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African stock market returns and liquidity premia

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ABSTRACT

We investigate the association between African real stock returns and stock liquidity for sixteen countries over the years 1995–2010. Using fixed effect models (FEM) and system generalized method of moments (SGMM), stock returns and liquidity measures are positively related when South Africa is excluded from the sample, making liquidity “priced in” these less liquid markets. The discount rate (MSCI world index return) is negatively (positively) related with African stock returns. Overall, the results on controls are more robust in dynamic panels: equity markets respond negatively to local currency appreciation, consistent with the export-commodity nature of many of these countries.

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1. Introduction

The total value of stocks traded (in current U.S. dollars) of the African stock markets has increased on average over 1700 percent from 1995 to 2010.[2] The market capitalization of listed companies as a percentage of GDP has also increased dramatically since 2001. Recently published evidence further

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[2] The data source is the World Bank and the percentage changes are calculated by the authors.

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indicates flourishing African capital markets. Allen et al. (2011), for instance, provide facts about the investment potential of African stock markets by pointing out at historical records. Despite the challenges associated with liquidity, African stock markets performed remarkably well, both in terms of absolute returns and on a risk adjusted basis. According to Allen et al. (2011), the average annual return for these markets over the past 10 years was 25 percent. With the exception of 2008, the performance of these markets has been increasing significantly, with the returns on the markets in Egypt and Malawi exceeding 100 percent at times. When converted into U.S. dollar terms, the results remain impressive: an average annual return of 21.8 percent. Despite Africa's impressive returns, Senbet and Otchere (2005) indicate Africa is under represented, not only in the global portfolio, but also in the emerging market portfolios, indicating the tremendous potential for further financial openness to attract capital flows to this region.

Previous studies show that stock market liquidity affects asset price and returns. Brennan and Subrahmanyam (1996), Eleswarapu (1997), and Brennan et al. (1998) document that stocks with lower liquidity provide higher returns, i.e. investors expect higher returns from the less liquid stocks in developed equity markets. Despite previous emphasis on the predictability of African stock markets under specific countries and short time periods [e.g. Olowe, 1999; Magnusson and Wydick, 2002; Appiah-Kusi and Menyah, 2003; Hassen et al., 2003; Jefferis and Thupayagale, 2008], there is still lack of systematic empirical work on the return of African stock market indices subject to liquidity problems. In general, the African stock market return and liquidity are understudied. First, to the best of our knowledge there is no paper that investigates the relationship between African stock returns and liquidity. Second, our paper addresses the endogeneity of some of the variables in this study, such as between stock returns and the real economy (GDP growth and the discount rate) and between stock returns and liquidity, which are all simultaneously determined.

In this paper we focus on 16 African countries: Botswana, Cote d'Ivoire, Egypt, Ghana, Kenya, Malawi, Mauritius, Morocco, Namibia, Nigeria, South Africa, Swaziland, Tanzania, Tunisia, Uganda, and Zambia, with active stock markets. Zimbabwe, also with an active stock market, is excluded from our analysis due to its very high inflation over the period of analysis from 1995 to 2010. Our sample countries of stock markets are largely small order driven markets but also includes very small market (Swaziland), frontier markets (Botswana, Ghana, Kenya, Mauritius, Morocco, Nigeria, and Tunisia—based on the MSCI classification), and emerging market (Egypt and South Africa—based on MSCI classification). The methodologies used are the fixed effect model (FEM) and the system generalized method of moments (SGMM) proposed by Blundell and Bond (1998), in which we take into account the proliferation of instruments based on Roodman (2009).

This paper has as its main objective an investigation into the association of (real) African stock index returns and liquidity, itself measured in two different ways: the first being the ratio of stock traded to market cap and the second being the ratio of stocks traded to GDP. Controlling for real GDP growth (and the discount rate), MSCI world index stock return, the real competitiveness of the exchange rate against a basket, and financial and trade openness measures (GEQY of Lane and Milesi-Ferretti, 2007, among other indicators), we would like to estimate if liquidity factors are priced in African markets. The fixed effect models indicate a positive and significant relationship between stock market returns and liquidity variables (either turnover/Mkt capitalization or turnover/GDP) when South Africa is excluded from the sample. Furthermore, SGMM results confirm these results and advance new ones. We explain these findings by appealing to the fact that African stock markets are not well developed and suffer from liquidity problems. As such, increased liquidity has a positive effect on stock returns for the vast majority of African countries; specifically, when South Africa is not included in the sample. In all specifications of the dynamic models and controlling for all else, a one percent increase in liquidity leads to a more than proportional increase in stock returns when South Africa is not included in the sample, which suggest that less liquid markets fully "price in" advances in liquidity.

This paper is organized as follows: We present in the next section the literature review; followed by sections on the research questions, data and methodology, and results. A concluding remarks section summarizes this study.

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