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Stock market development and integration in SADC (Southern African Development Community)

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Abstract

The paper analyses the extent of stock market integration in SADC by first analyzing beta and sigma convergence and then using cointegration analysis. The US market and the SSA index were used as benchmarks. The sample period was from January 1999 to December 2011 using daily market index data. We observe beta convergence but not sigma convergence; though the sigma values are falling for most of the SADC countries. Under normal conditions, no cointegrating vector was identified when using the US market as benchmark. When using the SSA index as benchmark one cointegrating vector was identified. The paper also takes stock of the extent of software and hardware stock market integration in SADC. The SADC stock exchanges must work towards greater integration so that they can attract more sustained portfolio flows rather than volatile portfolio flows and also greater FDI flows which are much needed for the financial and economic development of the SADC countries. We also need to consolidate and reduce the number of exchanges with the view to improve market capitalization, liquidity, market infrastructure, governance amongst others but most importantly to increase the visibility, robustness and reputation of SADC stock markets at the international level.

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Keywords: Stock market; Mauritius

1. Introduction and background

Many markets in Africa are small and there are major scale inefficiencies. The challenge for most African stock markets is to increase liquidity, expand access and reduce the cost of capital. Although some progress has been made in deepening financial instruments in Africa in recent years, there is still a lot to be done. Financial market activities remain limited, with low capitalization and inadequate liquidity in capital markets. Most financial instruments continue to be concentrated at the short end of the term structure. Consequently, lending rates remain very high and spreads are large. Moreover, there is a lack of involvement by domestic investors. The stock markets in the Southern African Development Community (SADC), except for a few, exhibit the same characteristics. In view of promoting financial market development within the SADC region, it is accepted that there is the need to: integrate and consolidate SADC financial markets; to facilitate the access to information and its free flows; to harmonize the regulatory and legislative frameworks for stock market and listing of securities operations; and to speed up the

implementation and monitoring of the Financial and Investment Protocol.

In fact, a main aim of the Financial and Investment Protocol (FIP) was to inform U.S. based institutional investors of the investment opportunities offered by African stock exchanges. Forums such as these could help African participants to showcase some of the high-performing companies listed on their countries' exchanges, while also drawing attention to the need for more public–private partnerships between large international companies, African SMEs, and international donors, to nurture nascent African private sectors to grow, create jobs, and contribute to economic growth.

Source: [AfDB Regional Integration Brief, 2013](#).

Within the SADC region, stock markets such as the “Johannesburg Stock Exchange” and the “Stock Exchange of Mauritius” could definitely play a key role in this regard. The SADC region constitutes an interesting space, one which could be used as a pilot case to understand the changes that need to be brought to the operational, regulatory and technological framework for stock exchanges in the region to foster the growth of intra-regional trading, intra-regional portfolio investments and intra-regional funding of listed companies. South Africa and to some extent Mauritius have emerged as significant sources

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of investment into other SADC countries. Some other countries can also become significant regional investors while others may become major recipients of SADC investment. Such a trend needs to be encouraged in order to develop the industrial base of the SADC countries (AfDB Regional Integration Brief, 2013).

Moreover, a plan that aims to forge an integrated network of autonomous national exchanges—as envisaged by the Southern African Development Community’s Committee of SADC Stock Exchanges—is likely to gain more support from participating member countries than a plan that closes down and replaces existing national exchanges with a single regional exchange. The inherent nature of nation states implies that it is not uncommon for all regional integration plans to encounter some resistance at the national government level. Governments may oppose the idea of relinquishing the symbol of national sovereignty that a national exchange represents. Of course, resistance is likely to vary according to the degree to which sovereignty is relinquished (Irving, 2005). Therefore greater regional stock market integration can make SADC countries compete better for international capital which is much needed for the economic development of these countries.

1.1. Objectives of the study

This study seeks to determine to what extent has integration of the SADC African stock markets been achieved and to find out if there is a long-run relationship in the returns of the SADC African stock markets? The specific objectives of this study are to take stock of the progress made with respect to stock integration in the SADC stock markets in terms of harmonization of market infrastructure and to assess the extent of the linkages among the stock markets in the SSA and see whether they are integrated with each other and with the larger international stock markets such as the USA. This will be done by assessing the degree of beta and sigma convergence and identifying the existence of long-run equilibrium relationships in the stock market returns.

1.2. Motivation of the study

The motivation of the study is based on the following main factors. First, the empirical literature confirms that for decades the African stock markets are characterized by small sizes, poor liquidity, high concentration and insufficiently developed market infrastructure. So we contend that greater stock market integration is much needed and should be the way forward. Regional integration, if carried out at the right pace and in a pragmatic way, could improve the liquidity, efficiency, and competitiveness of the region’s stock exchanges. Cooperation and integration of national stock exchanges could offer a way of overcoming some of the impediments to development that most of the African stock markets now face as relatively fledgling and illiquid exchanges.

Second, the empirical literature shows that on balance the benefits of regional stock market integration tend to outweigh the costs; yet the progress towards significant stock market integration for African stock exchanges has been rather slow. This paper argues that we need more concrete action on the ground

and greater political commitment with respect to stock market integration and do nothing is not an option. When we study the capital flows to Africa relatively speaking they are still low and they can be increased substantially through regional stock market integration. Capital flows which Africa badly need.

The economic and financial crisis of 2008/2009 brought wider awareness that financial integration comes with considerable benefits and non-negligible costs. When mechanisms for maintaining financial stability are not in place; the costs of financial integration generated by a crisis can be considerable. Therefore, monitoring the degree of financial integration is useful in both good times, when the long-run benefits of economic growth are realized, and in bad times, when the costs of financial integration (through contagion) are present.

SADC countries need large amounts of financing to build infrastructure for sustained growth. Capital markets are needed as an alternative source of financing, supplementing commercial banks. Recognizing the benefits of capital markets and the limitations of individual country approaches, the creation of regional stock exchanges can help significantly for a quantum leap in harnessing much needed capital to the African countries. From the literature there seems to be no empirical study of stock market convergence/integration analyzing the SADC countries together, which serves as our motivation to explore for this empirical evidence in this study and thus add some knowledge based on our findings to the existing literature.

2. Characteristics of African stock markets

Africa’s markets are perceived as being excessively risky, highly illiquid and the institutional environments in which they operate are underdeveloped. Stock markets in Africa have received little attention due to under development and illiquidity of the markets. However, there have been considerable improvements, rapid growth and liberalisation in a number of African countries stock markets (see Allen et al., 2011). They carried out a comprehensive study on Africa’s financial systems. The study shows that there has been a rapid increase in the establishment of stock exchanges, particularly in Sub-Saharan Africa (SSA). There were 5 stock exchanges in SSA about two decades ago, but now there are about 20 in operation [see Hearn and Piesse, 2008]. Capital flows to Africa¹ also show that Africa (except South Africa) is not faring so well compared to Asia and the BRICS countries.

With regards to listing on the African stock markets, Senbet and Otchere (2008) show that in 2007 the mean number of firms listed on the African stock markets was 129 far less as compared with individual countries such as Malaysia with 911 firms listed and 158 companies in Mexico. Similarly, Afego (2011) reports that for most African stock markets, market capitalisation as a percentage of GDP is still low, below 50% for 11 out of 15 of the exchanges on which data is available (see Table 1 above). So African stock markets suffer from depth; though the situation has improved.

¹ Table not reported due to space limitation but available upon request.

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