CDIE

Impact Evaluation

United States Agency for International Development

DEVELOPING THE CAPITAL MARKET IN KENYA AND MOROCCO

The stock exchanges of these two countries have been transformed. They and their regulatory authorities are now able to guide modernization of the capital markets to their countries' benefit. USAID support, at a modest level, provided critical technical assistance that made this transformation possible.

OVERVIEW

This Impact Evaluation examines capital market development in two case studies, Kenya and Morocco. It is part of a larger overall assessment that also includes capital market projects in India, the Philippines, and Romania. All case studies were undertaken by the Center for Development Information and Evaluation (CDIE) of the U.S. Agency for International Development. The five country projects were chosen to reflect the diversity and individuality of USAID activities. The evaluators undertook to extract findings and lessons learned by applying a common evaluation methodology to the individual activities.

The information and analysis in this evaluation is based on field evaluations conducted by CDIE in 1997. In March and April, a four-person team visited Kenya for three weeks and then visited Morocco for two weeks. Collectively, the teams interviewed more than 60 people from within and without the financial sector. The team's findings are based on those interviews, USAID program documents, and data provided by Kenyan and Moroccan financial sector organizations.

Team leader: Frank D. Martin
Team members: James A.M. Elliott, Walter Kerschbaum, Sushil K.C. Khushiram

CONTENTS

PN–ACA–928

April 1999

Overall, the evaluation teams found that USAID capital market projects made a discernible difference in both Kenya and Morocco—and they did so at a very modest cost. Among other accomplishments, the projects helped install sound, well-managed capital market institutions such as regulatory agencies and stock-trading exchanges. And they helped instill good corporate governance in listed companies, protecting stockholders from managerial venality. As to problem areas, the evaluators found little inclination on the part of Kenyan commercial bankers to advance the development of the capital market (in contrast to bankers in Morocco). And they found that USAID planners in both countries underestimated the reluctance of companies (for a variety of proprietary reasons) to list on stock exchanges.

KENYA CASE STUDY

Kenya was chosen as a country case study because the financial and technical resources allocated to the activity were modest. In an era of limited resources, it is important to answer the question "How much is enough to have a significant impact?"

Tradition of Stability

In striking contrast to the political and economic upheavals experienced by many other African countries, Kenya has a long tradition as a stable, market-based economy. This stability and tradition of private ownership of businesses should offer a fertile ground for the emergence of a vibrant capital market.

Since independence from Britain in 1963, Kenya has based its development strategy soundly on agricultural development, particularly on smallholder agriculture. The government encouraged production of tea, coffee, hybrid maize, and dairy goods. During the first decade of independence, gross domestic product (GDP) grew annually at close to 7 percent; the agricultural sector grew at nearly 5 percent. Rural incomes rose and poverty fell.

Performance of the nonagricultural economy, while strong during 1964–78, was less buoyant after the mid-1970s, as the protected, oligopolistic industrial sector became badly distorted. For some time those emerging distortions did not noticeably retard growth: the sector grew annually at 10 percent from 1964 through 1978. But then the system began to break down as import substitution—establishing domestic industries behind tariff and quota barriers—came to account for two thirds of the expanding industrial subsectors.

Pervasive in the 1970s were external trade shocks: oil price increases at both the beginning and end of the decade, and a coffee boom in the middle. These shocks, both adverse and favorable, coincided with a decline in the quality of economic management. By 1981 the economy was in trouble, a condition manifested in several severe imbalances: the current-account deficit in the external accounts was nearly 13 percent of GDP; the budget deficit was 10 percent of GDP; and domestic demand exceeded GDP by 11 percent.

Efforts to stabilize and reform the economy began in 1981. During 1980–84 the country achieved a steady reduction in excess demand, mainly by paring government spending. Ultimately, though, that first attempt at structural adjustment failed. Donor-supported structural adjustment had sought to liberalize trade and reform the agriculture sector. But trade liberalization was only partly implemented, and little was done to promote exports. Agricultural reform was even less successful. Throughout the decade, the government's commitment to economic reform waxed and waned.

Meanwhile, macroeconomic management was uneven. By 1991 the ratio of budget deficit to GDP was back to the level of the early 1980s. Lax public transparency and accountability was attracting donor attention. In December 1992 the World Bank stopped disbursements on an agricultural loan because the government reversed itself in various commitments on policy reform. A new macroeconomic framework was agreed to in April 1993, but by then considerable damage had been done to the country's fiscal position. Economic growth recovered from 1993 through 1996, going from 0.2 percent to 4.6 percent in real terms. In 1997, though, the problem of the recurring deficit returned.

As 1999 began, the Kenyan economy was in trouble, hammered by corruption, bad weather, and gross mismanagement. Provisional figures from the Central Bank record a decline in the real GDP growth rate to 1.6 percent between October 1997 and October 1998, compared with 2.3 percent in 1997. The poor growth performance was mainly in cash-crop production, trade, manufacturing, transport, and services. Political and economic problems were mounting. They ranged from presidential succession to the fiscal deficit (once again).

USAID Activities

The Kenya mission's activities in support of capital market development embraced two bilateral projects: the Private Enterprise Development (PED) project and the Structural Adjustment Assistance Program. Taken together, the funding for capital market development (excluding a venture capital initiative) came to less than $1 million.

The PED project paper made clear the exploratory nature of the work:

> In equity markets, USAID/Kenya has begun working on a program to modernize and expand the operations of the Nairobi Stock Exchange. . . . A search to identify potential consultants to construct an action plan . . . has already taken place. USAID/Kenya has begun to discuss priorities and options for development of the money market with others in Kenya. Resources from the PED project may be used for such activities as [helping] the government of Kenya draft and implement new policies on treasury bills, allowing private money market instruments to develop, and developing professional brokerage services.

The Structural Adjustment Assistance Program of 1988 introduced policy conditionality into the capital market development activity. That conditionality called for the government to 1) establish a regulatory body, to be called the Capital Markets Authority, by June 1989 and 2) make the authority fully operational by June 1990.

The project paper saw technical advice as the key input for this component:

> The Ministry of Finance has requested USAID to fund a long-term technical adviser . . . to assist the government in the creation of a functional Capital Market Development Authority. . . . USAID proposes to use the technical assistance component of the Structural Adjustment Assistance Program together with the Private Enterprise Development project to pursue the dialog and to ensure that necessary policy actions are taken. The long-term technical adviser will be complemented by short-term consultancies as needed.

Funding for the advisory component was set at $600,000 in the original project paper. The budget for capital market activities was increased $100,000 by a 1991 amendment and a further $75,000 in 1992. Project activities added in the amendments dealt with promotional activities of the Nairobi Stock Exchange and training of brokers.

Although the bulk of USAID assistance to the capital market was channeled through the regulatory Capital Markets Authority, some financial support was later provided directly to the Nairobi Stock Exchange.

Capital Market Institutions

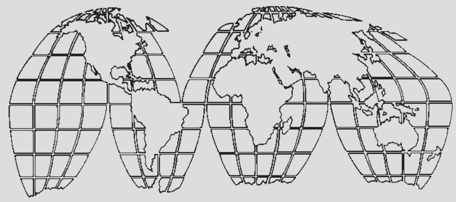
The **Capital Markets Authority** came into operation in early 1990. The idea for such an organization originated from a 1984 study conducted by the Central Bank of Kenya and the International Finance Corporation. The principal objectives of the authority are

- To create, maintain, and regulate an orderly, fair, and efficient securities market, and to protect investor interests. (This objective carried a specific provision to allow for market self-regulation to the maximum practicable extent.)

- To take on a developmental role with regard to all aspects of capital markets, especially in fostering productive investments.

- To encourage wider participation of the general public in the stock market.

Both a *developmental* and a *regulatory* mandate are explicitly assigned to the Capital Markets Authority. Furthermore, the body is required to advise the minister of finance on capital markets, implement government capital market policies and programs, and license and supervise market operators.



"The Capital Market Authority's task of promoting capital market development has been greatly hampered by the adverse macroeconomic environment. In particular, high interest rates have prevailed over most of the decade."

Creation of the authority was of fundamental importance in developing capital market policies and institutions. It led to the radical transformation of an informal and embryonic equity shares market into one of the most advanced securities markets in Africa.

Since its inception, the authority has been fulfilling its market development role, especially with regard to setting up the basic infrastructure for the operation of a stock exchange. The authority set out to modernize the **Nairobi Stock Exchange.** It reviewed and updated the exchange's rules and regulations and provided training to stockbrokers. For its part, the exchange introduced a new outcry trading system. In 1991, after just a few months of activity by the Capital Markets Authority, the Nairobi Stock Exchange began operating as a modern exchange.

The authority's task of promoting capital market development has been greatly hampered by the adverse macroeconomic environment. In particular, high interest rates—they've averaged 25 percent—have prevailed over most of the decade. The rates reflect tight monetary policies designed to counter the inflationary consequences of excessive government borrowing. They also manifest the need to stabilize the exchange rate.

Achieving a favorable investment climate is a necessary condition for speeding up progress in stock market activities and greater capital-raising through private equity and debt securities. But if high interest rates have crowded out private issuers in the equity market, they have positively buoyed the government securities market. That market has attracted sizable domestic funds and foreign capital inflows.

In tandem with its developmental role, the Capital Markets Authority has established a relatively strong presence as a market regulator. Its regulatory task has grown with the sharp increase in the activities of the Nairobi Stock Exchange following its modernization. Share turnover on the exchange rose from 200 million Kenyan shillings in 1990 to 3.1 *billion* in 1994 and further to 6.1 billion in 1997. The growth was due largely to privatization and other public offerings.

The Capital Markets Authority constituted a **Capital Market Disclosure and Standards Committee** in 1996. One of its tasks is to make recommendations for minimum disclosure standards and reporting obligations. Another is to review and make recommendations on best corporate governance practices. A third is to serve as a forum for building consensus on matters relating to capital market development and regulation. In 1995 the authority issued regulations governing the investment activities of foreigners. New rules on takeovers, mergers, and delistings were issued in September 1997 to protect minority shareholders. A few companies have been delisted for lack of regulatory compliance.

The absence of a mutual funds industry is a notable feature of the Kenyan capital market. Addressing that, the authority is reviewing legislation to set up and regulate collective investment schemes and promote broader participation in the stock market.

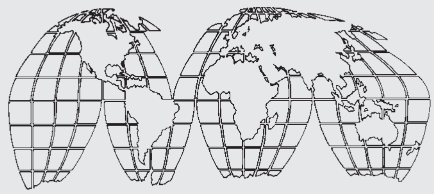
The Nairobi Stock Exchange as it exists today goes back only eight years. Before 1991 the exchange was an informal, though registered, association of six stockbrokers. It operated through a weekly meeting of its members over coffee. During the meetings, business in hand was disclosed by each to the other members and later in the week transacted by telephone. Trading took place by gentlemen's agreement. Standard commissions were charged, with clients being obliged to honor their contractual commitments of making good on delivery and settling relevant costs.

Since 1991, and after a period of intense activity during which the structure of the current Nairobi Stock Exchange and the Capital Markets Authority were established, the stock exchange has functioned much like any other in the world. The informal gentlemen's agreements have given way to a set of rules and regulations. The telephone dealing has become a daily two-hour session of open-outcry order transaction. And the class of securities dealt has expanded beyond equity shares to include preferred shares as well as government and corporate bonds.

Between 1991 and the present, the number of brokerages grew from 6 to the current 20. More important, the total employment of the exchange and the brokerage firms went from the roughly 20 people in 1991 to the current estimated 400-plus.

The most important role played by the Nairobi Stock Exchange is providing a market for the 53 quoted companies' shares. The steady progression of trading volumes and the exchange's ability to discover a price for quoted shares within an acceptable range—together these attest that the exchange is a real, and the only, market for Kenyan quoted shares.

In its role as promoter of greater participation in financial markets, the Nairobi Stock Exchange has actively recruited new market participants. Along with, but independent of, the Capital Markets Authority, the Nairobi exchange sponsors programs to increase public awareness of investment opportunities in equities and other quoted financial instruments. A visit to the exchange is instructive. Overlooking the trading floor is a visitors gallery; each day numerous groups (high school and university classes, among others) visit the exchange. The trading floor becomes, in the words of an exchange director, "the training floor." Both the Nairobi exchange and the Capital Markets Authority have sponsored seminars in the large cities and in the regional towns to explain the workings of the stock market. Those efforts have met with some success in attracting new investors.



"A significant portion of the medium and large Kenyan companies are closely held by families. Not wishing to make full disclosure of their financial performance, in many cases such families prefer not to list."

That said, there is little evidence average Kenyans are much involved in capital markets. Estimates of the number of shareholders in Kenya range from around 400,000 on the low end to 700,000 in the most optimistic case. If we split the difference, we get the percentage of Kenyans as shareholders as only 1.7 percent of the population.

With 53 quoted companies, the Nairobi Stock Exchange covers a broad range of the country's economic activities. The four principal sectors listed in order of market capitalization are *financial, industrial, commercial,* and *agricultural.* In 1997, Kenya's gross domestic product was $9 billion; market capitalization of the Nairobi exchange was $2 billion, or 22 percent of GDP. In advanced emerging markets, it is not uncommon to see this figure approach 100 percent. The low 22 percent figure can be explained by three factors: 1) the still high number of wholly state-owned enterprises, 2) the absence from the exchange of nearly all the multinational companies operating in Kenya, and 3) the circumstance that a significant portion of the medium and large domestic companies are closely held by families. For fear of giving up control and not wishing to make full disclosure of their financial performance, in many cases such families prefer not to list.

In its role as facilitator for capital-raising, the Nairobi exchange has been used as a conduit for early privatizations of state-owned enterprises. Those that have already come to market include such blue-ribbon offerings as Kenya Airways, Kenya Commercial Bank, and National Bank of Kenya. In 1996 and 1997 a total of 3.8 billion Kenyan shillings was raised by selling partial government ownership. These privatizations do not, however, directly finance new capital investments. The government has used the proceeds to finance its deficit.

Over the period 1996–97, only two instances occurred of companies raising new capital from the market. In 1996, East African Portland Cement raised 1.08 billion Kenyan shillings ($18 million) through a rights issue (an offer to existing shareholders). And in 1997, Kenya Breweries Ltd raised 1.5 billion shillings ($25 million) through a rights issue.

Along with these rights issues, there were two initial public offerings of private companies over the years 1996–97. In 1996, Rea Vipingo, a plantation company, went public, raising 84 million shillings ($1.4 million). In 1997, Athi River Mining floated shares valued at 282 million shillings ($4.7 million). The combined values of these were minimal, though. They represented an addition of only 1.8 percent to overall market capitalization.

Clearly, most of the funds raised through the market have been those associated with privatizations. This is likely to remain so in the coming year or two.

Prospects for Capital Market Development

Prospects for further development of the capital market depend on policies and measures adopted on a number of core market issues, including market liquidity, company listings, foreign investments, regional cooperation, and the extent to which the right balance of market regulation and development is achieved. The Capital Markets Authority is presently designing policies that will lead to a stronger and deeper capital market. Among the proposed new mandates: 1) creating a legal framework for the operation of a central depository system, 2) regulating mutual funds, 3) harmonizing different legislation pertaining to securities, and 4) issuing guidelines on corporate governance.

Besides policy action, the state of the Kenyan economy will be crucial in determining the course of future capital market development. To foster business confidence, the macroeconomic environment and the overall investment climate need to be substantially improved. Accelerating the pace of public enterprise reform and privatization of parastatals will stimulate capital market activities. Restraining public expenditures and containing the budget deficit will allow the government to pursue a less restrictive monetary policy and thus bring down interest rates to more reasonable levels. Lower rates are essential to sustained growth of the stock market.

MOROCCO CASE STUDY

Morocco was chosen as a country case study although it did not have, in a strict sense, a capital market development project. Morocco did have a large privatization support program, part of which was carried out through the Casablanca Stock Exchange. This country case study affords a look at the relationship between privatization programs and capital market development.

Two Decades of Transition

Morocco is a lower-middle-income country with a per capita GNP, in 1996, of $1,290. Historically, on average, Morocco's per capita gross domestic product has grown in real terms at 3 to 4 percent a year, with frequent sharp departures from that trend occurring as a result of drought. In the last 10 years or so, thanks in large part to economic reforms and economic restructuring from 1986 onward, per capita GDP has grown at an average annual rate of about 4 percent a year. Population has been increasing at 2.5 percent a year. In 1994 it totaled 26.6 million. At market exchange rates, the country's total GNP is approximately $28 billion.

Over the last two decades Morocco has carried out significant reforms in both its politics and its economic policy. While reshaping the political system into one combining constitutional monarchy with multiparty parliamentary democracy, Morocco has also implemented a gradual but steady reform process oriented toward economic stability and growth and private sector development. The country has made particularly strong progress over the last decade in strengthening macroeconomic policy and economic performance.

The success of economic policy in achieving sustainable macroeconomic balances has been remarkable. The years 1984–87 were a time of crisis. During that period Morocco had a current-account deficit of 3.7 percent of GDP, on average, on its international balance of payments. It had a large budget deficit (8.8 percent of GDP, on average), low foreign direct investment flows, and a growing external debt. Since then, the turnaround has been impressive. By 1997 the current account deficit had been reduced to 1.1 percent of GDP and the central government budget deficit, on a commitments basis, to 3.2 percent of GDP. Benefiting from a hefty inflow of direct foreign investment, the capital account surplus on the international balance of payments was a comfortable $600 million.

Despite the clear successes on many fronts of its economic policy in recent years, Morocco's economic growth rate has remained only moderate. At least partly as of result of this weak economic growth performance, the country's urban unemployment rate remains high—16 percent. Furthermore, a number of Morocco's social indicators are low relative to the country's per capita GDP. To improve this overall situation on a sustainable basis, the government needs to accelerate economic growth and stimulate greater private investment.

USAID Activities

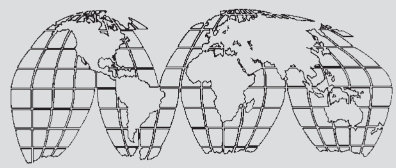
USAID-supported privatization and capital market development activities for Morocco began in 1991. They were part of, and benefited from, earlier accomplishments of an overall process of economic reform and restructuring dating back to a 1983 foreign exchange crisis. Agency support was delivered through two programs: the Privatization Sector Assistance Program, and the Economic Policy Analysis Support project. The Program Assistance Approval Document of the former lays out the connection between privatization and development of the country's capital market. It then goes on to describe the then-underdeveloped state of the capital market, including a float among ownership by the general public of less than 3 percent of the shares of listed companies and a capitalization of the Casablanca Stock Exchange equivalent to less than 3 percent of GDP. Thus the market value of the general public's holdings of shares in Moroccan companies listed on the Casablanca Stock Exchange was equivalent to less than one tenth of 1 percent of GDP.

The USAID privatization program had total outlays of $25 million divided between project assistance of $5 million and nonproject assistance of $20 million.

Program conditionality linked privatization with expansion of the capital market. In the section dealing with conditionality, the approval document stated: "To achieve the objective of strengthening capital markets, a minimum number of transfers [eight—of share ownership] via the stock market will be required." And it stated that "other conditionality relates to helping ensure that certain objectives of privatization, such as widespread share ownership, are achieved." Thus one of the conditions precedent to the first disbursement of nonproject assistance was that the government submit a plan for a promotional and educational campaign on share ownership and a plan identifying possible measures to promote broader public share ownership. The second disbursement required that "at least two transfers will have been completed via the stock exchange or a public stock offering."

The second initiative, the Economic Policy Analysis Support project, had total funding of \$8.6 million. Of this, only a small part (no more than \$1.7 million) went for capital and financial markets development work. Activities funded under the project included

- An initial study of proposed stock exchange reform that resulted in several changes in the law establishing the Casablanca Stock Exchange as a private, self-governing entity
- A study on the feasibility of establishing a secondary debt market for short-term treasury bills
- A long-term financial sector adviser in Casablanca
- Seminars on topics such as secondary mortgage markets and rating agencies



"Developments in the Moroccan capital market have taken place with the strong involvement of the major banks."

Capital Market Institutions

The two capital market institutions of primary interest here are a regulatory body, the **Council on Securities Markets Ethics** (also known by its French abbreviation, **CDVM**), and the **Casablanca Stock Exchange,** though the capital market is not limited to these organizations. Mutual funds have developed a growing business, and there are significant money market activities. Banking still occupies a preeminent role in the financial intermediation process, as in most emerging economies. Developments in the capital market have taken place with the strong involvement of the major banks. These institutions have responded positively to the challenges of diversification in the financial sector. In doing so, they have contributed to the emergence of a more advanced capital market.

The 1993 Financial Sector Reform Law has provided the guidance for recent developments in Moroccan capital markets. It provided for five principal undertakings:

1. Privatization of the **Casablanca Stock Exchange Management Company (SBVC),** the operating company for the Casablanca Stock Exchange
2. Creation of a legal basis for **stockbroking companies**
3. Creation of a legal basis for **mutual funds**
4. Creation of the CDVM
5. Creation of a **central depository system**

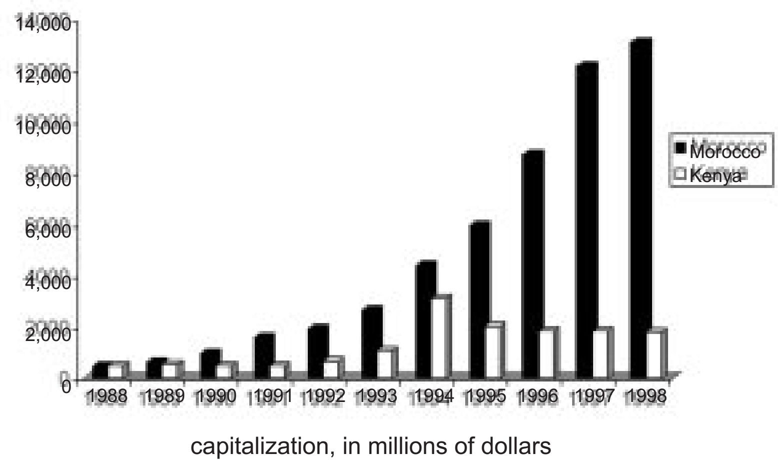
CDVM: An Advisory Role

The regulatory CDVM seeks to protect investors from fraud in securities markets. To this end, it 1) ensures that the information provided by issuers to the public is in accordance with the legal requirements, 2) oversees the proper functioning of securities markets, and 3) assists the government in market regulation. The CDVM is also responsible for regulating mutual funds.

The board of the CDVM is chaired by the minister of finance and comprises one representative of the Finance Ministry, one representative of the Ministry for Legal Affairs, one representative of the central bank, and three persons having financial expertise. Those three are appointed by the minister of finance for a four-year term, renewable only once. The CDVM is managed by a chief executive with voting power on the board.

It operates with considerably less autonomy than the Kenyan Capital Markets Authority. In most matters it serves an advisory role to the Ministry of Finance, where most decisions are made.

Figure 1. Stock Market Data, 1988–98



Casablanca Stock Exchange: From Public to Private

Besides creation of the CDVM, another central feature of capital market reform in 1993 was the restructuring of the Casablanca Stock Exchange. The company managing the exchange (SBVC) underwent a transition from a public institution to a private company. The statutes of the SBVC are approved by the minister of finance.* The company is managed by a board of directors, which is appointed with the approval of the minister of finance. The Finance Ministry can remove any of the directors on the recommendation of the CDVM. Two representatives of the Finance Ministry attend board meetings, essentially as observers.

In 1998 a total of 13 stockbroking firms were operating. All are shareholders of the SBVC. Many are commercial bank subsidiaries. Stockbroking firms need the approval of the Ministry of Finance, with recommendation of the CDVM, to do business. The firms hold the exclusive right to transact business on the Casablanca exchange and are authorized to participate in all primary issues, act as custodian, undertake portfolio management, and provide investment advice. In all, they employ around 200 people.

Notable about the stockbroking business in Morocco is the absence of professional qualifications for any person to act as a stockbroker. Although the legislation provides for an association of stockbrokers, there is no easily identifiable category of people belonging to this profession, because stockbroker examinations or qualifications do not exist. Brokerages are generally managed by people with a banking background.

As of December 1998, 53 companies were listed on the SBVC's official market. Market capitalization stood at $13.1 billion at the end of October 1998, as against $8.7 billion in December 1996 and $2.7 billion in December 1993. (See figure 1 for a comparison of Kenyan and Moroccan stock market development.) Although the number of listed companies stood higher at 65 in 1993, several companies were delisted owing to inadequate disclosure or to lack of liquidity. Some companies also withdrew voluntarily. The privatization program and the

*The Règlement Général, the operating procedures that describe the rules and regulations of the exchange, was approved by the Ministry of Finance in March 1998. It confers on the SBVC certain powers of self-regulation as regards the operation of the market and of stockbroking companies.

introduction of state-owned companies through public offerings beginning in 1993 significantly boosted the size of the official market. Sales of shares of privatized companies were oversubscribed.

Institutional investors—chiefly insurance companies and pension funds—dominate the securities market. However, privatization of state-owned companies and introduction of mutual fund accounts has led to a significant expansion in the number of individual shareholders. Those individuals are currently estimated to number 200,000, from fewer than 50,000 in the early 1990s.

Disappointingly, private sector firms have been reluctant to list. Only four private companies have listed since 1993, all in the financial sector, in such areas as leasing and consumer credit. Market capitalization as a portion of GDP is around 25 percent, a rather low figure that reflects the dearth of major nonfinancial companies on the stock exchange. The weak presence of Moroccan companies on the exchange is attributed to manifold reasons such as closely held family ownership, inadequate financial skills, insufficient awareness of the benefits of listing, and a reluctance to be exposed to the scrutiny of the public and of the tax authorities.

The SBVC has conducted outreach exercises revealing that unlisted companies do adhere to fairly high standards of accounting but are wary about disclosing to the public information that would be available to their clients or competitors. The companies also presume that a public listing will involve new shareholders interfering in their management. Attracting more companies to the stock exchange is nevertheless the paramount objective of the SBVC for the years 1998–2000. Privatization of the state telecommunications company also due that year would give a renewed impetus to the market and possibly encourage further listings.

The stock exchange index progressed by an average of 21 percent a year from 1993 through October 1998, reflecting an overall shortage in the supply of securities relative to demand. Turnover in listed shares represents about 12 percent of market capitalization, but only 4.2 percent excluding off-market block transactions. This level of liquidity partly reflects the limited extent of widespread ownership. The amount of capital raised on the exchange through the issue of new shares has been modest. In 1998, new share subscriptions were offered by three companies for a total of 456 million Moroccan dirhams ($48 million). On a positive note, 10 firms have announced their intention to list on the exchange by 2000.

Companies rely mostly on internal and bank financing for their investment funds. Project financing by Moroccan banks is marked by an undue emphasis on collateral and guarantees without sufficient regard for a project's intrinsic return and other characteristics, or the company's debt–equity situation. As a result, many companies have not provided for more equity capital in line with the growth in their activities, while bank borrowings have continued to rise as long as sufficient collateral can be furnished. These companies need to restructure their balance sheets before listing on the exchange.

Foreign investment in listed shares is unrestricted. Foreign investors currently account for about 5 percent of transactions on the exchange. There has been no strong and sustained marketing effort to attract foreign investors, mainly because of the lack of share availability.

12

Prospects for Capital Market Development

The Moroccan capital market has shown considerable progress during this decade. At first, its remarkable performance was spurred chiefly by the privatization of state-owned enterprises. The creation of new institutions, a modern regulatory framework, and an enhanced operational infrastructure have created conditions for sustained development. Government policymakers have firmly backed a modern capital market to support the privatization program and, for the longer term, to enhance mobilization of savings and promote greater investment.

The banking system too has played an important modernizing role. Banks have traditionally dominated the financial system, capturing a substantial portion of domestic savings. They have seized the new emerging opportunities to diversify the channels of financial intermediation. They have participated actively in establishing a new landscape for the capital market.

The pace of progress slackened in 1997, owing partly to a slowdown in the privatization program. The last privatization through the stock market occurred in June 1997. Other fundamental issues, however, need to be addressed to revive capital market growth. An insufficient number of companies are listed, and the Casablanca Stock Exchange is undertaking a major program to attract more listings. A good deal of effort must be devoted to make companies better aware of the benefits of listing. In this regard, the government should seriously consider granting fiscal incentives to listed companies, incentives such as a reduced level of taxation for a specified number of years following their listing.

As a general principle, the authorities should allow capital market institutions to develop with a greater degree of autonomy while continuing to spearhead the creation of the legal and regulatory framework. With the adoption of the new Règlement Général (which prescribes the rules and regulations for the stock exchange) the exchange was given some self-regulatory powers on operational matters. It remains for the full extent of the respective powers of the Ministry of Finance, the CDVM, and the exchange to be well delineated and the degree of delegation of powers to the exchange to be clearly defined. The regulatory framework is often perceived by market participants as overbearing; in their view, it can be implemented best by themselves.

A major weakness has been the insufficiency of public participation that would foster wider ownership and ensure greater liquidity. Intensifying privatization efforts should help boost liquidity, in conjunction with greater promotion of the exchange. The mutual fund clientele is dominantly institutional investors, but the funds have nevertheless raised the level of investment by private individuals. The market can develop only if more companies are introduced to the exchange and more public offerings are realized.

The various markets for treasury paper and other debt obligations are fragmented. They possess inadequate interest-rate fluidity to ensure proper flows of funds between different categories of financial instruments in accordance with their risk and return characteristics. Differing tax treatment and a lack of skilled intermediaries largely account for this segmentation. Rationalizing the money and debt markets would yield better conditions for determining interest rates.

The banking system is highly concentrated. Five banks account for three fourths of total deposits, a situation that inhibits competition. Bank interest rates are set by the bankers association and are not flexible enough to respond to competitive and liquidity factors. The banking system has only recently emerged from a regime of selective credit policies and administered interest rates. With greater bank competition and a rationalized market for debt instruments, interest rates could play a more effective role in allocating funds to the best competing uses.

The future of the Moroccan capital market is closely linked to the banking industry, which has at its disposal a wealth of resources, human and financial, to make further substantial changes to the financial landscape. Skillful and intelligent use of appropriate fiscal incentives can help harness the country's resources toward a more diversified and deepened financial sector. To speed development of the capital market, the authorities should therefore concentrate their efforts on policy orientations that encourage private initiative and innovation.

ECONOMIC EFFECTS OF CAPITAL MARKET DEVELOPMENT ACTIVITIES

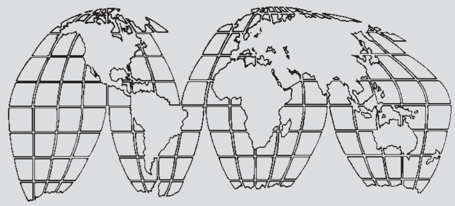
Capital market operations, including those of stock markets, are expected to afford the following benefits: 1) provide an additional channel to link savers and investors—a channel that overcomes the disjuncture between savers' desire for liquidity and the locked-in nature of physical capital investments; 2) allocate savings to more productive investments, increasing the productivity of a nation's capital; and 3) increase managerial discipline. We can get a sense of the value of USAID's work in capital market development in Kenya and Morocco by ascertaining the degree to which Agency activities led to the three benefits.

Linking Savers and Investors

People in developing countries have a narrow range of savings mechanisms available to them. The most common mechanism offered by the formal financial system is a *savings* or *passbook account.* Prior to the USAID activities in Morocco and Kenya, the stock markets were too small and too illiquid to appeal to savers. In both cases the project planners expected the *modernized exchanges* to attract savers who had not previously used stocks as a savings mechanism.

Neither exchange has official estimates of the number of people who hold stock purchased through it. A partial privatization in 1996 of Kenya Airways, the country's flagship carrier, attracted 110,000 individual shareholders. In Kenya, as we've seen, scarcely 2 percent of the people hold stock shares—perhaps 555,000 people, probably fewer, of Kenya's 33 million people. Even so, this level represents a major increase from the estimated 100,000 shareholders in 1990. Officials of the Casablanca Stock Exchange expressed skepticism about the reliability of estimates of the number of stockholders in Morocco. Those stock market professionals willing to hazard an estimate put the range of individual stockholders between 200,000 and 300,000. In addition, there are more than 15,000 clients of mutual funds. Both the Kenyan and the Moroccan estimates suggest a large increase in market participants during the 1990s. Savers have been attracted to the new financial instruments made available by the stock market expansions.

Another aspect in linking savers and investors is the flow of *foreign savings* into an economy. In the last few years, foreign portfolio investors have begun to take an interest in the Kenyan and Moroccan stock markets. The Kenyan market was opened in January 1995 to foreign investors. They are subject to an aggregate limit of 40 percent of a listed company's shares. Any single foreigner's share is limited to 5 percent. Foreign investors have responded positively to the opening of the Kenyan market: $37 million of foreign money has flowed into listed securities over the last three years. Transactions by foreign investors account for fully 40 percent of the Nairobi Stock Exchange turnover. Morocco places no restrictions on foreign institutional investors. Market experts estimate foreign holdings of Moroccan listed companies to be about 5 percent of market capitalization.



"Market participants in both countries affirm that the emergence of capital market research and analysis was a response to the willingness of foreign investors to pay for this information."

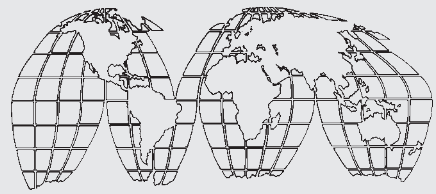
Foreign investors have contributed to the development of Kenyan and Moroccan stock markets in two significant ways beyond financial flows. First, foreign institutional investors scan dozens of stock markets. They seek out market research on country economic conditions and on individual company prospects. Generally, before foreign institutional investors enter the market, there is inadequate demand for this type of market research and it is not produced. Local brokerage firms compete for these investors' business by introducing market research and analysis products. Once local investors realize the value of these products, demand is stimulated. As these products spread throughout the economy, they become an important channel for transmitting market information. Timely and reliable information reduces uncertainty and broadens the appeal of stock market investing among retail, or individual, investors. A Moroccan brokerage firm called Upline Securities got its start as the first market research firm in the industry. Initially, it catered to the foreign institutional investors. Market participants in both countries affirm that the emergence of capital market research and analysis was a response to the willingness of foreign investors to pay for this information.

The second contribution of foreign institutional investors is a push to improve the settlement process. Both Kenya and Morocco are establishing central depository systems to reduce risks in settlement. A central depository narrows the time gap between the payment transfer and the subsequent share transfer. Long settlement delays frustrate efforts to uncover and prosecute fraudulent activity. Traditional settlement can involve a delay of several months in the delivery of new share certificates after payment has been made. Modern systems settle in a matter of days.

Another channel for allocating the flow of savings to investors is *leasing.* A particular appeal of leasing is that it provides small and medium-size firms with indirect access to money raised on the stock market. Leasing has received a boost from the Moroccan stock market. Equipment-leasing companies are able to raise capital by placing bonds on the Casablanca Stock Exchange. (The funds raised on the exchange finance equipment purchases by the leasing companies. Through term agreements, the equipment is rented to companies that could not themselves raise capital on the exchange.) Leasing's share of gross fixed capital formation rose from 1.9 percent in 1988 to almost 4 percent in 1996. Firms entering into lease arrangements have indirect access to the capital market for expansion even though they may not be large enough to obtain funds directly by listing on the exchange.

Capital Formation: No Evidence of Increases

The team uncovered no evidence that the capital market development activities have increased capital formation. Privatizations that took place on the two exchanges transferred existing physical capital assets from public to private hands and transferred an equal value of financial wealth from private to public hands. The transactions created no new capital. Most of the activity on the exchanges has been the transfer of existing assets. Neither exchange has succeeded in raising large amounts of new capital to finance the expansion of private companies. While there were some initial public offerings, the volumes were not large enough to influence economywide trends. Persuading the owners of privately held firms to finance expansion through the stock market has to be considered an area of unfinished business.



"The evaluation team believes three factors led to the success of the activities in Kenya and Morocco: a comprehensive assessment of the . . . equity market . . . privatization . . . and avoiding the debt market."

Improvements Seen In Corporate Governance

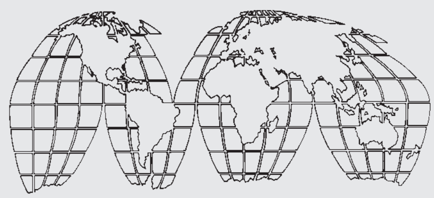
The third expected benefit of capital market development is an improvement in corporate governance (also known as managerial discipline). That is the concept that managers work to benefit the owners (stockholders) of the firm and not for their personal benefit at the expense of owners. Market professionals believe that corporate governance has improved, certainly in the case of privatized firms and to a lesser extent among other publicly held firms. Managers are confronted at annual stockholders meetings and expected to defend corporate decisions. Stockholders, having access to brokerage house reports, are better informed about corporate performance. Although much room remains for improvement, the rights of minority shareholders are better defined in the regulations and better respected by corporate managers than they were in the past.

APPROACHES TO CAPITAL MARKET DEVELOPMENT

Kenya is a striking case of how under favorable conditions a modest amount of donor money can have far-reaching effects. The government wanted to modernize Kenya's equity market. USAID/Kenya had a multipurpose project with funds set side for new opportunities. Spending less than $1 million, the mission was able to transfer the institutional technology for both a regulatory body and a modernized stock exchange. In the transfer, the key USAID-financed input was providing high-quality technical assistance.

The mission project officer functioned unofficially as chief of party, inasmuch as the activity did not have an institutional contractor responsible for implementation. The mission coordinated delivery of technical assistance, training and study tours, and equipment and operating expense support. While this hands-on management may no longer be possible in downsized missions, we conclude that a well-staffed mission can competently manage activities in the technically complex area of capital market development.

The Morocco activity did not zero in exclusively on the equity market as did the Kenya activity. Rather, aiding the equity market was a secondary outcome in a privatization support program. Measured by its capital market objectives, the Morocco program was a success. Privatization did boost activity on the Casablanca Stock Exchange. Volumes traded on the exchange increased by a factor of 6; market capitalization increased by a factor of 5. The mission also accomplished its objective of broadening the investor base.



"Listed firms are easier for tax authorities to audit than are privately held firms. That results in a higher tax burden on the listed firms."

The evaluation team believes three factors led to the success of the activities in Kenya and Morocco. First was a *comprehensive assessment.* The designers of both activities saw the need to examine the three levels of the equity market: the legal framework, the regulatory structure, and the stock exchange operations. It would have been a mistake to think that any one of the levels could have been isolated from the others and singled out for support. Regulators' oversight systems should reflect the degree of complexity and sophistication of the markets they regulate. Likewise, stock exchange development that outpaces the regulatory framework can become a source of economic instability. Capital market regulators and operators can learn much from each other. A project structure that brings them together has indirect beneficial effects on information flows. USAID activities encouraged collaboration.

The second factor leading to success was *privatization.* Privatization fuels a stock market. This Impact Evaluation has mentioned several times the interplay of privatization and capital market development. One of the major challenges in equity market growth is an adequate supply of new securities. Share offerings of state-owned enterprises give the market something to work with as the capital market institutions tool up. Retail investors are more easily attracted by offerings of well-known national flagship companies. We can safely conclude that privatizations through the stock market dramatically aided efforts to develop capital markets.

Third, both programs *avoided the debt market.* Capital markets have two main elements: equity markets and debt markets. A comprehensive approach to capital market development would have identified and tried to remove constraints in both types of markets, fostering a balanced growth between them. In both Morocco and Kenya the missions did preliminary work on the debt and the equity markets and then decided to devote their resources to the latter.

The narrow approach in the Morocco program followed from the subsidiary nature of the capital market objective: privatizations do not take place through the debt market. The reason for the narrow approach in the Kenyan case is not evident. Both Morocco and Kenya have serious deficiencies in the structure and operations of their government debt markets. Neither country has an adequate long-term primary or secondary market for government debt. By avoiding these markets and their more intractable problems, the two projects improved the probability of success of their activities. From this perspective, the value of the successes is reduced, since the nonfunctioning debt market acts as a drag on future stock market development.

Neither country attempted to use fiscal incentives to stimulate capital market development. The argument for fiscal incentives is that they mitigate a distortion in weakly administered tax regimes. Listed firms are easier for tax authorities to audit than are privately held firms. That results, predictably, in a higher real tax burden on the listed firms. Fiscal incentives available only to listed firms can offset this burden. Officials in both countries anticipated trouble with International Monetary Fund staff if they introduced fiscal incentives and therefore did not seriously explore their advantages and disadvantages. Fiscal incentives have been used successfully elsewhere to encourage companies to list on the stock exchange. In light of the reluctance of firms in Morocco and Kenya to issue public offerings, the tax treatment of listed firms should have been explored.

EVALUATION FINDINGS

The foregoing leads to findings and lessons regarding capital market projects undertaken by the Agency.

Kenya

1. The USAID project was a success. The Capital Markets Authority and the Nairobi Stock Exchange are sound, well-managed organizations with the technical expertise to carry out their mandates. The Nairobi exchange is no longer an informal association but a self-financed corporation. The brokerage industry went from 6 to 20 firms. Transactions fees have declined and trading volumes are up by a factor of 20. The Capital Markets Authority finances 30 percent of its operations from fees, obtaining the balance from the government. Foreign assistance no longer represents a significant contribution to its financing. The Agency provided indispensable assistance to the Capital Markets Authority and the Nairobi Stock Exchange during the formative stages of their development. Under the right conditions, such as existed in Kenya, the donor costs of support for capital market development are not high.

2. A broad consensus exists among financial market experts that the Capital Markets Authority and Nairobi exchange would not have taken their present form without USAID assistance. The Ministry of Finance requested the USAID support, and Kenyan government support remained strong during implementation.

3. Kenyan interest in developing the capital market remains high. The Capital Markets Authority, Nairobi Stock Exchange, and other organizations are collaborating on a central depository organization. Kenya is participating in a regional stock exchange initiative with Tanzania and Uganda. The Nairobi exchange, the most advanced of the three exchanges, has provided technical assistance to the two others. Commercial banks, by contrast, have displayed little interest in further capital market development.

4. The contribution of the Nairobi exchange to the financing of private sector development is modest and has been hampered by two factors: the weak state of the economy and the characteristics of the corporate sector. Those factors include very high interest rates and the prevalence of multinational and closely held family firms that have shown little interest in listing on the exchange. The government is financing large deficits with the sale of treasury bills carrying interest rates in excess of 25 percent. This weakness in the macroeconomic framework is retarding growth in the stock exchange.

5. Government reforms have been important in the growth of the Nairobi exchange. Two specific examples are the removal of capital controls and the privatization and divestiture programs.

Capital controls. Foreign investors have entered the Kenyan market, offering an additional source of funds for investments. The market would not have attracted foreign portfolio investors if controls on the outflow of capital had remained in effect.

Privatization. The government has used the stock exchange to "democratize" the sale of state assets. In the case of the Kenya Airways privatization, 100,000 citizens became shareholders in the company at the same time as did the Dutch airline KLM. It would have been politically difficult for the government to sell a substantial portion of the national airline to a foreign firm without a simultaneous sale to the Kenyan public. The Nairobi exchange will be important to future large privatizations in the power, financial, and telecommunications sectors.

6. Foreign investors have responded positively to the opening of the Kenyan market. Over the last three years, a net figure of $37 million has flowed into listed securities. Transactions by foreign investors account for 40 percent of turnover on the Nairobi exchange.

7. The government is unwilling to consider fiscal incentives for firms listed on the Nairobi exchange. Officials apparently believe that such a proposal would complicate relations with the International Monetary Fund.

Morocco

1. The privatization program boosted activity on the Casablanca Stock Exchange. Volumes increased by a factor of 6; market capitalization increased by a factor of 5. Market professionals developed skills in underwriting, managing initial public offerings, and dealing in higher trading volumes.

2. The mission accomplished its (unquantified) objective of broadening the investor base. Although there is no agreement on the number of individual investors in the market, all participants agree that the publicity campaigns in support of the privatizations did induce more than 100,000 people to invest in equities.

3. The stock exchange has not become a significant financing source of private sector investment. Private firms have not followed the lead of the government privatization program into the stock market. Very few new listings or secondary offerings have taken place on the Casablanca Stock Exchange since the privatization program was launched. The most commonly cited reasons for this lack of interest are 1) fear of loss of family control of the enterprise, 2) belief that disclosed financial information will aid the firm's competitors, and 3) a reluctance to disrupt the firm's relationship with its commercial bank.

4. The government maintains a heavy presence in the capital markets. This is a conscious decision on the government's part. Typical of this presence is the government's majority share in the central depository system. While this is not reproachable, it is far from the U.S. concept of self-regulatory organizations and closer to the French system of extensive state participation in economic activities.

5. Development of the debt market is stymied by weak debt management practices. The treasury bill market, foundation of the debt market, is not managed in a way that produces an anchor for the yield curve. Without a reference yield curve, the capital market cannot perform its function of valuing risk. Without a market price for risk, the pricing of corporate paper or bonds is speculative.

6. Moroccan commercial banks are dynamic, innovative institutions playing a leading role in the expansion of financial services. Leasing is one example of this. Commercial banks set up leasing subsidiaries, which got the market started. Subsequently, nonbank leasing companies were established and entered the market. Innovative uses of lease financing then developed rapidly. Leasing companies have become effective intermediaries between the capital market and small and medium-size companies. In 1996, leasing operations amounted to 4 percent of gross fixed capital formation.

7. Foreign investors account for 5 percent of the volume of transactions on the exchange. There has been no strong and sustained marketing effort to attract foreign investors, mainly because of the lack of share availability.

LESSONS LEARNED

1. Capital market development need not be an expensive undertaking. The Kenya activity was clearly a development bargain. A basic exchange and regulatory structure now operate at a modest cost to both the government of Kenya and USAID.

2. Privatization programs give a boost to equity market projects. Share offerings of state-owned enterprises give the market something to work with as the institutions tool up. Retail investors are more easily attracted by offerings of well-known national flagship companies. We can safely conclude that privatizations through the stock market aided efforts to develop capital markets.

3. A commercial banking sector willing to innovate will magnify the positive effects of donor-funded development activities. Morocco's commercial banks are more innovative than Kenya's. The range of financial services and products available to companies of all sizes is greater in Morocco. Analysis of capital market development design should include an assessment of the likely response of the commercial banking sector to new opportunities.

4. Missions undertaking capital market projects should be held accountable for the quality of the institutions they assist but not for the level of market activity. Stock and bond markets reflect the state of the national economy, which itself is the result of host government economic policies, the underlying structure of the economy, and external factors. Market indices will rise and fall during and after the USAID activity. The goal of a USAID activity should be to help put in place institutions capable of meeting the financial intermediation demands of the private sector.

5. USAID designers underestimated the reluctance of firms to list on stock exchanges. Promotional efforts in both activities were directed to attracting retail investors to the market. Because these promotional efforts succeeded, the demand for securities increased. Meanwhile, though, the only supply increase came from the privatization programs. The combined result: an overall shortage in the supply of securities relative to demand. Activity designers need to examine the attitudes of and the incentives greeting private firms considering entry into the stock exchange.

6. Activity implementors should take a flexible attitude toward adopting the American

model. The American model for the capital market regulatory structure relies heavily on self-regulatory organizations. Delegation of regulatory functions to nongovernmental organizations may not be acceptable to governments outside the Anglo-American legal tradition. The decision on the type of regulatory framework need not be an either–or decision.

7. An active stock exchange imposes managerial discipline in widely held listed firms. Managers of listed firms in both Kenya and Morocco said that stockholder oversight, while not always welcome, did induce them to increase the efficiency of their plant and equipment. Efficiency gains occurred in, but were not limited to, privatized firms.

To order paper copies of this report, PN–ACA–928, please contact USAID's Development Experience Clearinghouse, 1611 N. Kent Street, Arlington, VA 22209. Or you can phone (703) 351–4006, or fax (703) 351–4039, or e-mail: docorder@dec.cdie.org.

To access from the intranet, the address is www.usaid.gov. Look under CDIE Online, then under Documents, then under Economic Growth.

Editorial and production services provided by Conwal Incorporated.

U.S. Agency for International Development Washington, D.C. 20523