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Constraints to Capital Market Development and Growth in Sub-Saharan Africa: The Case of Ghana

1. Introduction

A recent World Bank report on Sub-Saharan Africa (SSA) indicates that many African countries are worse off now, in terms of their per capita income, than they were at the time of their political independence. The *Economist Journal*, in their recent edition, paints a gloomier picture of the state of affairs in SSA countries. Also, a recent survey by USAID reveals that during the first half of the 1990s, only four SSA countries, representing just one percent of SSA's population, experienced growth rates of over two percent in per capita income.

Thus, the question raised by researchers and policy makers is, what accounts for the low growth in per capita income of many SSA countries? An answer to that question was provided by a World Bank study (1990) that concludes that the most severe constraint on private sector development and growth in SSA is the scarcity of capital or credit to the private sector for growth and poverty alleviation. Other researchers conclude that the scarcity of capital to the private sector may be due to the underdevelopment of capital markets and institutions that intermediate the capital market.

Over the past decade, many countries in SSA undertook structural adjustment and financial sector reform designed to reverse the poor performance of their economy. Ghana is one of those countries that had undergone structural adjustment and financial sector reform aimed at enhancing savings mobilization and credit allocation to the private sector. Ghana's case was unique for several reasons. First, Ghana was the first SSA country to gain political independence from the British colonial rule. Secondly, at the time of independence in March 1957, Ghana was the richest country among the SSA countries outside South Africa; its per capita income compared favorably with that of South Korea. Yet Ghana experienced the sharpest economic decline, which also destabilized its financial sector. In the 1970s and 1980s, Ghana became the first SSA country to

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formulate a comprehensive financial sector reform to deregulate the financial markets from decades of government intervention.

However, a decade after the financial sector reform, critics argue that the reform has had little impact on the capital market development and financial savings mobilization. Instead, the reform led to a macroeconomic imbalance of high inflationary pressures, high nominal interest rates, and continuous devaluation of the local currency.

Critics of the reform argue that the liberalization measures instituted in 1988 as part of the financial sector reform were not far reaching enough to solve the root causes of Ghanaian financial sector problems. They argue that the reforms were not geared towards full liberalization of interest rate policy and institutional rigidities that constrain efficient functioning of the capital market. Thus, the relevant policy research questions raised here are: (1) What are the major constraints to the development of capital markets and the operations of non-banking financial institutions (NBFI) that intermediate the capital markets? (2) What is the impact of the financial sector reform on the development of capital markets and institutions in Ghana? (3) To what extent has the existence of stock exchanges been a source of supply of long-term capital for private corporations for growth and poverty alleviation? (4) What are the benefits and challenges of regional and globalization of capital markets in Ghana? (5) How strong is the linkage between capital market development and real sector growth? (6) What are the policy implications of reform and poverty alleviation issues in Ghana?

This study integrates an analytical framework with a synthesis of secondary financial and primary data in order to address the policy research questions. A field survey was conducted through the dissemination of survey questionnaires to a stratified sample of capital market institutions and intermediaries. These include listed companies, unlisted companies, stock brokers, Ghana Stock Exchange, Bank of Ghana, commercial banks, non-bank financial institutions, insurance companies, and employees of private and public corporations. The study also applies descriptive statistical tests guided by the analytical foundation and stylized facts of the capital market in Ghana. We also perform regression modeling and estimation of the link between capital market development and real sector growth.

2. Findings of the study

Based on the analysis described above, this study shows that the commitment of the Ghanaian government to a comprehensive structural and financial sector reform has begun to bear useful results. The establishment of the Ghana Stock Exchange (GSE) has provided an avenue for corporations to raise long-term capital to the tune of 153.5 billion Cedis ($125.8 million) from 1991 to December 1998.

The policy environment has been greatly improved by various initiatives to liberalize foreign exchange rates, privatize state-owned public enterprises, and implement other market-based policy changes that have the potential to deepen the capital market. The passage of various regulatory laws such as the Securities Industry Law (SIL), the Securities and Regulatory Commission (SRC), and the NBFI law have provided strong legal foundations for efficient capital market development.

Some visible successes of these policy changes include the active performance of the GSE in terms of raising domestic and international capital through the issue of initial public offerings (IPOs). Furthermore, active GSE secondary market performance distinguished the exchange as the best performing stock exchange among emerging capital markets in 1994 (IFC). The spectacular performance of the GSE has attracted Wall Street and other foreign institutional and individual investors to the market. The beginning of Ghana's capital market globalization is evident as a result of the cross listing of AGC in New York, London, Toronto, South Africa, and other international exchanges.

This study also shows that although Ghana experienced some significant success in capital market development and deepening, some major challenges still remain. At the macro-level, the instability of the macro-environment has become "a fiscal drag" that impedes the full potential of the Ghanaian capital market's contribution to growth and poverty alleviation. The macroeconomic indicators that stabilized around 1991 worsened after 1992. The fiscal deficits accommodated by issuing high-yield, short-term government securities have adversely affected the demand for securities being issued by private firms in order to raise long-term capital. As a result, many potential investors prefer to hold short-term government Treasury bills. This has led to disintermediation of financial resources from the securities markets. Furthermore, this has crowded small and medium-sized enterprises from the capital market.

The tax system is biased in favor of fixed income securities. As an example, interest income on short-term government Treasury bills is exempt from tax withholdings, while dividends on equity investment are subject to tax withholding. This serves as a disincentive against investing in the stock market.

The lack of product innovation and the limited number of investment instruments being traded on the stock exchange limit the exchange's attractiveness to domestic and foreign investors. Also, the lack of disclosure of accounting information by listed firms constrains the efficiency of price discovery and valuation of underlying companies listed on the exchange.

Additionally, the absence of a hedging mechanism through financial derivatives, futures, and options has increased investors' risk exposure. The thinness of the market and the limited number of shares traded on the stock exchange also limit the potential for market diversification and deepening.

The study also finds that the Ghanaian capital market structure makes it difficult for small and medium-sized firms to raise capital. Moreover, the absence of investment banks, underwriters, and venture capital firms constrain the development of primary and secondary capital markets for raising long-term capital through IPOs.

The stock exchange's role in promoting capital market deepening is also hampered by the government's divestiture programs, which emphasize privatization through strategic investor financing rather than through the Stock Exchange. Furthermore, the lack of automation of trading practices leads to inefficient trading and settlement practices. The market is still illiquid. The number of listed companies is small and the businesses are not fully representative of the country's main economic activities.

Regionalization and globalization of the Ghanaian capital market has the potential to diversify and attract international capital. It also enables domestic companies to cross-list in major international capital markets, resulting in greater exposure. However, the greatest challenge facing those domestic companies are their price fluctuations which are associated with their fundamental valuation in the international capital market. The study shows that Ashanti Goldfield which was priced at \$20.00 at the time of its IPO in 1994, closed at \$1.87 on the New York Stock Exchange (NYSE) as of mid-May, 2000.

The study shows that, contrary to expectations, credit allocation to small and medium-sized entrepreneurs has been curtailed after financial sector reform. Prudential regulations that govern bank lending to borrowers work against small enterprises. The requirements of collateral, disclosure of financial reports, and guarantors for loans are conditions that make it harder for small and medium-sized enterprises to obtain loans from the banking sector. The effect is the reduction of their potential impact on post-reform Ghana's growth and poverty alleviation.

Ghana's Vision-2020 has as its main target the transformation of Ghana from a poor, underdeveloped, and low income country into a prosperous middle income country by the year 2020. However, at the current rate of growth in GDP, population, and per capita income, that goal may not be possible within the targeted time period. With the goal of moving Ghana from its present state of growth to a more sustainable growth, the following recommendations are offered.

3. Policy recommendations

The urgent task facing Ghana is to stabilize its macroeconomic variables in order to create an enabling environment for capital market development. This implies adopting policies that lead to low inflation, stable foreign exchange rates, low fiscal deficits, and a balanced budget. The attainment of these goals is essential for market efficiency and the public's confidence in increasing their financial asset holdings.

Government borrowing from the short-term securities market exerts heavy pressure on short-term Treasury bill yield curves. Synchronizing government long-term projects with long-term sources of financing through the issue of medium-term to long-term bonds will stabilize interest rates and encourage greater private participation in the securities market.

The current tax regime favors short-term investments. Interest income on Treasury bills does not attract tax; dividend income on equity investment attracts 10% withholding tax. In order to provide a level playing field for tax treatment of income on equity and fixed income securities, the withholding tax on dividends should be abolished. Additionally, capital gain's tax exemptions on listed securities until the year 2000 should be extended indefinitely. Furthermore, in order to provide incentives for companies to list on the exchange, special listing tax rebates should be considered for un-listed companies. This tax rebate should include deductions for the cost of initial public offerings and investment tax credit for machinery that will improve labor efficiency.

Stock brokerage firm operations are highly centralized and concentrated mainly in Accra. The brokerage firms should be encouraged to open branches at regional capitals in order to reach a wider pool of investors.

In order to encourage foreign investment in the Ghanaian capital market, the 10% limit for foreign individual investors in one listed company and the maximum total of 74% holding by non-resident foreigners should be abolished. This restriction has a negative impact on the provision of long-term capital for listed companies. It is also biased in the sense that it does not apply to unlisted companies. In addition, as experience has shown, such government regulations are quite burdensome and difficult to enforce.

The modern information technology and the Internet has become a useful tool of e-commerce and investment channels. Online trading has the potential to increase the demand for securities and lower average trading costs. Furthermore, discount brokerage houses have the potential to reduce the public's investment transaction costs.

To attract a wider audience of both foreign and local investors, product innovation and development is essential. Innovative products such as preferred shares, options and futures, and financial derivatives for risk management will increase the attractiveness of the stock exchange.

Competitive trading activities on the exchange will reduce transaction costs. It is recommended that commission rates on trading activities be liberalized in order to induce price and product competition.

In view of the current stock exchange thinness and illiquidity, the proposed establishment of the Privatization Trust Fund (PTF) should be reviewed. In order to encourage individual participation in the stock exchange and to avoid the disruptive tendencies of privatization of state corporations, employee stock ownership schemes (ESOP) should be encouraged in Ghana.

It is recommended that in order to increase the number of shares listed on the exchange, the government divestiture program should be channeled through the exchange. It is necessary to revive the over-the-counter (OTC) market where small and undercapitalized companies may list their shares. The current threetier structure is unworkable, since all shares are listed under tier 1 while no stocks are listed under the second or third tiers.

The introduction of various classes of stocks with varying voting rights will enable individual corporate owners fearful of losing control of their companies to list their shares on the stock exchange.

Regional integration of the West African sub-region capital market should be encouraged. Thus, the current negotiations over the creation of a monetary union for the British speaking West African countries should embrace the existing West African Monetary Union (OMOA) of the Francophone West African countries. This will prevent the fragmentation of the West African states into Francophone and British speaking zones.

In order to sustain the confidence of domestic and foreign investors, it is essential to improve the management of domestic corporations in a more transparent, efficient, and accountable manner. Moreover, efficient corporate governance should be free from government interference and excessive regulation.

The creation of an automated central clearing, settlement, and depository system is needed to enhance the efficiency of capital market transactions. Thus, the computerization of GSE operations is recommended for efficient operations, clearings, and settlements. Furthermore, the technical infrastructure for a continuous trading method should be implemented to ensure continuous trading in the future when demand picks up. This has the potential to increase market liquidity and reduce the extreme volatility of share price movements.

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In the absence of adequate information disclosure and a rating agency of corporate performance and risk profiles, it is difficult for investors to assess risk before undertaking investment in a company. It is recommended that the government encourage the establishment of a national rating agency that performs risk assessment and performance evaluation of listed and unlisted companies. This will enable domestic and foreign investors to assess the risk and valuation of domestic companies before making informed investment decisions.

This policy brief is based on EAGER Discussion Paper Number 80, *The Development of Capital Markets and Growth in Sub-Saharan Africa: The Case of Ghana,* 2001, by Sam Ziorklui [sziorklui@aol.com], Howard University, Washington, D.C., in collaboration with Lemma W. Senbet [lsenbet@rhsmith.umd.edu], University of Maryland, Philip Fanara, Jr. [pfanara@howard.edu] and William Barbee, Jr., [wbarbee@howard.edu] Howard University, Kofi Osei [kaosei@ug.edu.gh] and Fritz Gockel [economics@libr.ug.edu.gh], University of Ghana, John Kwakye, Bank of Ghana, John Aheto [soa@ug.gn.apc.org], University of Ghana, Ekow Afedzie, Ghana Stock Exchange, and Anthony Doku, Merchant Bank of Ghana.

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