

The Way Forward



8.1 Introduction

The focus of this chapter is to summarize the main findings of the report, the challenges and the way forward. Monetary and financial integration is an important step toward deeper economic integration. As indicated in previous chapters, there is ample empirical evidence in the literature to show that trade within a community and outside increases significantly when a regional bloc attains an advanced form of monetary cooperation (such as a common currency). Furthermore, the literature also shows that if a regional economic community is able to achieve a common market, then stronger monetary integration is needed to strengthen that market. In addition, advanced form of monetary and financial cooperation improves overall economic performance and per capita output in participating countries.

“*Monetary and financial integration is an important step toward deeper economic integration*”

In order to reap the benefits of monetary unions, several African RECs are taking steps towards the formation of such unions. This report has examined progress made by the RECs towards monetary and financial integration in Africa. The analysis was divided in two parts. The first provided theoretical underpinnings for monetary and financial integration, while the second provided progress reports on the performance of the RECs in their move towards monetary and financial integration. In doing so, the report shed light on the progress towards macroeconomic convergence in those RECs that have formally agreed to convergence criteria and the status of capital markets, stock exchanges and investments in Africa. Preceding the two parts was a progress report on regional integration on the continent.

8.2 Monetary Cooperation

The success of regional integration hinges on member countries pursuing convergent macroeconomic policies. However, for successful macroeconomic convergence it is essential that, at the minimum, the following conditions should be fulfilled:

“ Despite the efforts of the RECs in establishing protocols and MOUs for monetary programmes, reality on the ground shows substantial gaps in the implementation of the programmes ”

- Efficient and non-distortionary markets for products and factors of production, including freer movement of capital and labour;
- A mechanism such as an effective compensatory financing arrangement to make the domestic costs of adjustment affordable, has to be in place for participating countries to handle the ill-effects of exogenous shocks such as adverse weather, terms of trade and external financing shocks;
- Proper timing and sequencing as well as consensus-based choice of a convergence anchor (whether rigid or flexible benchmarks and criteria); and
- Mitigating policies that reduce risks.

However, most of the participating countries of the RECs are not able to attain the conditions suggested above. The assessment carried in the report indicates that most African countries have great difficulties in achieving the desired macroeconomic convergence criteria set by the regional economic communities. In addition, most African countries are registering double-digit inflation and are therefore not able to achieve the desired inflation targets or the desired fiscal targets. This poor performance is partly attributable to negative external shocks, unsustainable budget deficits, lack of reliable statistics and poor growth performance.

8.2.1 Challenges

Despite the efforts of the RECs in establishing protocols and MOUs for monetary programmes, reality on the ground shows substantial gaps in the implementation of the programmes, due to:

- **Multiple memberships.** Most African countries belong to more than one regional economic community. Given the resource constraints faced by many countries, the multiple memberships in RECs lead to wasteful duplication. REC countries find it difficult to pursue macroeconomic convergence policies because of the variations and conflicting objectives of their monetary programmes;
- **Slow implementation of monetary programmes.** Participating countries have been reluctant to fully implement monetary programmes on a timely basis. This is due in part to countries lacking full information on the net benefits of the programme. In addition, there are minimum consultations within the member countries concerned;
- **Divergence in economic policies.** Participating countries tend to pursue different economic policies because of the difference in their levels of economic performance. These policy inconsistencies have contributed to the low level of implementation of REC monetary programmes and activities. There have been challenges to integrate regionally where there have been continuously

glaring policy, implementation and information inconsistencies at the national level. There is therefore need for an appropriate policy mix and coordination at the national level that targets low inflation and fiscal discipline;

- **Limited national and regional capacities.** The lack of capacities, mechanisms and resources at the national and regional levels for the effective planning, coordination, implementation and monitoring of monetary programmes has made it difficult to satisfy macroeconomic criteria;
- **Lack of mobility of factors of production.** Macroeconomic performance stands to benefit from the mobility of factors of production. However, xenophobia has partly hampered labour movement among member countries, while underdeveloped financial markets are responsible for the limited mobility of capital.
- **Domestic, regional and international financial and investment constraints.** These drawbacks have limited the ability of member States to achieve sound macroeconomic performance. Moreover, considerable resources are needed to plan, coordinate, implement and monitor progress in the implementation of monetary programmes. Compounding the problem is the savings rate of many African countries as well as limited inflow of FDI;
- **Lack of private sector involvement.** The engine of growth in developed countries is the private sector, and its contribution to sustainable economic growth cannot be underestimated. However, in Africa, the participation of the private sector in the formulation of macroeconomic convergence criteria is very limited. In addition, in most African countries, the private sector remains very weak and not well organized; and
- **Lack of mechanisms to handle external shocks.** African countries are extremely vulnerable to exogenous shocks, including heavy and unsustainable external debt burdens, inadequate and erratic external resource inflows, unfavourable terms of trade shocks as well as adverse weather patterns and natural disasters. These factors make it extremely difficult for countries to meet the set macroeconomic targets. Hence, appropriate mechanisms need to be developed to mitigate these external shocks.

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From the above challenges, it could be concluded that, on the whole, Africa's ability to achieve monetary integration remains very difficult. This raises the question of the appropriateness of the convergence criteria for Africa. As argued in the report, macroeconomic convergence mechanisms are needed because the success of regional integration hinges critically on member countries pursuing convergent macroeconomic policies. Misalignments of key macroeconomic variables could hamper the regional integration process. It is therefore imperative that the process of strengthening regional integration should include guidelines for the convergence of macroeco-

conomic and trade policies of the entire regional space so as to strengthen the overall regional integration agenda.

It is important that the macroeconomic convergence criteria established by member States should:



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- Ensure that only member States that have economic conditions that are favourable to the achievement of the set targets participate;
- Ensure that the countries meet the convergence targets at all times;
- Be coherent and holistic, drawing on the development objectives of the RECs and member States;
- Be simple, transparent and consistent with broad, national and regional objectives; and
- Be satisfied and meet on the basis of current data.

However, for the coordination of macroeconomic policies in the RECs to succeed, African countries should have a clear sense of their own development objectives and strategies and be fully committed to the pursuit of these goals. Member States should muster the political will to mainstream regional monetary and macroeconomic objectives into their national development strategies.

8.3 Financial cooperation

It is also essential to strengthen and consolidate Africa's financial markets and institutions, in order to mobilize the financial resources needed to finance integration efforts such as infrastructure projects. These institutions also enhance the payment system and help facilitate trade within and outside the regional communities. In addition to improving the financial markets, efforts must be made to encourage the RECs to establish development banks in their regions, in order to assist member countries in financing infrastructure projects. However, the integration of financial markets in Africa requires the harmonization of national policies and procedures governing these markets and institutions across member countries.

As noted in the previous chapters, stronger financial markets contribute significantly to economic growth by promoting domestic savings and increasing the quantity and quality of investments. The markets also act as vehicles for wealth generation, as individuals are able to invest in additional financial instruments according to their risk preferences and liquidity needs, and help boost the national savings rate. Firms also use the financial markets to raise capital at lower cost. In countries that have advanced markets, firms use the markets more than the banks for financing and therefore reduce the risk of a credit crunch. Hence, sound functioning financial

markets influence economic growth by boosting savings amongst individuals and financing the activities of firms.

Financial markets also ensure the efficient allocation of resources, with poor-performing firms generally under the threat of a takeover. Such perceived threat provides an incentive for management of the poor-performing firm to try to maximize the value of the firm to fend off any attempts by another group of investors to take control of the firm. In this regard, financial markets foster corporate discipline and ensure the efficient allocation of productive assets and the efficient use of managerial resources.

Financial markets also ensure the best use of information at low cost, through the generation and dissemination of firm-specific information as revealed in stock prices. Efficiency of the markets ensures that market prices of firms reflect all available information, thus reducing the costs of acquiring market information and thereby improving resource allocation. The markets also assist investors in making better investment decisions, thereby ensuring better allocation of funds among productive firms and boosting economic growth.

Africa is making progress in the development of financial markets. Before the 1990s, Africa had only five stock markets compared to 19 today. With the exception of South Africa, most African stock markets are very small. However, total market capitalization increased from \$US113,423 million to \$US244,672 million between 1992 and 2002.

Despite the rapid growth in the development of stock markets, most of the markets are not very deep and therefore not mature, with very few stocks traded and accounting for a large part of the total market capitalization. The average number of listed companies on sub-Saharan African markets excluding South Africa is 39. In addition, the markets suffer from low liquidity, making it extremely difficult to support a local market with its own trading system, market analysis or brokers, because the business volume would simply be too low.

The markets also face serious informational and disclosure deficiencies. Furthermore, supervision by regulatory authorities is often far from adequate. Compared to advanced markets that have electronic trading, most of the markets in Africa are paper-based, trading manually and using manual clearing and settlement systems. Furthermore, most of the markets do not have central depository systems and restrict foreign participation.

Despite these challenges, African stock markets continue to perform remarkably well in terms of return on investment. The markets in Ghana, Uganda, Kenya, Egypt, Mauritius and Nigeria were among the best performers in 2004.

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Most of the financial markets are not integrated. At the moment, the only regional stock exchange in Africa is the BRVM, which is located in Côte d'Ivoire and serves eight French-speaking West African countries of UEMOA. The BRVM was created in 1998 and has branches in each UEMOA country. The bourse is mainly owned by the private sector, but the member States own 13.4 per cent of the capital. Trading on the BVRM is computerized with satellite links. Brokers and agents can transmit orders and consult and edit quotation results to the central site in Abidjan while in the national branch offices. All trades are cleared and settled at the Depositaires Central/Banque de Reglement SA.

There have been other initiatives undertaken to integrate the markets in Africa. The Southern African Development Community (SADC) has created a Committee of SADC Stock Exchanges (COSSE), whose responsibility is to develop a framework for an integrated real-time network of securities markets within the community. The COSSE requires each national market to automate its trading of financial instruments through a single and accessible regional system. It also encourages the harmonization of listing rules across the region. The Johannesburg Stock Exchange (JSE) and the Namibian Stock Exchange (NSX) have also advanced further in harmonizing their systems, with the NSX using the trading and settlement systems of the JSE. The two exchanges are also linked on the regulatory side; the NSX rules and requirements are based on those of the JSE, and the majority of shares listed on Namibia Stock Exchange (NSX) are also listed on the JSE.

Bilateral Memorandums of Understanding (MOUs) have been reached between the JSE and each of the markets in Egypt, Ghana, Kenya, Nigeria and Uganda. The Nairobi Stock Exchange has also signed MOUs with Nigeria and Ghana. South Africa is in discussions with a number of African countries to create a virtual African exchange for the trading of shares of large African companies. The market would enable qualifying companies to simultaneously list on all member exchanges.

Under the framework of the MOU of the East African member States Securities Regulatory Authority, the East Africa Community (EAC) is promoting the integration of its markets, and member States are currently harmonizing their rules and regulations in accordance with those of the Nairobi Stock Exchange.

8.3.1 Conclusion

As discussed earlier, African stock markets are small, illiquid, with infrastructural bottlenecks and weak regulatory institutions. Despite the challenges they face, the markets have financed a number of companies, thereby contributing to economic growth. It is therefore imperative that the RECs and national policymakers design

policies that would support the deepening of the markets in Africa. Some of the suggestions proposed in the literature include:

- **Need to promote a stable macroeconomic environment:** A stable macroeconomic environment is needed for the development and strengthening of the stock market in Africa. Increased volatility of macroeconomic variables worsens the problem of informational asymmetries and becomes a source of vulnerability for the financial markets. Low and predictable rates of inflation are more likely to contribute to stock market development and economic growth. Both domestic and foreign investors are reluctant to invest in financial markets where there are expectations of high inflation. Sound macroeconomic environments and sufficiently high income levels, including GDP per capita, domestic savings, and domestic investments, are key factors for the promotion and development of financial markets.
- **Need to increase automation:** By increasing the level of automation, financial markets in Africa would be more efficient, increasing their trading activities as well as their liquidity. Automation would cut down the cost of trading and also speed up operations and activities on the markets. Automation requires that stock exchanges adopt a central depository system (CDS), which would eliminate risks associated with the loss, mutilation and theft of certificates and paper-based securities. CDS systems also reduce errors and delays associated with paper-based systems.
- **Demutualization of exchanges:** All financial markets would have to be demutualized. This means that the legal status, structure and governance of stock exchanges would be changed from non-profit to profit-making ventures. The process of demutualization involves a change in ownership structure and a change in legal and organizational form. With regards to the ownership structure, members' seats on the exchange are monetized and values assigned per seat. Members then either keep or sell shares. Ownership restrictions are placed (for example, 5-10 per cent non-controlling stakes) on individuals and groups to prevent potential takeovers by other exchanges. The legal and organizational change normally entails the exchange becoming a typical profit-making company with limited liabilities and abiding by company laws. Demutualization of exchanges, which started in the 1990s, encourages competition among exchanges; increases capital infusion; promotes good corporate governance; opens up ownership to public investors; and eliminates government interference in the operation of exchanges.
- **Integration of African financial markets:** In order to overcome the challenges of fragmented markets, African financial markets need to be fully integrated. Merging stock exchanges (the extreme form of integration) would increase the volume of trade. An integrated regional stock exchange in Africa will be a powerful source and driver of capital flows to Africa.

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Such an exchange will also, if well structured, solve the current problems of illiquidity, small size and fragmentation. Integration of the markets would promote cost efficiency and improve liquidity and price discovery. Integrated markets would help assemble the economic and human capital skills of various markets in one single market. Moreover, integration enhances synergies in risk management as trading, operations clearing and settlement systems are harmonized. In addition, integration improves surveillance and risk management, by enabling access to information in all market segments. A prerequisite for a successful integration of the markets is that trading laws, accounting standards, legislations, rules, listings, trading days, settlement, and reporting standards would all have to be harmonized. Furthermore, participating countries should ensure currency convertibility, because an integrated exchange with a multiplicity of inconvertible currencies only compounds the administrative costs which integration itself seeks to remove.

- **Need to promote institutional investors:** It is important that institutional investors are encouraged to participate in the financial markets in Africa, because they are effective in promoting efficient market practices and financial innovation. As well, this group of investors encourages greater transparency and integrity in both primary and secondary markets, seeks lower transaction costs, and promotes efficient trading and settlement facilities. Pension funds, insurance houses and other institutional investors can therefore act as a countervailing force to commercial and investment banks as well as other market intermediaries, forcing them to be more competitive and efficient.
- **Need to have sound regulation and supervision:** Regulation and supervision are typically aimed at preventing exploitation by some investors. Protecting the rights of investors helps eliminate the problem of information asymmetry. This helps in making optimal decisions, increasing access to external finance and results in productive investment and eventually higher firm growth. Policymakers would have to provide well-structured and clear rules within an efficient judicial system that allows for the respect of contracts and eliminates expropriation risk. Regular disclosure, transparency and enforcement of the law underpin the regulation and supervision of the markets. Important disclosure requirements include relevant information with regards to transactions, accounting and the identity of ultimate beneficial owners. The presence of strong corporate governance mechanisms also helps boost investor confidence in regulatory issues. Thus, regulation and supervision of the financial system play a great role in determining both its stability and the extent of services provided.
- **Need to encourage foreign participation:** Private capital flows such as foreign direct investment, remittances and portfolio investment are crucial for

the development of financial markets in Africa. African countries need to do more to attract capital flows, especially portfolio flows. Africa would have to increase its efforts to create an enabling environment with low costs of doing business, property rights protection, effective regulations, legal institutions and liberalization of capital accounts. Furthermore, African countries should engage in sustainable economic growth and establish quality public institutions and infrastructure, trade liberalization and efficient capital markets, so as to attract increased capital flows. Capital account restrictions need to be removed in order to attract cross-border investments. However, capital account liberalization should be preceded by trade liberalization and domestic financial liberalization to minimize financial market risks.

African countries should engage in sustainable economic growth and establish quality public institutions and infrastructure, trade liberalization and efficient capital markets, so as to attract increased capital flows



Economic Commission for Africa



African Union

Regional integration remains a viable strategy for Africa to achieve sustainable economic growth and development, reduce poverty and participate effectively in the globalization process. This vision is embodied in the Abuja Treaty Establishing the African Economic Community, and is re-emphasised in the Constitutive Act of the African Union. These blueprints include a roadmap for a monetary union and the harmonization and integration of financial systems and markets across the continent. Achievement of these goals requires a climate of macroeconomic stability, monetary and financial integration and effective trade and economic relations.

Monetary unification and financial integration overcome problems associated with multiple and non-convertible currencies and with underdeveloped capital and financial markets and would also propel the continent towards establishment of the envisioned African Monetary Union. Several Regional Economic Communities (RECs) have adopted common macroeconomic policy frameworks and convergence targets, underpinned by monetary and financial cooperation.

As follow-up to ARIA-II, ARIA-III focuses on gauging the performance of African RECs in the areas of macroeconomic convergence, monetary cooperation, and financial integration. The report finds that although there are some successes, African countries are still experiencing enormous difficulties in achieving the macroeconomic convergence criteria set by their RECs, such as targets on inflation, debt-to-GDP ratio, and deficit-to-GDP ratio. The assessment also indicates that despite some financial developments, African financial market activities remain shallow, with capital markets characterized by low capitalization and liquidity.

The report also provides policymakers with recommendations on how to deepen monetary and financial integration on the continent and create an enabling macroeconomic environment for the continent.

