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AFRICAN CAPITAL MARKETS AND REAL SECTOR INVESTMENT

YOHANE KHAMFULA*
University of the Witwatersrand, Johannesburg, Republic of South Africa

Abstract: Many African capital markets find the lack of an efficiently organized capital market a serious obstacle to the efficient use of their savings, and thus to their overall economic development. To improve the situation, this paper suggests the following policy recommendations: removal of impediments to capital market development, improvement of the financial system infrastructure for efficient trading activities, sound economic policies that stabilize the exchange rate and prices to help attract foreign investors, increased integration of the local capital market with the world capital markets, encouragement of family-owned firms to go public and, most importantly, liberalization of international capital flows. The study also proposes 'privatization' and 'currency union' as enhancers of capital mobilization for real sector investment in Africa. Copyright © 2005 John Wiley & Sons, Ltd.

1 INTRODUCTION

In this paper we attempt to analyse critically the effectiveness of African capital markets in mobilizing capital for real sector investment. Equity or capital markets allow some individuals, firms and countries to finance spending in excess of their current incomes. They also enable individuals, firms and countries to lend to others savings they cannot employ as profitably themselves. The general notion among economists is that well developed capital or equity markets should be able to mobilize capital for real sector investment. However, many developing countries and former planned economies find the lack of an efficiently organized capital market a serious obstacle to the efficient use of their savings, and thus to their overall economic development. It is in this predicament that Africa finds itself—its capital markets are deemed not to effectively mobilize capital for its real sector investment.

*Correspondence to: Dr Yohane Khamfula, School of Economic and Business Sciences, University of Witwatersrand, P/Bag 3, Wits 2050, Johannesburg, Republic of South Africa.
E-mail: khamfulay@sebs.wits.ac.za

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The presence of strong and dynamic capital markets is vital for the inflow of foreign capital and will help domestic companies in seeking additional resources in the form of new equity. Most of the developing world still lacks a well-developed financial sector. In recent times, a growing body of theoretical reasoning and empirical evidence seems to suggest a positive, first-order relationship between financial development and economic growth. However, there are different opinions among economists concerning the importance of the financial system for economic growth. According to Bagehot (1873) and Hicks (1969), the financial system played an important role in setting in motion industrialization by facilitating the mobilization of capital for 'immense works'. And Schumpeter (1912) argues that a well-functioning financial system spurs technological innovation by identifying and funding those entrepreneurs with best chances of successfully implementing innovative products and production processes. But Robinson (1952) contends that economic development creates demands for particular types of arrangements, and the financial system responds automatically to these demands. But some economists just do not think that the finance-growth relationship is of importance. Lucas (1988) argues that economists badly over-stress the role of financial factors in economic growth. And development economists frequently express their skepticism about the role of the financial system by ignoring it (Chandavarkar, 1992).

There is an expanding theoretical literature on the links between stock markets and long-run growth. Levine (1991) and Bencivenga *et al.* (1995) derive models where more liquid stock markets—markets where it is less expensive to trade equities—reduce the disincentives to investing in long-duration projects since investors can easily sell their stake in the project if they need their savings before the project matures. This means that enhanced liquidity facilitates investment in longer-run, high-return projects that boost productivity growth. Such similar outcome is also pinpointed in the studies undertaken by Devereux and Smith (1994) and Obstfeld (1994) where they show that greater international risk sharing through internationally integrated stock markets induces a portfolio shift from safe, low-return investments to high-return ones, and hence this accelerates productivity growth. However, these liquidity and risk models also show that greater liquidity and international capital market integration ambiguously affect saving rates.

An expanding body of literature shows that differences in how well financial systems reduce information and transaction costs influence saving rates, investment decisions, technological innovation and long-run growth rates. In arising to make transaction and information costs less severe, financial systems serve one primary function: they facilitate allocation of resources, across space and time, in an uncertain environment (Merton and Bodie, 1995). Thus, in the presence of specific information and transactions costs, financial markets and institutions may arise to ease the trading, hedging, and pooling of risk—either liquidity or idiosyncratic risk.[1]

The central argument in this paper is that African stock exchanges, in particular, do not seem to have made much progress beyond the initial wave of activity, and, apart from few (e.g., Johannesburg and Cairo), they have not reached the point of being vibrant markets that have gained the confidence of the public and attract foreign investment. In comparison with the highly organized and properly regulated stock operations in the advanced countries, most of the emerging stock markets in Africa are not well functioning. With

[1]Liquidity is the ease and speed with which agents can convert assets into purchasing power at agreed prices. Thus, real estate is typically less liquid than equities, and equities in, say, the United States are typically more liquid than those traded on, say, the Johannesburg Stock Exchange (which is relatively a less developed stock exchange compared to the New York Stock Exchange).

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only few exceptions, equity markets in Africa are characterized by the following: (i) too few listed companies; (ii) very small average size of listed companies; (iii) low liquidity levels; and (iv) low levels of trading activity. Constrained by these shortcomings, African capital markets do not seem to effectively mobilize capital for its real sector investment. To this end, the paper suggests a number of policy recommendations to deal with such shortcomings and these include removal of impediments to capital market development, improvement of infrastructure of the financial system for efficient trading activities, sound economic policies that stabilize the exchange rate and prices to help attract foreign investors, increased integration of the local market with the world capital markets to eliminate distortions in the domestic securities, encouragement of family-owned firms to go public and, most importantly, liberalization of international capital flows to bring about significant improvement in the African capital markets. We also propose 'privatization' and 'currency union' as enhancers of capital mobilization for real sector investment in Africa.

This paper has seven sections. Section 2 looks at effectiveness of equity markets in developed countries. Effectiveness of equity markets in emerging markets (other than African) is assessed in Section 3. In Section 4, the current state of African equity markets is presented. Section 5 analyses effectiveness of African equity markets in mobilizing domestic resources and attracting foreign capital for real sector development. Section 6 assesses how to encourage family-owned enterprises to transform into publicly listed firms. Section 7 offers policy recommendations and conclusions.

2 EFFECTIVENESS OF EQUITY MARKETS IN DEVELOPED COUNTRIES

There is adequate research undertaken in the case of individual developed countries that attempt to find a link between financial development and economic growth. For example, Cameron *et al.* (1967) dissect the historical relationships between banking development and the early stages of industrialization for England (1750–1844), Scotland (1750–1845), France (1800–1870), Belgium (1800–1875), Germany (1815–1870), Russia (1860–1914) and Japan (1868–1914). The researchers carefully examine the legal, economic and financial linkages between banks and industry during the industrialization of these 7 countries. They typically begin by describing the political system, economic conditions and financial structure at the outset of the analysis period. Then, they describe in detail how the financial system evolved during a period of rapid development. In the final analysis, they document critical interactions among financial intermediaries, financial markets, government policies and the financing of industrialization. However, these country-case studies depend heavily on subjective analyses of banking system performance and do not systematically control for other factors determining economic development. Analytical limitations of country-case studies notwithstanding, however, Cameron (1967b) concludes that the banking system played a positive, growth-inducing role in these countries.

A number of cross-country studies have investigated the relationship between economic growth and aggregate measures of how well the financial system functions by employing statistical and econometric methods. King and Levine (1993a; 1993b; 1993c) study 80 countries over the period 1960–1989. Systematically controlling for other factors affecting long-run growth, they examine the capital accumulation and productivity growth channels, and analyse whether the level of financial development predicts long-run economic

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growth, capital accumulation and productivity growth.[2] They find that there is a statistically significant and economically large empirical relationship between the initial levels of financial development and future rates of long-run growth, capital accumulation and productivity improvements. Berthelemy and Varoudakis (1996) report that insufficient financial development has sometimes created a 'poverty trap' and thus become a severe obstacle to growth even when a country has established other conditions—such as macroeconomic stability, openness to trade, education attainment—for sustained economic development.

Rajan and Zingales (1996) assume that financial markets in the United States are frictionless. They use the US as benchmark country to define each industry's efficient demand for external finance (investment minus internal cash flow). Then they examine industries across a large sample of countries and test whether the industries that are more dependent on external finance (in the United States) grow relatively faster in countries that begin the sample period with better financial systems. Their finding is that industries that depend heavily on external funding grow comparatively faster in countries with well-developed financial intermediaries and stock markets than they do in countries that start with relatively weak financial systems. In a related study, using firm level data from 30 countries, Demirguc-Kunt and Maksimovic (1996b) contend that firms with access to more developed stock markets grow at faster rates than they could have grown without this access.

Thus, it is argued, these recent studies present evidence consistent with the view that the level of financial development greatly affects the rate and structure of economic development. However, these empirical studies do not clearly resolve the issue of causality. Financial development may predict growth simply because financial systems develop in anticipation of future economic growth. Moreover, differences in political systems, legal traditions or institutions may be influencing both financial development and economic growth rates. Rajan and Zingales (1998) develop a new methodology to investigate whether financial-sector development has an influence on industrial growth. In doing this, they partially circumvent the causality issue. The study is successful in finding evidence for a channel through which finance theoretically influences growth. Also, since there are multiple observations per country, the researchers are able to examine situations where the direction of causality is least likely to be reversed. Apart from its methodological contribution, the study's findings suggest that financial development has a substantial supportive influence on the rate of economic growth and this works, at least partly, by reducing the cost of external finance to financially dependent firms. And, in the context of the literature on financial constraints, the study provides fresh evidence that financial market imperfections have an impact on investment and growth.

There is more theoretical debate existing about whether greater stock market liquidity really induces a shift to higher-return projects that stimulate real sector investment. It argued that, since more liquidity makes it easier to sell shares, more liquidity stimulates the incentives of shareholders to undertake the costly task of monitoring managers (See Shleifer and Vishny, 1986; Bhide, 1993). This implies that, in turn, weaker corporate governance strangles effective resource allocation and derails productivity growth. Thus, theoretical debate over the relationship between economic growth and the functioning of equity (or capital) markets is not over yet.

[2]For similar studies, see Gelb (1989), Easterly (1993), Pagano (1993) and Gertler and Rose (1994).

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Levine and Zervos (1998) empirically investigate whether measures of stock market liquidity, size, volatility, and integration with the world's capital markets are robustly correlated with current and future rates of economic growth, capital accumulation, and productivity improvements using data on 47 countries for the period 1976–93. The investigation is able to provide empirical evidence on the major theoretical debates concerning the relationship between stock markets and long-run economic growth. Furthermore, the study also evaluates whether banking and stock market indicators are both robustly correlated with current and future rates of economic growth, capital accumulation, productivity growth, and private saving. They find that stock market liquidity—as measured both by the value of stock trading relative to the size of the market and by the value of trading relative to the size of the economy—is positively and significantly correlated with current and future rates of economic growth, capital accumulation, and productivity growth. The results from the Levine and Zervos (1998) study, therefore, underscore Levine's (1991) and Bencivenga *et al.*'s (1995) theoretical predictions that there are strong, positive connections between stock market liquidity and faster rates of growth, productivity improvements, and capital accumulation.

3 EFFECTIVENESS OF EQUITY MARKETS IN EMERGING ECONOMIES

Since the mid 1990s the share of the total world capitalization represented by the emerging markets has increased by at least 10 per cent. To this end, trading has also surged with the value of shares traded on emerging markets increasing by about 20 per cent of the world's exchanges. Apart from this rapid growth in emerging markets, there is also evidence of greater integration of capital markets with foreign portfolio investment in emerging markets increasing to about US$40 billion (See Levine, 1996).

Drabek (1993) observes that capital markets in four transition economies—Czech Republic, Slovakia, Hungary and Poland—are extremely thin both for securities and for equities and they are yet to fulfil their main tasks. His study finds little activity among companies to raise capital outside the banking sector and very little interest on the part of investors to position themselves in these markets. The report contends that, on the demand side, privatization is a vital element of capital markets and will therefore play an important role in the development of capital markets of the countries under study. However, in the early stages privatization may not provide a strong stimulus for the development of capital markets.

In recent times a substantial amount of literature has concentrated on the subject of volatility in emerging capital markets. Understanding volatility in emerging capital markets is important for determining the cost of capital and for evaluating direct investment and asset allocation decisions. It is now a well-known fact that equities from emerging capital markets have more volatile prices than equities from developed capital markets. Emerging markets exhibit high-expected returns as well as high volatility. Bekaert and Campbell (1999) argue that in segmented capital markets, risk premiums may be directly related to the volatility of equity returns in the particular market. Higher volatility implies higher capital costs. Higher volatility may also increase the value of the 'option to wait'. Hence this would delay undertaking of investments.

Harvey's (1995) analysis of the predictability of the returns in emerging capital markets reveals that the returns are more likely to be influenced by local information than they are in developed countries. One possible interpretation of the influence of local information is

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that the emerging markets are segmented from world capital markets. Another interpretation is that there is important time variation in the risk exposures of the emerging markets. However, many researchers studying time-varying asset returns for countries with stable, developed industrial structures have assumed that risk loadings are constant. This assumption is far less reasonable for developing countries. The country risk exposure reflects the weighted average of the risk exposures of the companies that are included in the national index. As the industrial structure develops, both the weights and the risk exposures of the individual companies could change. This may induce time variation in risk exposures.

4 CURRENT STATE OF EQUITY MARKETS IN AFRICA

In recent years, the evolution of capital markets in Africa has been rather dramatic, as countries have sought not only to mobilize domestic resources but also to attract foreign direct investment. To this end, operations in a number of capital markets that had been dormant for years picked up significantly and a number of new markets have emerged.[3] Operations on the established stock exchanges have boosted by increased listings of companies, which has been mostly made possible by privatization of public enterprises.

However, a relatively limited number of securities, which are held to a substantial extent in perpetuity by few insurance and pension funds, characterise many African stock exchanges. And the participation by individual savers/investors is significantly limited in most of these markets. As a result of this, African stock markets (with the exception of Johannesburg) are short of liquidity.

In comparison with the highly organized and properly regulated stock operations in the advanced countries, most of the emerging stock markets in Africa are not well functioning. The current state of most of Africa's equity markets is characterized by inadequate government regulation and inefficient private information gathering and disseminating firms as found in more developed stock markets. It is also observed that young firms in most of Africa's emerging stock markets may not have a long enough track record to form a reputation. In addition, in many of the African equity markets there is a serious shortfall of skilled financial experts and the lack of training institutions with the necessary equipment to meet the human capital needs of securities markets. Tirole (1991) notes that, because of such anomalies, one expects share prices in Developing countries' markets to be 'noisy', often arbitrary and volatile.[4]

It is worthwhile looking at some of the African countries that have taken positive steps to encourage investment in their economies. The Johannesburg Stock Exchange (JSE) plays a leading role in the Southern African Development community (SADC). There are a number of developments currently in place on the JSE. The first development is that there is a strong activity to enforce compliance with JSE listing requirements for existing

[3]At present there are around 20 stock exchanges in Africa. The recent times have witnessed buoyant markets in Africa such as the Malawi Stock exchange, the Ugandan Securities Exchange, the Lusaka Stock Exchange, the Botswana Stock Exchange and the West African regional Stock Exchange.

[4]Singh (1999) gives three reasons that explain why share price volatility is a negative feature of stock markets: (i) it reduces the efficiency of the price signals in allocating investment resources (ii) it increases the riskiness of investments and may discourage risk-averse firms from financing their growth by equity issues and thus from listing on the local stock market and (iii) it may lead to financial fragility for the whole economy, at a macroeconomic level that is.

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exchanges in the SADC.[5] The second development is that within South Africa, the JSE itself has merged with the South African Futures Exchange and the Bond Exchange of South Africa as part of the reforms of the South African securities market. The third development is that a new electronic settlement that will bring South Africa in line with advanced international standards and will enhance the security of settlements in the equities market has been introduced. The fourth development is that in March 1996 the JSE commenced automated trading that converted the first group of shares from floor trading to the Johannesburg Equity Trading (JET) system. Significant improvements have arisen for investors, listed companies and the JSE itself from the JET system through improved transparency, security and audit activities, which greatly enhance investor protection. To date, the JSE is linked with the Namibian Stock Exchange through the JET system for cross-border trading.

The Nigerian government has abolished legislation preventing the flow of foreign capital into the country. This has given foreign brokers a chance to enlist as dealers on the Nigerian Stock exchange; and any outside investor is free to invest in Nigeria. And Nigerian companies are also allowed multiple and cross-border listings on foreign markets. However, withholding tax on dividends and interest earned still remains at 105, corporate income tax at 35 per cent and capital gains tax at 10 per cent.

In order to attract foreign investors to invest in Zambia, the Zambian government has ensured absence of exchange controls or restrictions on shareholding levels and foreign ownership, and capital gains taxes. Moreover, there are no restrictions on foreign investment and outsiders may invest on the Exchange on similar terms as Zambians. Companies' income taxes have been reduced from 35 to 30 per cent and sales of unlisted securities have been waived by a 2.5 per cent property transfer tax in order to give companies an incentive to list as opposed to being quoted. Dividends are partly taxable. With these measures in place, the number of securities traded on the Exchange is anticipated to increase since approximately 150 public enterprises have been earmarked for privatization. Treasury bills and other government bonds are also expected to trade on the Exchange.

The Ghana Stock Exchange (GSE) lists all types of securities, and the criteria for listing include capital adequacy, profitability, spread of shares, years of existence and management efficiency. The manufacturing and brewing sectors dominate the exchange. Other listed companies include the banking, insurance, mining and oil sectors. Most of these companies are local but there are some multinationals. The GSE was voted the best performer among all stock markets in Africa in 1998 in terms of capital appreciation.

In Ghana, there is a 10 per cent withholding tax on dividend income for all investors. The exemption of tax on capital gains applies to all investors on the Exchange. There are no exchange control regulations on the remittance of original investment capital, capital gains, dividends, interest payments and other related earnings.

In general, capital markets in developing countries are characterized by high variations, price inefficiencies, inequality of treatment of taxation *vis-à-vis* banking sector, small size and dominance of few participants. Additionally, the corporate sector is characterized by the predominance of family-owned groups who are risk-averse with regard to divesting equity share. The markets in developing economies are also limited in the number and variety of tradable instruments.

[5]These exchanges include JSE, Botswana Stock Exchange, Malawi Stock Exchange, Namibian Stock Exchange, Stock Exchange of Mauritius and Swaziland Stock Exchange.

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5 EFFECTIVENESS OF AFRICAN EQUITY MARKETS IN MOBILIZING DOMESTIC RESOURCES AND ATTRACTING FOREIGN CAPITAL FOR DEVELOPMENT

This section attempts to explain why African equity markets are ineffective in mobilizing domestic resources and attracting foreign capital for real sector development. To this end, the section also pinpoints problems with and limitations to the growth and effectiveness of African equity markets.

Although it still lags behind that of other regions of the developing world, Africa's real sector investment has been increasing since 1994. Real sector investment is now relatively higher than it had been since the 1970s. The International Finance Corporation tracks stocks in ten African countries.[6] Between 1991 and 1998, excluding South Africa, market capitalization increased by 160 per cent, the number of listed firms by 26 per cent and the value traded from $117 million to $1.5 billion.

It is important to point out, however, that the extremely turbulent world economy of the past two years has affected Africa in a number of ways. First, because of its relatively low level of economic development and the economic weight of traditional activities, the East Asian crisis and erratic stock market movements have affected Africa less until recently than most other emerging markets. Some investors, put off by East Asian, Russian and Argentinean markets, have turned to Africa, at the margin, in search of diversification. And this has contributed to the region's increased capital inflows. However, empirical evidence shows that share prices in the developing world's markets such as Africa's are to a great extent more volatile than in advanced countries' markets. Singh (1999) points out that in spite of the high share price volatility in developing markets, firms in the developing world do not shun the markets. This indicates that developing stock markets have been useful in providing significant funds to firms.

While the number of stock markets is increasing slowly, there are a number of challenges that bedevil some of these African equity markets in their effort to mobilize domestic resources and attract foreign capital for significant development. Of vital importance at this stage are issues such as finding a way to increase the supply of securities in the market, increasing returns to shareholders and liquidity of shares in the market and making firms go public. Most of enterprises in Africa are still small and medium-sized and, for this reason, it is appropriate to encourage them to use second-tier securities market to raise capital for their operations and expansion. But firms are from time to time discouraged from going public due to regulatory bodies that are ready to intervene to hold down the issue prices in the primary market.[7] This, therefore, means that the relatively low prices of securities may not provide a suitable environment for a fast increase in the supply of securities in later periods. The relatively low level of prices in the secondary market, as a result of control measures, may have to be eased for the sake of attracting more active participants in the market.

As pointed out in Section 4, many emerging stock markets in Africa are not operating properly. This is, understandably, due to underdeveloped equity markets and banking sector. Moreover, most of Africa's equity markets have inadequate government regulation and inefficient private information gathering and disseminating firms compared to the

[6]These countries include: Benin, Central African Republic, Cote d'Ivoire, Kenya, Malawi, Mauritania, Mauritius, Namibia, South Africa and Togo (See Glen and Sumlinski, 1998).
[7]For example, in Nigeria the Security Exchange Commission has often times frustrated enterprises to go public by using this tactic. See Yohannes (1999) for further explanation.

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more developed stock markets in developed countries. Furthermore, in most of the African equity markets, there is a serious shortage of skilled financial experts and the lack of training institutions with the necessary equipment to meet the human capital needs of capital markets.

It is further noted that Africa's emerging markets face impediments such as legal, regulatory and tax barriers to capital market development. To this end, the legal and regulatory environment lacks the required operational ingredients such as accepted standards of accounting and the disclosure of information. And the tax barriers are obstacle to domestic firms in the sense that these firms find it unprofitable to go public since there are no tax incentives offered in the early periods.

Africa is yet to improve its infrastructure for efficient trading activities and put sound economic policies of stabilizing the exchange rate and prices to help attract foreign investors. Apart from this, there is little integration with world capital markets. Global capital-market integration is very important since it would improve the operation of the local capital market by being instrumental in eliminating distortions in the prices of domestic securities. This means that the effectiveness of the underdeveloped local capital markets is greatly reduced by barriers to international investment. Moreover, this problem is compounded by the interference of the foreign exchange market by monetary authorities, which results in upsetting the market rather than stimulating it.

Many African countries have not taken steps to fully liberalize international capital flows to their capital markets. This problem limits opportunities for long-term economic growth through greater market liquidity. With a liquid market, it easier for firms to raise capital for investment. By making long-run investments more attractive, liquid stock markets may improve investment in longer-term and more profitable activities, thereby enhancing the prospects for long-run economic growth.

Lastly but not least, the problem of political stability also affects Africa's capital markets in effectively mobilizing domestic resources and attracting foreign capital for real sector investment. Foreign investors shun the African capital markets because of the perceived high degree of political instability in some of the African countries.[8] Since investment is a long-run process, it is important that policymakers make long-run investment more attractive by creating a stable and favourable investment environment where political risks could be reduced. Authorities should see to it that their policies are credible and that investors, both domestic and foreign, are confident enough to take an active role in the market.

However, the issue of creating massive and lucrative investments gets entangled with that of privatization. Admittedly, Africa cannot attract significant investments from both home and abroad without acceleration of privitazation. The disadvantage of privitazation is that it may create economic, social and political chaos. A big proportion of people in African economies are employed in the public sector. Many people would not likely accept privatization albeit its long-run merits of boosting investment like that in the real sector as its introduction would mean a massive loss of jobs. The economic, social and political implications of such an outcome can be irreparable. One solution in this case is that the individual economies can take a middle course that requires a balancing formula of 50 per cent privatization of public institutions and the remaining portion should remain public.

[8]For example, political differences are still unabated in countries such as Zimbabwe, Liberia and Democratic Republic of Congo.

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It can also be proposed that formation of currency union in Africa will provide a good basis for creating a health environment for mobilizing capital for real sector investment in Africa. The starting point could be formation of regional currency areas with the long-run goal of uniting these separate currency unions into one. There are already underway a number of such regional currency unions in Western Africa and Southern Africa.[9] The existing African currency unions represent a high degree of capital and money market integration the African economies.

However, Africa has diverse economic structures among its countries and this may posit a very serious obstacle to the promotion of regional integration in the African continent.[10] For example, whereas South Africa has a quite sophisticated manufacturing sector, most of the rest of the African economies produce primary goods.

6 HOW TO ENCOURAGE FAMILY-OWNED ENTERPRISES TO TRANSFORM INTO PUBLICLY LISTED COMPANIES

One important stylized fact about family-owned businesses is that they are the predominant form of business organization in the early stages of a country's economic development (Battacharya, 2001).[11] Payne's (1983) historical survey of family businesses in Britain concludes that the family firm is 'the vehicle whereby the Industrial Revolution was accomplished'. Japan's family businesses began as merchant houses during the Edo period (1603–1867), and, in spite of government-prodded attempts to go public during the Meiji Restoration (1868) and their dismantling by the 'Allied forces' after the Second World War (1945), they metamorphosed into the *zaibatsus*. In China, family businesses began during the Ming Dynasty (1368–1644), but revolutions in the home country in the twentieth century restricted them to mushroom only in the rim of countries bordering the mainland.

Battacharya also points out a second stylized fact about family businesses that their dominance decreases as capital markets develop. Large family firms are an exception rather than the rule in economies with well-developed capital markets. In the United States, the large family enterprises of the nineteenth century have become publicly held corporations. Battacharya's third stylized fact about family enterprises is that, despite their diminished dominance, they are still very important in all countries. They account for quite a significant proportion of the economy in developed countries. For example, they contribute 40 per cent of the USA's GDP and 60 per cent of its workforce, 66 per cent of Germany's GDP and 75 per cent of its workforce, and approximately 50 per cent of Britain's workforce. In the developing world, however, family enterprises account almost for the entire private economy. For example, in India family firms represent 70 per cent of the total sales and net profits of the biggest 250 private-sector companies.

Most big family-owned firms that operate in Africa are multinationals whose roots are found in developed countries. Given the important and changing nature of the role played by family firms in Africa, it is important to review briefly here the likely economic factors that influence the decision to sell a family enterprise privately or publicly. The recent

[9]We have Western African Monetary Union and Southern African Common Monetary Area.
[10]See Khamfula and Huizinga (2004) for a summary of criteria for assessing a currency area.
[11]As pointed out in the last paragraph of Section 4, the corporate sector in most of emerging markets is characterized by the predominance of family-owned groups who are risk-averse with regard to divesting equity share. Africa's corporate sector is no exception in this regard.

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literature has attempted to present a little discussion on this. Pagano (1993) contends that a public market for equity may not arise at all; since an issuer shoulders all the costs of listing, but gains only a portion of the increased diversification benefits he provides to others, he may refuse to issue. Zingales (1995) emphasizes the private benefits of control; selling to a dispersed group of shareholders increases proceeds for the cash flow rights, but selling to a private buyer maximizes proceeds for the control rights. Ibbotson and Ritter (1995) hypothesize that an enterprise will offer its stock publicly late in its life cycle, when the diversification benefit outweighs the moral hazard or adverse selection cost plus the fixed cost of issuance.

Shleifer and Vishny (1997) stress that external financing is best raised in economies where legal protections are in place to provide external financiers with confidence that they will get their money back. Bolton and von Thadden (1998) and Pagano and Roell (1998) have extended the agency conflicts identified by Jensen and Meckling (1976). They argue that concentrated ownership leads to better monitoring of mangement but lower liquidity. Chemmanur and Fulghieri (1999) focus on asymmetric information; although selling to a broad group of shareholders is good from a diversification point of view, the disadvantage is that these shareholders are deprived of information related to firm value.

An obviously important economic factor mentioned in the preceding two paragraphs is that a publicly owned firm has more dispersed share of ownership. Thus, once a family-owned enterprise is transformed into a public-listed firm the required capital is generated in general by selling shares to a large number of investors. This is unlike in the case of a private firm; one large investor or a small group of large investors provides much of its external financing. This argument, therefore, gives the whole background to the reason for encouraging family-owned firms to transform into publicly listed companies.

The fact that private firms obtain their capital from a much smaller group of investors than public firms has two noticeable outcomes. One is that the presence of numerous equity holders in public firms, each with a smaller equity stake means that these equity holders are much better diversified than those in private firms. The other consequence is that a more concentrated shareholding in private firms implies that a large investor or a small group of large investors will have considerably more bargaining power against the entrepreneur in such an enterprise than the numerous small investors in a public firm. These two consequences should in practice act as incentives for family-owned firms to go public.

However, a direct consequence of the fact that a public firm raises its capital from a much larger number of investors than a private firm is that a much larger group of investors must be convinced about the quality of the firm's projects. Equilibrium requires that any such costs expended by outsiders in evaluating the firm's projects should be borne by the firm in the form of a lower share price. Furthermore, when a firm goes public, the common price at which equity is sold is publicly observable by all outside investors. This implies that the magnitude of the total costs involved in the outsiders' evaluation of the firm's projects will be reduced somewhat by many unsophisticated investors being able to free ride on the information they can infer from this publicly observable share price. For example, given that public firms have a more dispersed ownership structure, public enterprises' insiders (managers) may also be subject to considerably less monitoring of their actions from outside shareholders compared to mangers of private firms.

It should be clear that the success of encouraging family-owned businesses in Africa to go public depends on how reliable the capital markets are in terms of efficiency in their operations. It is important that the infrastructure has to be improved for efficient trading activities. There is also the need to remove impediments such as legal, regulatory and tax

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barriers to capital market development. Improvement of legal and regulatory environment may involve the enforcement of adopting accepted standards of accounting and the disclosure of information. As for tax barriers, family-owned firms may find it helpful to go public if they are offered tax incentives in the early periods.

7 POLICY RECOMMENDATIONS AND CONCLUSIONS

In Section 4 we learnt that the participation by individual savers/investors is significantly limited in many African markets. The result of this is that African equity markets (with the exception of Johannesburg) are illiquid. Widening stock market access beyond national boundaries to other stock markets in the region should enhance stock liquidity and provide savers/investors with significantly more diversified risk opportunities. Thus, the establishment of the West African Regional Stock Exchange in Abidjan in 1998 and Central African Regional Stock Exchange in 2000 are very encouraging developments.[12]

The existence of well-functioning capital markets (especially stock markets) is essential to the mobilization of resources both internally and externally. For there to be some degree of efficiency in the operations of these securities markets, the following conditions should prevail: a stable macroeconomic environment, an appropriate capital market infrastructure, and adequate regulatory, legal and supervisory framework in order to insure that investors are protected, promote public confidence and guarantee market discipline.

Furthermore, in Section 4 we also noted that there is a shortage of skilled financial technocrats and the lack of appropriately equipped training institutions that can meet the human resource needs of securities markets. The best way to deal with this limiting initial condition for capital market development in Africa is to increase educational activities, public awareness campaign, support the development of institutional investors, encourage unit trusts and pension funds and train key market participants such as brokers.

Specifically, there are a number of measures to be put in place to deal with the dismal performance of African equity markets, which are as follows:

(i) The need to introduce policies aimed at fostering development of both the equity market and banking sector. However, stronger emphasis should be directed to the equity market since as the economy's stock exchange market continues to develop, the debt equity ratio falls, with enterprises depending more on equity and less on debt.
(ii) The need to remove impediments such as legal, regulatory and tax barriers to capital market development. Improvement of legal and regulatory environment may involve the enforcement of adopting accepted standards of accounting and the disclosure of information. As for tax barriers, domestic firms may find it helpful to go public if they are offered tax incentives in the early periods.
(iii) The infrastructure has to be improved for efficient trading activities. Sound economic policies of stabilizing the exchange rate and prices may help attract foreign investors.

[12]The West African Regional Stock Exchange was established in September 1998 by the West African Monetary Union (WAMU) countries, namely: Benin, Burkina Faso, Cote d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo. The central African Regional Stock Exchange comprises Central African Franco Zone countries—Cameroon, Central African Republic, Chad, Congo Republic, Equatorial Guinea and Gabon.

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(iv) Increased integration with world capital markets would improve the operation of the local capital market by being instrumental in quashing distortions in the prices of domestic securities. This suggests that one way of improving the size of the local capital market is reducing barriers to international investment.

(v) Liberalizing international capital flows in those African countries may bring about significant improvement in their capital markets. This will ensure expanded opportunities for long-term economic growth through greater market liquidity since a liquid market makes it easier for enterprises to raise capital for investment. By making long-run investments more attractive, liquid stock markets may improve investment in longer-term and more profitable activities, thereby enhancing the prospects for long-run economic growth.

(vi) The foreign exchange market should not unnecessarily be interfered with monetary authorities, as doing so would only result in upsetting the market rather than stimulating it; for example, South Africa.

(vii) Because of the huge advantages of a publicly owned firm mentioned in Section 6, African countries should make it a priority to encourage family-owned enterprises to go public. This requirement becomes even more pressing considering the predominant nature of family-owned firms in African countries.

(viii) Since investment is a long-run process, there is need for policymakers to make long-run investment more attractive. One possibility to achieve this is to create a stable and favourable investment environment where political risks could be reduced. Authorities should see to it that their policies are credible and that investors, both domestic and foreign, are confident enough to take an active role in the market.

It should be emphasized that for there to be a significant boost in the operations of African equity markets, the African countries should make an effort to design appropriate policy frameworks for their capital markets including adequate regulatory regimes and to acquire the necessary skills for the development of efficient capital markets. African Governments should also seriously consider the issues of privatization and currency unions.

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