only severe shortage of financial capital but severe shortage of human capital trained in financial markets. Actually there has been massive flight of both financial capital and human capital. Again, capital - both financial and human-knows no borders. Again, the very measures that steer foreign capital - financial and human - are the same ones that retain domestic capital.

International financial markets have become highly sophisticated in recent years with the advancing information technology. They are increasingly characterized by advanced and exotic securities, including a variety of derivative securities, demanding that market participants stay abreast of recent advances. Indeed, derivatives have gotten their way into
Africa. They are useful mechanisms in terms of risk control and hedging, but if mismanaged, they lead to financial disasters. This is to dramatize my point that training of financial manpower should be at the forefront of financial market development in Africa. It can be done through improved business school curricula in universities and training programs at capital market unsteadiness, including securities and exchange commissions, central banks, stock exchanges, etc. Human resource development should include all those with the potential to participate in the market place as securities dealers, brokers, fund managers, and regulators both in banking and other financial services.

The need for human capital development and optimal deployment cannot be overemphasized. At the level of an African country, returns on capital are a function of available natural and human resources. There is little Africa can do about its endowment of natural resources; however, it can provide the infrastructure to optimally exploit the resources. The provision of infrastructure goes beyond just conduits for goods and energy, such as rail, road, air, water, but also, very significantly, telecommunications. Indeed, in this information age, the role of natural resources is increasingly less important. Thus, while it is natural for African countries to be proud of immense natural resources, it has not brought them the standard of living commensurate with that abundance. Actually, the strongest economies are notoriously devoid of natural resources (e.g., Japan, Singapore, Hong Kong). If anything heavy reliance on natural resources, with lack of diversified economic base, has exposed Africa to volatile commodity prices. On the other hand, the investments made in human capital are long-term, with permanent returns, in terms of efficient deployment of existing resources and adapting to global change and information technology. Human capital
development manifests itself in increased knowledge base, skilled labor, better morale, and resourcefulness, potentially resulting in higher value-added, and hence economic growth of the continent and its attractiveness as a repository of capital.

**D. Promoting Capital Market Development through Privatization**

Privatization is an enhancement of the role of the private sector in an economy. The three principal forms are: (a) privatization of state-owned enterprises, (b) creation of new private enterprises, and (c) re-privatization (i.e., returning nationalized property to original owners). The actual implementation of privatization, particularly of state-owned enterprises can be a difficult task, although there are now well-studied mechanisms, such as employee stock ownership plans, mass privatization and voucher system, and privatization through mutual funds or active investors.

The mutuality between privatization and capital market development often stirs a “chicken and egg” debate. Clearly, the existence of capital markets makes it possible for price discovery of privatized assets. Unfortunately, privatization in Africa has to take place in the face of thin, or even non-existent, capital markets. In those countries where there are stock exchanges, privatization of state-owned companies enhances the depth of the existing markets, while being carried out in a fair way. Indeed, capital market development is an important means of depoliticizing privatization, by making it possible for large-scale privatizations to take place at fair pricing of assets to be sold. In addition, local capital markets allow for local investor participation and help alleviate concerns about foreign grab of assets in privatization. Small investors can participate in large scale privatizations through
institutional funds or unit trusts, if capital markets have developed sufficiently to allow for the establishment of such funds.

What exactly are the efficiency gains from privatization? An important efficiency gain of privatization of state-owned enterprises is to mitigate, or even eliminate, the free rider problem associated with public monitoring. In principle, public enterprises are owned by all the citizens of the state, and no single individual has an incentive to monitor an inefficient management of the state enterprise if is costly to do so. Under privatization the free rider problem is reduced considerably as ownership becomes less diffused, giving rise to better monitoring by active investors. Beyond that, in the stock market economy which allows the transferability of ownership rights in the open market, corporate control contests and the threat of takeover serve as a powerful discipline against inefficiency in the management of private enterprises. Thus, privatization allows firms to be subject to the full disciplining force of capital markets (see Section II) and frees up the government from running and sustaining losing enterprises. Once its burden of running companies is removed, the government will then focus on the delivery of its vital functions, such as education, health, justice, and infrastructure. This is, indeed, an indirect benefit of capital markets, since large scale privatizations (facilitated by capital markets) can redeploy the government's efforts to its areas of comparative advantage.

A similar argument convinces me that privatization should include financial institutions, such as banks and insurance companies. Competing financial institutions will seek out the most profitable investments when evaluating their prospective borrowers, and hence serve as public agents in allocating resources to the most efficient use.
E. Designing Efficient Regulatory Systems

A genuine capital market development is accompanied by a credible and rational regulatory scheme that promotes, rather than inhibits, private initiative, whereby investors and savers build confidence in the financial system. The environment should foster investment allocation to the most productive sectors and lead to growth in productivity and employment. More savings can be attracted into the formal financial system away from the informal sector, as the credibility of the formal system improves.

Financial institutions play a crucial function as delegated monitors in resolving agency problems between ultimate users of funds (corporations) and ultimate suppliers of funds (household savers). Specifically in the face of costly contracting and information imperfections, investors find it optimal to appoint "large" financial institutions as "delegated monitors". In this form of contracting investors buy the securities - deposits, life insurance claims, etc. - issued by financial institutions who in turn purchase the primary claims, bonds and stocks, issued by corporations. The delegated monitoring advantage of financial institutions emanate from economies of size and diversification. Large size allows them to collect information at a lower average cost than individual investors. Also, their larger absolute investment stakes creates greater incentives for financial institutions, compared to small-sized investors, to expend resources to monitor firms. In addition, large-size allows financial institutions to optimally diversify across projects. As a consequence, bank-type financial institutions can sell almost risk-free deposit claims to investors as long as they are backed by a well-diversified portfolio of risky (primary) asset claims.

In order for financial institutions to play their functions in a credible and economically
meaningful way, they need to be unconstrained both (a) in size and diversification dimensions and (b) in the pricing dimensions, especially in their ability to set loan rates and fees based on the perceived role of the ultimate borrower. This suggests that the usual African financial institution system based on separatist or unique asset functions for commercial banks, thrifts, insurance companies, with restricted pricing schedules, may be highly inefficient when compared to highly product-diversified universal banks that have wide powers to set price and fee schedules. It may well be more than coincidence that many developed countries of the world, such as Germany, Switzerland, the UK, have such universal banking systems, and that the US and Japan with largely separatist financial institutions systems have introduced reforms to widen the scope of activities of existing activity-constrained financial institutions.

There is a warning, though, to those who wish to mimic the entire institutional features of advanced economies, such as the US, in developing market economies, such as those in Africa. It is simply that these systems have some serious imperfections and depart heavily from the benchmark idealized market system. These problems have manifested themselves in certain disastrous financial failures, the most notable being the recent savings and loan crisis in the United States.

Governments in advanced economies and many developing economies grant formal deposit insurance to reduce the risk of systemic failure of banks and hence stabilize the payments and financial system. When deposits are guaranteed, depositors themselves face no risk. However, risk due to the risk increasing incentives of the banker is transferred to an insuring agency. Bank owners may gain by choosing excessively risky asset portfolios. In the United States, for instance, the financial deregulation of the 1980s led to increased
incentives for limited liability thrifts and banks to engage in excessively risky lending, hoping for big payoffs under favorable conditions and transferring losses to the insurance agencies under adverse conditions, leading to the savings and loan crisis which has engendered exorbitant costs to US tax-payers.

In an ill-designed deposit insurance system, public mismanagement of the system and private incentive incompatibility problems can actually work to increase the systemic risk and instability of a financial system, a good example again being the current US banking system. As yet, no country in the world has come up with an entirely satisfactory scheme. Abolishing deposit insurance may be desirable, but in countries that lack formal deposit insurance schemes (i.e., most African countries), deposits are implicitly insured even when they are not explicitly insured. The implication is that some useful lessons can be learned from the blunders of the advanced economies, if African countries contemplate deposit insurance system for the banking sector. Otherwise, a blind importation of some institutional mechanisms is cause for disaster. There is, for instance, a prevailing view now that the flat rate insurance systems do not work in the manner of reducing bank failure and financial system risk. Thus, if an African country simply mimics the US deposit insurance scheme, it faces the risk of enhancing financial instability and impairing its economic development3.

**E Globalizing African Financial Markets**

3Fallacies in bank restructuring (the IMF approach). They recapitalize but attribute banking crisis to macro shocks. In a healthy environment the banking system should wither ordinary shocks. It must be that there is mismanagement and excessive risk-taking due to bad governance. It is not the crisis that is causing failure. In an optimal system there ought to be an optimal degree of default and bankruptcy. The question is how do you control excessive bankruptcy and lending?
The data from the Wall Street investment houses and international financial agencies make a compelling case for the benefits of global diversification that includes emerging countries. The implications for development capital and economic growth are accordingly enormous. It is only rational that investors take a global view in their holdings of their portfolios. Consequently, the evaluation of investment portfolio performance must be based on a global risk-reward ratio. The competitiveness of a region like Africa in attracting international capital depends on its role in improving the global risk-reward ratio faced by international investors. Let me illustrate this by using Figure III which is constructed on the basis of data from Morgan Stanley, an investment company which has also premiered an African fund traded in Wall Street.

**Insert Figure III**

The reward (annual return) for an investment portfolio is measured along the vertical axis, and the risk dimension is along the horizontal axis. There is a frontier (hyperbolic) with the extreme right point represented by emerging markets and the curve bends backward in the left with the last point represented by the US market (represented by the S&P 500). Investors with a 100% allocation faced (during the sample period) a reward of 18% but with correspondingly high level of risk exposure (standard deviation of 27%). Those with a 100% allocation in the US market faced a much lower return (11-12%) but with correspondingly much lower risk exposure (standard deviation of 17%).

Interestingly, though, a combined strategy of investment in both emerging markets and the US market clearly dominates investment in the S&P 500 alone (the US market). For instance, an allocation with 75% in the US market and 25% in the emerging markets offered
a higher return (13-14%) return but with a lower risk exposure (17% standard deviation). Indeed, the efficient diversification strategies should plot along the frontier, beginning with the minimum risk allocation, and the US market is dominated by any of these strategies, irrespective of the risk attitudes of international investors.

The diversification benefits of emerging markets and their impact on global risk-sharing have been firmly established by the available evidence, giving rise to opportunities for emerging economies to mobilize capital internationally. The World Bank estimates that equity portfolio inflows (see Claessens, eds., Portfolio Investment in Developing Countries, 1993) to developing countries in the 1990s will reach $27 billion annually. It is also expected that half of the expected net external financing to developing countries will come from portfolio capital inflows. Africa should be able to tap into this source by opening up its markets and engaging in policies that create an enabling financial environment. Currently, the region is grossly underweighted in the perceived optimal portfolios - optimal from the standpoint of industrial investors who are increasingly taking international perspective. advanced economies. In other words, Africa is poised to be in the next wave of emerging securities markets. Those who move fast - both host African countries and international investors - are likely to benefit from the unique risk-return opportunities that Africa offers.

What exactly are the benefits of international diversification to Africa? The more specific benefits to African countries that host international capital include, but not limited to, (a) more diversified source of external finance, unlike heavy reliance on sovereign debt and its attendant crisis, (b) greater risk-sharing by investors, especially through equity investments, in contrast to the syndicated bank lending of the 1970s, (c) reduction in the cost
of capital, (d) reversal of flight capital (often an initial capital inflow and source of privatization capital), and (e) promotion and validation of the credibility of capital market institutions (custodial, clearing, settlement, and brokerage services, information and accounting disclosures, etc.) and regulations.

Thus, apart from enhanced liquidity, participation by global investors allows for wider risk-sharing of local investors. When an asset market is globalized, the previously restricted security would now be traded as unrestricted. This means the security is now subject to global price of risk, and the reference point for the relevant measure of risk is world covariance risk. This has the effect of enhancing the price of the unrestricted security. From the standpoint of productive efficiency, the cost of equity capital diminishes, leading to local firms mobilizing capital more advantageously (enhanced capital mobilization) and greater foreign firm participation (enhanced direct foreign investment). The net effect again is greater economic growth (higher output). These ideas are more fully developed in Errunza, Senbet, and Hogan (1996).

The reduction in the cost of capital is not a “pipe dream”! For instance, an African firm can reduce its cost of capital through international listing, as in the case of Telmex, the Mexican telephone company whose cost of capital went down dramatically upon international listing in 1991. The prominent example from Africa is Ashanti Goldfields, which is cross-listed, is in London, New York, and Zimbabwe. An additional recent mechanism which may yield a similar effect has to do with international listing of country funds comprising portfolios of emerging market securities.

Thus, increased openness and market integration has the effects of enhanced efficiency
(price discovery, liquidity), enhanced risk-sharing/diversification, and enhanced competitiveness (with pressure for the best practices to bear upon the domestic financial sector). In the context of Africa, both regionalization and globalization may contribute to the welfare of countries individually and regions as a whole. The focus on the banking sector precludes opportunities for building up informational technology unique to risk capital and derivative markets (e.g., disclosure and accounting standards). This informational discipline has a positive externality over the entire financial sector, including the banking sector.

It is, therefore, important that African countries do not put counterproductive restrictions in place by stacking odds against outside investors. In particular, taxation of capital gains and dividends should be harmonized with industrial countries. The preferred strategy is actually tax exemption on capital gains and no imposition of withholding taxes on dividends. In this context, it is counterproductive to the development of stock markets to provide preferential treatment of interest income over dividend income for tax purposes (e.g., Ghana). With the development of regional markets and enhanced globalization of African markets, the future holds for regional cross-listing and cross-border investments. There are also indirect benefits coming from the pressure of foreign investors demanding word-class services (e.g., custodial services, clearing and settlement, accounting standards). Thus, globalization exposes African stock markets to the best practices and standards, which in turn put pressure for reforms of the local stock markets.

Insert Table 3

Now caveats to globalization. There are lessons learned from the recent Mexican crisis. It could be potentially troublesome, if inflows are driven by favorable external shocks,
which could be easily reversed. Some believe that historically low US interest rates and the slow down in the US economy were partially responsible for large inflows into emerging economies. Therefore, it is crucial that domestic policies be improved to make these flows resilient to adverse changes in the global environment. That is precisely what is happening in the wake of the Mexican crisis. The development in the emerging markets have stabilized after adverse contagion effects. According to the IMF study (1996), “Most developing countries appear to have become more cautious about relying on highly volatile short-term portfolio capital inflows, and investors seem to be paying more attention to economic fundamentals when evaluating the risks of investment in emerging markets. Significant flows of capital had surged, at relatively low spreads, into many of the emerging markets during the first half of the 1990s, as a result of optimistic assessments of the [recipient countries’] economic prospects...” (p.5). Also, on the positive side, Africa did not face the adverse shocks of the Mexican crisis due to its relative absence in the global financial markets, but it now stands to gain from the more sober behavior of international investors. Sometimes, there is a “last mover” advantage! The emerging consensus is that portfolio capital is much more likely to be channeled to those countries best suited to increase productive investments and improve fundamental economic factors and policies. Thus, macro-economic stability is being rewarded with success in financial sector growth.

**F. Fostering Financial Innovation and Using Signals from the Informal Sector**

Financial innovation leads to a deeper market with an expanded menu of risk allocation mechanisms, whereby investors can *hedge, diversify, or insure*. This may in turn lead to investor and firm undertaking riskier investment opportunities so long as risk is priced
correctly. The market may naturally become more volatile as investors become more aggressive in undertaking high risk and high return opportunities. Due to specialization and comparative advantage in trading risk, the society will, in fact, be better off. Indeed, it is possible that greater speculative activity and greater participation by international investors in the local stock market leads to greater trading activity with more information production, and possibly more price volatility. However, the accompanying increased volatility may create a temptation for policy-makers to stifle innovation and increased trading activities through discouraging foreign investments and domestic speculative trading. Such ill-conceived policy interventions have been observed to have taken place even in the advanced economies. However, the ultimate guidance should be the increased liquidity and social value arising from risky activities. The goal of the social planner is not to minimize risk but to maximize social welfare via maximization of social value of ventures undertaken in the economy. This is achieved by optimal risk allocation and not by risk minimization.

In fact, the biggest dangers in emerging markets, such as in Africa, are market manipulation and thinness. Consequently, policy-makers should facilitate liquidity and promote market transparency rather than stifle innovation and trading in the market place, including erecting barriers to globalization. Capital knows no borders, as is widely demonstrated by capital flight. Indeed, Sub-Sahara Africa is totally integrated into the global markets in terms of capital outflow. Government policies should be targeted toward reducing the cost of trading, cost of intermediation, and cost of legal enforcement. Some trading costs arise implicitly. A prominent example is legal ban on short sales or exorbitant collateral requirements against short selling. In a nutshell, the policy should create an enabling
environment for capturing the full functional potentialities of markets. For instance, there is a need to build capacity in the provision of risk allocation facilities.

Financial innovation takes place both in the formal and informal sectors. It is important to appreciate signals coming from the informal sector in gauging the adverse impact of current financial policies and the potential impact of policy proposals. In general, the informal sector is a response to the impediments to the development of the formal sector. The informal sector feels market need and void. It should not be stifled, but used as a signal for innovation in the formal sector. However, the informal sector falls far short of completing the market, particularly in the African economies. In the absence of formal derivatives markets, for instance, individuals and firms seek other less efficient means of risk management. Part of the inefficiency arises because the informal sector is characterized largely by localized risk among close family circles and acquaintances. However, the informal sector gives a signal for what is needed in undertaking full development of the financial sector. In other words, rather than discouraging the informal sector, regulators should be guided by signals coming from the informal sector in fostering an innovative formal financial sector.

G. Is There Optimal Sequencing of Markets?

In the advanced countries capital markets have developed from primary to secondary, from fixed to residual, and from residual to derivatives. Also banking development preceded equity market development. Thus, the temptation for developing economies, particularly for Africa, is to follow the same kind of sequencing. This is motivated by the view that the less developed would follow stages of development of the advanced countries.

This view is fallacious. Consider the case of derivatives and their role in risk
management. Where else do you need more control and allocation of risk (e.g., agricultural risk through commodities futures) than in Africa. By the same token, human capital development is needed to manage risk more efficiently. That is to say, advanced training in derivatives and other instruments of risk management is very desirable in such economies.

**H Is Africa too risky? Perception and Financial Marketing**

Despite the unprecedented political, economic and financial reforms that have taken place, Africa still conjures up images of war, famine, massive corruption, failed projects, grossly undisciplined governance, and gross violations of human rights in international news headlines. This obviously leads to perceptionally high, and even untenable, political and investment risks facing potential investors in Africa. While political risks are inherent in investments in emerging, and pre-emerging, economies, there is a need to evaluate and quantify these risks as accurately as possible for purposes of optimal investment strategies. Is there clear evidence for a reduction, or positive trend, in political risk, despite some continuing wars, ballot-rigging, corruption, political unrest, etc.? It seems, overall, that the thirteen stock exchanges in Africa are domiciled in countries of moderate political risk. For instance, there are no such markets in Zaire, Liberia, Angola, etc. Thus, one of the functions of the ACMF should be to promote Africa to global investors on a sufficiently documented basis. Conversely, as African countries rely more heavily on private sources of capital, they will naturally be subject to the discipline of markets for international capital and hence carry greater incentives to put into place mechanisms to reduce and control investment and political risks.

Part of the perception problem arises from the monolithic view of Africa as a single,
troubled "country". In truth, Africa is a continent of many diversities. There is a need for more extensive, detailed and reliable data capturing the diversity of Africa, along with data capturing the financial circumstance of private institutions within the formal financial system to be available to regulatory authorities. A much more complete description of the institutional environment within which these institutions operate is essential, as is a good account of the demand for formal finance.

The timeliness and reliability of financial data is crucial in making reliable estimates of investment risks in Africa. Thus, there is an important role to be played by governments and private sectors in developing and maintaining new sources of financial data. This should also be a priority of the African Capital Market Forum. This is a subject that we turn to now.

I. Research and Information Collaboration

Given the thinness and "balkanized" nature of the stock markets in Africa, there is a need for information pooling and collaboration. This complements measures that were already discussed earlier to promote pooling of resources in the development of regional stock markets and cross-listing of securities. Among these measures are elimination of barriers to cross-border investments and cross-listing of securities by way of harmonizing investment rules and tax policies across countries. The deepening of existing stock exchanges and elimination of investment barriers would also allow for listing of stocks of outside companies operate in countries without stock exchanges. It is critical, though, that the quality of information available on such companies is credible and that there are services providing indicators of the stock market environment.
Thus, a genuine development of capital markets in Africa needs a research and information arm. Again, this is an area of synergy and team effort. Fortunately, there are already some important institutions in place that can anchor the collaborative effort in quality information generation and developing an ongoing research agenda that helps keep African capital market operators and policy-makers abreast of the state-of-art developments in capital market knowledge and its application. Existing institutions that can perform such research and information functions include the African Economic Research Consortium (AERC), United Nations Economic Commission for Africa (UN ECA), African Development Bank (ADB), International Development Research Center (IDRC), International Center for Economic Growth (ICEG), among other institutions and networks. In addition, a recent launching of the African Capital Market Forum (ACMF) is a welcome news. A research arm of the ACMF should directly play in proving quality research and coordinating the disparate research and information efforts of the other institutions. Given the limitation of resources, it is critical that there is little duplication of efforts amongst these organizations. The Forum should be an arena to promote the coordinated research effort in a way that capitalizes on the comparative advantages of the different organizations.

It would be useful to highlight some priority research issues. First, there is a need to develop and organize an African capital market database. The information requirements include publication and timely updating of stock market indices (individual country and regional), sectoral indices, market depth (capitalization, listing size, turnover, new issues, privatization), firm performance measures, such as price-earnings ratio,
dividend yield, earnings per share, etc. It is critical that there is timeliness and accuracy of
disclosures of financial information on listed companies. Researchers may also require
availability of data on time series of stock prices on relatively short frequency.

Second, there is a need to track down the introduction of new products, new
listings, and developments of institutional funds and unit trusts. As a related matter, a
researcher needs to have adequate information to answer the basic question: Is the stock
market operating in an operationally efficient and fair manner? Thus, information is
needed on settlement procedures and clearing systems, custodial services, trading systems
(electronic and computer-based), infrastructure (electricity, telecommunications, postal
services, automation), technology and institutional development (quality of brokerage
services, unit trusts, pension funds, insurance services, etc).

Third, a comparative information on the costs of trading (e.g., transaction costs,
taxes, bid-ask spreads) and features of foreign investment barriers or incentives (e.g., tax
discrimination, withholding taxes, liquidity and exit strategies, etc.) across countries and
regions would facilitate the discussion and evolution of regional markets (e.g., trends in
currency regions, cross-listing of securities, the development of country funds). Also, it
would be useful to obtain information on comparative trading practices and insider trading
rules, particularly market transparency. Overall, the research agenda should include areas
for promoting access to international and flight capital. Fourth, investors also need to have
access to timely information on indicators of macroeconomic performance, as well as
indicators of fiscal stability (e.g., budget deficit and government indebtedness), and
policies affecting capital markets in general. Fifth, information on the diversity of stock
ownership (individual, government, institutional) will help gauge on the long-run supply and demand factors affecting the evolution of capital markets.

Sixth, it would be useful to track down risk exposures facing the real sector (e.g. commodity price fluctuations) and the financial sector (e.g., interest rate risk, credit risk, risk-return profiles of individual stocks and stock indices). This allows researchers and policy-makers to evaluate the depth of risk management techniques that are currently available and propose introduction of new risk-management techniques (e.g., derivatives). Also, such information impacts policies towards the requisite human resource development (e.g., capacity building in risk management, training and technical programs).

Finally, there is a need to assess the quality of the regulatory environment affecting the stock market, and data requirements include efficiency of banking regulation and surveillance (to a sound banking system, subject to internationally recognized regulatory and capital adequacy standards), efficiency of securities regulation, central bank independence, and non-statutory laws and self-regulatory mechanisms.
References


Table 1: Flow of Private Capital to Developing Countries (in Millions of U.S $)

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(1) "Other" capital flows is mainly bank lending and includes short-and long-term trade credits, loans, currency and deposits, and other accounts receivable and payable.
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Table 3: International Emerging Market Equity Funds

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(1) The funds include Global Equity Funds, Regional Funds and funds designated to specific countries (Country Funds).


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### Table: Real GDP Growth Rates (%) 1992-1995

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</thead>
<tbody>
<tr>
<td>1992</td>
<td>3</td>
</tr>
<tr>
<td>1993</td>
<td>2</td>
</tr>
<tr>
<td>1994</td>
<td>3</td>
</tr>
<tr>
<td>1995</td>
<td>1</td>
</tr>
</tbody>
</table>

#### Source: ADB Statistics Division

#### Figure 1: Real GDP Growth Rates (%) 1992-1995

- **1992**: 1
- **1993**: 3
- **1994**: 2
- **1995**: 1

**Not Available**
Figure 2: Payoffs to Capital Contributors and Society as a Function of Firm Cash Flow

Debtholders Contract for Fixed Payoffs

Firm Cash Flow

Payoffs to Debtholders

Payoffs to Equityholders

Payoffs to Society

Contributors and Society
Figure 3: International Emerging Markets Equity Funds

- **Net Assets (All Developing Countries)**
- **Net Assets (Africa)**
- **Number of Funds (All Developing Countries)**
- **Number of Funds (Africa)**