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Virtuous circle for east Africa

Regional capital market integration is the only option

Staci Warden, Milken Institute

Over the past decade, the major economies of east Africa – Kenya, Uganda, Tanzania, and Rwanda – have enjoyed annual growth rates of well over 5%. But unlike in Latin America and east Asia, where economic growth has spurred impressive growth in capital markets, in east Africa capital market development has lagged considerably.

With the exception of Kenya, the East African Community, made up of Burundi, Kenya, Rwanda, Tanzania, and Uganda, has among the smallest and least developed capital markets in the world, even as a share of GDP.

Market capitalisation

Equity market capitalisation is low, secondary market liquidity is paltry, benchmark domestic currency yield curves show major shortcomings, and corporate bond markets are virtually non-existent. Even Kenya's equity market capitalisation, at about 35% of GDP, is much smaller than what typically counts as a 'liquid market', both in terms of size and daily turnover. Nigeria's stock market, for example, is about three times larger than Kenya's.

East Africa has huge public and private financing needs, but corporates raise money almost entirely through bank loans, and small and medium-size enterprises in particular have limited access to reliable finance of any kind. Likewise, domestic savers have few retail savings products beyond bank deposits.

Given the financial repression and low levels of credit allocation caused by an over-reliance on banking systems, capital market development has become a priority for governments in the region. Kenya, for example, has just completed a comprehensive capital markets master plan and has undergone a number of important reforms, including the demutualisation of the Nairobi stock exchange. Rwanda has distinguished itself for its openness and its rapid approval process of licenses and new issue applications.

But a country's capital market development is related to the size of its economy, and in particular to the level of domestic savings on the supply side and the size of the banking and corporate sectors on the demand side. Apart from, perhaps, Kenya, the countries of east Africa are arguably too small economically to develop viable capital markets even if individually they put in place the right macroeconomic policies and institutions.

Rather, regional capital market integration is the only viable option for deep, well functioning capital markets for the EAC countries. Until recently, though, rather than pursue the scale opportunities that come with regional integration, each country has tried to develop its market in parallel, with modest success and at considerable cost.

For example, each country in the region has spent millions of dollars on trading and clearing and settlement systems, each one of which has the capacity to handle more trades per second than the turnover on the combined exchanges annually. To their credit, EAC governments have recognised both the error and the opportunity and have made some important progress towards integration in recent years, in particular regarding the harmonisation of their regulatory environments and in encouraging the cross-listing of stocks on national exchanges.

Required reforms

The recent automated linkage of the inter-depository mechanisms between Kenya and Rwanda is a significant step, and serves as a pilot for a regional system. But more work needs to be done on the standardisation of listing and other requirements, the harmonisation of tax and fee regimes, and the linkage of trading and clearing and settlement systems.

These reforms are required before capital can move freely across the EAC, with issuers raising money in any market and intermediaries providing services across the region from their home countries. Progress has been slow in part because of the fear on the part of some countries – Tanzania in particular – that liquidity will be consumed entirely by the Nairobi stock exchange.

But the benefits of EAC integration for the member countries far outweigh the risks. For companies, the harmonisation of listing requirements will significantly reduce the administrative burden of raising capital; for investors, a regional market will enable better diversification of risk; and a greater opportunity for (and competition from) intermediaries will reduce transaction costs and improve liquidity in all markets.

Kenya has the most sophisticated market intermediaries, the only well-developed fund management sector, and the largest institutional investors. Therefore, the other EAC countries, by leveraging Kenyan market infrastructure, should benefit disproportionately.

Economic growth

Despite their different levels of financial sector development and integration readiness, the participation of all EAC members should be the ultimate goal, not least because of the marketing opportunity. Combined, the EAC region is home to 135m people and has a GDP of $120bn.

This is a golden opportunity to promote the EAC as an asset class to international investors, with regional debt instruments as well as collective investment vehicles such as mutual funds or ETFs on offer. Capital market integration enables joint promotion of regional-level FDI opportunities, especially with respect to infrastructure.

There are other self-feeding benefits too. Not only does liquidity generate liquidity: capital markets create a virtuous circle for economic growth. Deeper capital markets attract more robust foreign investment flows that can finance large-scale infrastructure and export-oriented companies.

Better infrastructure and integrated capital markets facilitate intra-regional trade. Improved trade and larger regional companies drive economic growth. And richer economies generate greater savings that, in turn, facilitate deeper capital markets.

Both Asia and Latin America have already displayed this virtuous circle over the past 10 years. This is something east Africa can emulate in the coming decade. ■

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East African Community

Established in 1968, revived in 2008

EAC

JUMUIYA YA AFRIKA MASHARIKI