

THE PLACE OF CAPITAL MARKET IN DEVELOPING ECONOMY

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ABSTRACT

In recent past there has been an increasing concern on the vital role play by capital markets in many developing economy especially in Africa in inspiring economic growth. The proposition that African economies may be lagging and that the capital markets may not be providing the needed surplus for financial service intermediation and economic development has been argued by some researchers. The experience in some African economies is that of challenges of effective quality institutions such as democratic institution, accountability could have caused to the fragile capital market development in most Africa countries, the increased political risk which resulted to reduction in the viability of external finance. This paper is aimed at among other things evaluating the impact of capital market on developing economies, challenges to capital market development, capital market and economic growth in Nigeria and policy directions for promoting capital market growth in developing countries.

Keywords: *Economy, Developing Economy, Capital Market, Stock Exchange*

INTRODUCTION

Inspiring long term economic growth and development requires strategic long term funding longer than the normal duration time which most potential investors or savers are willing to commit their funds and this negatively affects economic growth. In this respect, the capital market offers an opportunity for the mobilization from the surplus micro economic unit and utilization for long-term development and hence it is referred to as the long term end of the financial system. Over the years, globally there has been dramatic upsurge in capital market operation, and emerging economy have accounted for a large amount of this boom. This indicates the rising acknowledgment of the capital market as a base for fast-tracking economic development in developing economies. Though, opponents have maintained that the capital market might not perform effectively in developing country like Nigeria and that it may not be achievable for these countries to stimulate stock markets given the enormous costs and the absence of sound financial structures as argued by (Singh, 1999). Capital markets in principal are expected to fast-track economic growth and development by accumulating and boosting domestic savings through increasing the efficient and effective, investment environment provide micro economic unit with additional financial instrument that may improve their risk preferences and liquidity requirements as suggested by (Levine and Zervos, 1998). This paper appraises the development in capital market operation, challenges, and its roles economic in growth and development in developing country like Nigeria.

Capital Market and Developing Economy

In recent past, financial liberalization in many developing countries has been mentioned as a strategic component and important part of economic policy design and promoted by what used to be called the “Washington Consensus”. Consequently, financial liberalization has

become an emerging trend in both developing and developed economy with well- established frameworks for its anticipated effects on economic growth. Thus efficient financial systems have indicated a sound drive towards effective markets operation particularly in developing country like Nigeria.

Cosh, Hughes and Singh (1992) enumerated numbers of interrelated factors that resulted to sifts of emphasis on capital markets;

- (a) the progressive deregulation of financial markets both within and outside in leading economies,
- (b) The markets internationalization
- (c) The introduction of a new of financial products and service permitting riskier and bigger financial investments and
- (d) The advent and the growing role of new actors in the financial markets principally, institutional investors.

On the other hand Sule and Momoh (2009) identifying the channels for economic development through the capital market argued that it offers opportunities for companies to borrow needed funds for long-term investment drives. It further provides opportunity for the trading of shares and other financial securities in order to raise additional funds for diversification and expansion of operations resulting to increase in economics of scale. It creates avenue for the allocating financial and real resources among various economic sectors. Their further suggested that through this mechanism of capital formation and allocation the capital market ensures an efficient and effective distribution of the scarce resources for the optimal benefit to the economy and it reduces reliance on short term financing for long term projects and also provides opportunities for government to finance projects aimed at providing essential amenities for socioeconomic development. Filler, Hanousek and Campos (1999) assert that the economic importance of the link between capital market and economic development differ according to a country's level of economic activities with a greater impact in under developed economies. Singh (1999) has argued that the capital market might fac serious challenges in developing countries and may not perform efficiently and that it may not be feasible for such economies to promote capital markets given the huge costs and the poor financial structures. These difficulties are expanded in developing countries where there is poor regulatory institutions and high macroeconomic volatility.

The higher level of fluctuation, on share prices in the market the poorer the efficiency of the price on equity investment. These limitations of the stock market have resulted to many analysts and researchers to question the significance of the system in promoting economic growth in developing economy. With reference to developing countries, IMF, (2007) noted that a significant development experienced in the equity markets in the early 1990s. Even though in the late 1980s, there were about five functioning capital markets in sub-Saharan and only about three in North Africa.

However this numbers has dramatically changed currently, with more than 19 Stock Exchanges ranging from new Stock Exchanges in countries like Mozambique and Uganda Stock Exchanges to the Johannesburg Stock Exchanges and Nigeria. South Africa is the only country with lower level of stock market increase but most other markets the capitalization has increase significantly between 2002 and 2006 (IMF2007). Adjasi and Yartey (2010) found that total market capitalization for African markets improved to US\$ 254,672 from US\$113,423 million between 2002 and 2008. This stock market movement indicates the

smaller level of African markets with limited numbers of listed companies and poor market capitalization. South Africa, Egypt, Nigeria, and Zimbabwe are the exceptions with listed companies of 503, 89, 892 and 307 respectively. The number of averagely listed companies on sub-Saharan African markets excluding South Africa is 49 compared with 123, with the presence of Egypt and South Africa as argued by (Yartey and Adjasi, 2010).

Capital Market and Economic Growth

Capital markets all over the world play a vital role in stimulating economic progress. This is less debatable especially where there is a well-established theoretical and operational framework. Though, the debates on findings and empirical evidence across countries and the arguments are quite inconclusive and with no conclusive results. Grilli and Milesi-Ferretti, (1995), Kraay, (1998) and Rodrick, (1998) found that capital market does not affect growth, while others suggested that it effect positive (Levine, 2001, Bekaert et al., 2003 and Bonfiglioli and Mendicino, 2004), others poise that it has negative effects (Eichengreen and Leblang, 2003). Certain studies s suggested that the effects varies across countries because of their level institutional and economic development differs (Bekaert et al, 2003).

The Role of Capital Market in Emerging Economy

Capital market play a vital role in stimulating economic growth this is less debatable where there is well a design conventional theoretical framework for window of opportunities to be favorable. Though, there is ongoing arguments about the outcomes and evidence from different researchers across countries and the arguments are fairly inconclusive and with diverse outcomes. For example (1995) and Rodrick, (1998) Grilli and Milesi-Ferretti, argued that capital market does not impact on economic development, while others suggested that its impacted even positively on growth and development (Bonfiglioli and Mendicino, 2004, Bekaert et al., 2003 and Mendicino, and Bonfiglioli 2004), on the other hand some few others argued that it has negative effects (Eichengreen and Leblang, 2003). While numbers of research suggest the effects to be heterogeneous through countries at dissimilar phases of economic and institutional development. (Bekaert et al, 2003, and Edwards, 2001) and nations with diverse macroeconomic arrangement (Arteta, Einchengreen and Wyplosz, 2001). Observed that we could expect the growth effect of capital markets to be smaller in high-income than in middle-income countries (Rancière, Tornell and Westermann 2006).

Some of the challenges in developing countries as examined below:

Macroeconomic Stability

A stable macroeconomic operating environment is critical for the development of the capital market. The exposure in macroeconomic activities increases the level of informational asymmetries this resulted to challenges in the financial system as argued by (Garcia and Liu 1999). Low and anticipated inflation rates are more likely to bring about stock market development and economic growth. The foreign and domestic investors will be reluctant to invest i the stock market where expected level of inflation is considerably high. Garcia and Liu (1999) assert further that steady macroeconomic environments and adequately high income levels; domestic savings, GDP per capita and domestic investments are significant element that determine level of stock market development in developing markets.

Banking Sector Development

The development of the banking sector is significant for stock market development in developing economies. At the initial phases of its instituting the capital market is a supplement not substitute for the banking industry. Increasing the financial intermediation can stimulate financial market development. It must be argued that macroeconomic behavior

and regulatory policies may also affect the operation of the financial system. Services support policy from the banking system contributes considerably to the development of the stock market globally. The inter-bank liquidity markets if supported by an efficient banking system that was based on twine element of trust and confidence are vital for the development of the stock market as argued by (Yartey 2007). Equally a weak- banking system negatively constrains the development of the stock market in most developing and emerging market. Demirguc-Kunt and Levine (1996) suggested that capital market indicators are highly interrelated with banking sector development. Countries with well-built stock markets tend to have good financial intermediaries in comparison their counterpart with poor stock market. Yartey (2007) argued further that empirical outcomes have suggest that a percentage increase in banking sector development increases stock market development by about 0.58 percentage for developing economies in Africa regulatory for macroeconomic stability, economic development and the excellence of legal and political institutions.

Institutional Quality

International Monetary Fund (IMP, 2007), found that quality institutional development is significant for stock market operation because effective and responsible institutions serve as a signal for increase appeal, and confidence in investment equity. Investment in equity becomes increasingly more attractive as external environmental risk is resolved over time. Thus, quality institutions operational can affect the attractiveness of stock investment and bring about to stock market development. Yartey (2007) argued that sound institutions such as good regulatory framework, good democratic institute, and accountability, free flow of information are important determinants of stock market development in Africa because this is likely to reduce political risk and improve the viability of external finance. In other findings Bekaert (1995) argued that political risks are associated to higher degrees of market segmentation that will further resulted to lower level of stock development. Erb et al (1996) found that expected returns rate are interrelated to the market political risk. They findings further suggested that in both developed and developing economy, the lower the level of political risk, indicates lower require rate of returns. The evidence from the literature poise that political risk is a priced factor for which investors are rewarded and that it affects the domestic cost of stock, which may have significant policy implications for capital market growth.

Protection of Shareholder

Another vital element of capital market development is the level of shareholder protection in publicly traded companies. The development in capital market is more possible in countries with some level of shareholder protection because investors do not fear expropriation argued by (Shleifer and Vishny 1997). Furthermore, ownership and control in such markets can be fairly dispersed, which offers liquidity to the market. La Porta, Lopezde and Shleifer (2Y03) argued that the significance of minority rights protection by using indicators of the quality of shareholder protection as a provision in regulatory frame work. They further argued that level of protection is associated with the capitalization and liquidity of stock markets in almost 50 countries globally. Laporta et al (1997) poise that countries with lesser quality of rules have smaller and narrow capital markets and that the listed companies on their markets are categorized by ownership that are concentrated.

The Development of Nigerian Stock Market

The stock market is regarded. as a complex institution with intrinsic mechanism through which funds are mobilized and made available for government, corporate and individual house hold unit for long-term developmental and business activities in the major sectors of the economy as argued; by (Nyong, 2007]. Capital market, development is a pre-requisite for the development of any marker economy and it is very obvious that stock market, offers

prospects for funds mobilization, enhanced effectiveness and efficiency in allocation of resource among both micro and macroeconomic units and further provision of desire information for market operation as suggested by (Inanga and Emenuga, 1997). Nwankwo (1991) explained that the development history of the Nigerian Capital Market can be traced back to 1950s when the Government at that time through its ministry of industries comes up committee to find a ways and means of instituting stock market. Before independence, the financial market operators in the country are dominated by foreign owned conventional commercial banks that delivered short-term commercial trade credits for the expatriate companies with subsidiaries in the country. Capital balances of these companies are reinvested overseas Stock Exchange market of the parent companies. Hence, in an effort to bring economic growth government embarked on the development of the capital market. This is to offer opportunities for domestic borrowing and lending of long-term investment in the economy as well as an opportunity for companies to offer their shares to the local investors to raise more funds that will result to more investment by the expatriate companies to develop the local economy.

Based on the recommendation made by Committee on stock market that Lagos Stock Exchange was established. This development brought about the enactment of the Lagos Stock Exchange Act 1961, it began operation in June, 1961 and assumed with main aim of providing facilities for the public to trade in shares, by maintaining fair prices through stock-jobbing and restricting the business to its members. The operation in the market started with the Developmental Stocks offered by the government, three national shares and one preference share (Stock Exchange report 2004). Market development at that time is slow but steady up to the end of 1966 only six equities were traded (Stock Exchange report 2004). Government stocks are the majority of the stock listed in the market. Before the indigenization exercise of 1972, activities in the market were not effective.

The 1972 Promotion Decree which strategically designs to stimulate capital formation, savings and investment culture in the real and other sector of the economy. This was further assisted in the stock market increased activities as it gave way to domestic investors to gain commanding heights of the market and economic activities. However, this is not without criticisms. The Nigerian Stock Exchange was argued to be not responsive to the needs and aspirations of local investors, particularly local businessmen who wanted to raise capital for their businesses. The 1985 introduction of the Second-Tier Securities Markets (SSM) by NSE, dramatically turned around the fortune of small and medium-sized firms by providing with opportunity for listing on the Exchange market. At that time six companies were listed on this market segment by 1988. In 2002 more than twenty-three companies were opportune to be quoted in this market (NSE, 2004). The major instruments traded in the Nigerian capital market are; the ordinary shares; industrial loans such as debentures, unsecured zero coupons, preference bonds/stocks, specialized project loans/infrastructural loans, government stocks/bonds, unit trust schemes, unlisted corporate/industrial loans stock, among others. (Nnanna, Englama and Odoko, 2004)

The Impact of Capital Market on Economic Growth in Nigeria

The Nigerian capital market has experienced significant growth from 1961 more especially late 1980s with promulgations of indigenization decrees of 1977 (Sule and Momoh 2009). The market experienced increase in numbers of securities traded to about 304 in 2008. In recent past the Nigerian capital market has witnessed stability and also recorded remarkable growth. This has impacted positively to the economic growth and development. There is strong indication that the capital market plays 'a vital role for economic transformation by providing needed capital and banking sector recapitalization in Nigeria. Ewan et al. (2009) using time

series data from 1961 to 2004 assert that the impact of the capital market efficiency on the economic growth of the country. They further argued that the capital market in Nigeria has the prospective of development inducing but it has not significantly contribute to the, development of Nigeria this is as a results of poor market capitalization; inadequate absorptive capitalization, illiquidity, insider abuse and information asymmetry and others. In another research conducted by Akinnifesi (1987) examine the relationship between rate of exchange and stock market by adopting disaggregated analysis. The findings suggested that a weak Naira exchange rate raises prices of stock and this is) not 'favorable to the capital market investment and of cause economic development.'

The Role of Capital Market in Emerging Economy

The recapitalization policy introduce b government that raised the banks paid up capital to N25 billion where out of 89 operation banks only 25 banks were emerged. This clearly indicated the significance of, the capital market; In fact, majority of the banks made this requirement achieved this by resolving to the capital market through public offer. About \$650 million was raised by the banks in 2005 as suggested by NSE report (2006). This figure that was raised from the capital market by banks in an attempt to meet minimum paid up capital of N2Sbillion (AlFaki 2006). Capital market is significant for growth and development, strength of any country because it supports government and corporate initiatives, finances the exploitation of new ideas and assists the management of financial and market exposure as argued by (Adebisi 2005). The phase of economic growth has been directly linked to the sophistication of the financial system and market efficiency. The financial and capital market facilitate the mobilization and channeling of surplus financial resources into productive sector of the economy and ensure that the funds are utilized for economic developmental activities to enhance growth and development to avoid financial leakage in the system Ologunde, Elumilade and Asaolu (2006), survey on the relationships between interest rate and stock market capitalization. Their findings suggested that market interest rate impacted positively on stock market capitalization rate.

The developmental stock issue by government negatively influences the stock market capitalization. The prevailing interest rate .impacted negatively on government stock as they further argued. Edo (1995) asserts that investment on securities is aimed at transforming savings into investment and subsequent economic growth and development and that the feature development in Nigeria is the expansion of the stock market to facilitating shares trading. The introduction of Structural Adjustment Programme (SAP) promoted by the International Monetary Fund, imposed on developing countries, suggested by (Soyode 1990). The emphasis on self-sustained growth process demand considerable investible resources, which are readily available at the stock market (Okereke-Onyiuke 2000).

The capital market has been a major source of financing state infrastructural projects and developmental progresses with little pressures and lean resources. Okereke-Onyiuke (2000) argued further that in the past recent years, some States have gone to the capital market to source for funds to finance their developmental projects. For example Ekiti State raised N4 billion in 2002 to finance electricity, agriculture, urban and rural roads, and water project. Yobe State raised N2.5 billion in 2001 to finance roads, houses and drainage improvement. In 2003 Lagos State raised N15 billion for developmental projects financing. Akwa-Ibom State raised N6 billion to finance developmental project, Delta State raised N5 billion to finance water, education and Health on the other hand Ni billion was raised by Edo state for developmental activities and Riverside Housing Estate (Osaze 1995). While the State and local Governments sought funds from the market stressed that the capital market could also be a veritable source of funding for the cash-strapped Nigerian universities yet to be

harnessed. According to Anyanwu et al. (1997), The Nigerian Capital Market played a vital role in the privatization of the State Enterprises (SOEs) by giving creditability to the exercises.

Challenges of the Nigerian Capital Market

The Nigerian capital market, just like the economy, has been confronted with numerous problems. These challenges are not peculiar to Nigeria. Thus some of these problems are external not directly control by the market but they are regulation-induced. There is also internal market problems which are manageable with improved operational procedures including the adoption of information technology. Some of these problems are enumerated below:

- (i) Market size
- (ii) Market Illiquidity problem
- (iii) Slow Securities development in the Market
- (iv) Problem of Double Taxation
- (v) Ineffective Underwriting
- (vi) Macro Economic Instability.

Conclusions

Inspiring economic growth and development involves long term financing, longer than the normal time duration for which majority of savers are eager to commit their funds and this constitutes a obstacle to economic growth. In this respect, the capital market offers an opportunity for the mobilization of long-term funds for development therefore; it is regarded as the long term end of the financial system. Over the years, globally there has been an improvement in capital market operations, and developing markets have acknowledged for a large volume of this boom. This further justified the increasing recognition of the capital market as a instrument for accelerating economic development in both developed and developing market.

Though, opponents have argued that the capital market might not perform effectively in developing countries and that it may not be realistic for these countries to support stock markets given the massive costs and the poor financial system. To this end, there is the need for researchers to survey more factors that can be related to the level of capital market development in Nigeria. Precisely it is suggested that study should examine the problems of information asymmetry in the Nigerian capital market.

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