Africa on the Brink of Economic Take off – Exchanges to play a Pivotal Role

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In the recent past, African economies has come into limelight more for constructive reasons than negative one such as political turmoil, which used to be the case before. For the ones who believe in Africa's success story, it is heartening to note, the big economic strides made by many African economies amidst economic struggle by many of the developed and the developing economies spread across three continents – Americas, Europe and Asia.

Africa on the Verge of Economic Boom

With already few African nations registering a double digit growth rate in the last few years, perception of Africa among investors are becoming distinctly positive especially over the long-term horizon. Certainly, Africa could be on the threshold of an economic take-off, akin to India in early 1990s and China around 1980s. The focus on Africa is only getting enhanced with World Bank and International Monetary Fund (IMF) predicting outstanding economic growth for many African economies and in certain cases it is expected to be in double digit numbers. In fact, according to IMF, Seven of the top 10 fastest growing economies in the world are going to be from Africa in the next five years. Indeed, one of the lead global business consultancy firms stated that capital investments in Africa are set to touch US$150 billion by 2015.

Considering the Africa's growth prospects, policy makers need to ascertain the right engines for growth to make sure 'the Africa growth story' would not become a "fad" rather result in sustainable growth. This is where efficient and vibrant markets could play a pivotal role as one of the powerful economic growth engines.

Vibrant Markets – Need of the Hour

Amidst the prospects of economic boom, there are certain big challenges for majority of the nations in the Continent. Policy makers are increasingly realizing that Africa needs to leverage on its strengths as it is gifted with abundant 'natural resources'.

Given the fact that Africa is comparatively land-abundant, natural resources and scarcely populated, importance of natural resources come as no surprise. Thus, there is a strong need to take advantage of natural resources, as Africa has a strong comparative advantage in natural resources. Natural resources such as agricultural commodities, minerals and metals, and energy products have accounted for ~35% of Africa's growth achievements success. The challenge is how Africa can achieve growth given its comparative advantage. There is a need for vibrant markets to monetize optimally its natural resources such as agricultural products, minerals and metals, and energy products.

The high price levels for commodities provide a window of opportunity which African countries must take advantage of. Driven by the phenomenal increase in demand from emerging economies such as China and to an extent India for raw material and agriculture and energy commodities, demand for commodities has remained high in spite of the current sluggishness in advanced economies. With increased role of commodity prices having a bearing on the resurgence of global economy, natural resources of Africa has hogged the limelight. Most of the foreign direct investment (FDI) in Africa went to resource-related activities, thus putting Africa back on the map of international investors and this has led to a number of impressive new discoveries of mineral and energy resources.

There is no doubt, lot of positive structural changes and reforms took place during the last decade, but Africa still needs much more effective transformation to create economic structures, which can propel the African economies to a new level. And one of those measures could be by establishing vibrant financial and commodity markets. African policymakers have increasingly realized that efficient financial and commodity markets are important for accelerated growth apart from ensuring inclusive and sustainable development.

Role of Exchanges in Africa Growth Story

Essentially, exchanges are capable of promoting economic growth. Some of the recent successful IPOs give testimony to the fact, that African stock exchanges are increasingly becoming important source of raising capital for large corporations. A well established stock market acts as a hedging and risk management platform and rising of capital resources for private sector participation in Africa's infrastructure development.

*The views expressed in this article are those of the authors and should not be construed or attributed to Bourse Africa or its subsidiaries.

Africa was paid a lot of attention in recent times due to its natural resources and increase in prices of raw materials and agriculture commodities. Africa is one of the major producers of agriculture commodities such as cocoa, cotton and coffee. Exports of these commodities is estimated to touch US$~10 billion in a decade (in constant dollars). The market for food products is also set to grow massively, which is expected to touch US$150 billion for the same period. Given its increasing role as being a major supplier of certain commodities, there is a dire need in the continent to have a vibrant commodity market – physical as well as derivatives. Having a well established commodity exchange would enable the African market to transform from a 'price taker' to a 'price maker'. This will ensure commodity sellers realize a reasonable consideration for their produce and in the process boost African exports and thus their economies.

An efficient commodity market can deliver improved market transparency, efficient price discovery for commodities, better financing of commodity value chain, platform for hedging and risk management. Commodity exchanges can also boost regional trade and they can also act as catalyst for the growth of the industries related to such trade. Apart from the above primary outcomes there are many secondary benefits such as enhanced job creation and rapid cross-border economic integration by offering platform for the mitigation of key financial and trade risks.

Therefore, an efficient stock and commodity market will bring inclusive and sustainable growth and can unlock Africa's economic potential. The emergence of commodity and stock exchanges has therefore become an important aspect of the development initiatives and aspirations in many African countries. Yet, some notable exceptions notwithstanding, African exchange market development have not yielded much in the past three decades.

Exchanges – Existing State

Currently, there are around two dozen stock exchanges in Africa, compared to a decade earlier when the total number of exchanges in Africa was less than twenty. As compared to number of stock exchanges, there are not even a half a dozen commodity exchanges notable being Bourse Africa, Mauritius, Johannesburg Stock Exchange (JSE) arm SAFEX, South Africa, and Ethiopia Commodity Exchange (ECX), Ethiopia. Of this the first two are multi-asset class exchanges that offer derivative products, while ECX is a commodity spot exchange. Other than these two exchanges, no other exchange in the sub Saharan region offer derivatives trade, certainly, not even in the stock and currency segments.

Related to stock market, except for few, majority of the African stock markets are still small and often dominated by a handful of large corporations. Trading in shares in many of these exchanges is less frequent, and even when it happens, it is usually confined to a few big corporations. Apart from the limitations of the exchange infrastructure, lack of liquidity is acting as a major impediment, while reliability of these exchanges among general public is unconvinced.

With respect to financial markets, there is currently an active over-the-counter and off-shore market for many African currencies. But access to these markets is limited as most of the contracts are for short durations. Except the two derivative exchanges in Africa, currency futures contracts are not traded on any exchanges. Currency futures contracts will enable enterprises especially the small and medium ones who have limitations in participating OTC or global derivatives market, to manage their currency risk thereby benefit intra-African trade. Currently, most of the Africa bond markets are highly inefficient (as exemplified by the wide margin between deposit rates and government bond rates).

Impediments and Way Out

There are many obstacles that inhibit the growth of stock markets in Africa. Except a handful of them, majority of the African stock markets are of small size. Absence of liquidity is often considered by investors, especially foreign investors as the major impediments to investing in the region. However, considering the economic size of many African nations, it is ambitious to expect a vibrant market in each and every nation. Indeed, not every country in Africa needs a stock or commodity exchange. Further, it is very expensive to operate an exchange and it is not commercially viable to have lots of exchanges all around the continent.

Based on recommendations by experts, some of the countries have come together to establish regional exchanges. Currently two regional exchanges in existence, one based in Central Africa and the other in West Africa have not made any big impact thus far. One big obstacle could be no harmony among the countries in the region with regard to trading laws and accounting standards. Also, nationalism is another factor which is playing a part as countries tend to treat stock markets as national symbols and hence are not hastening the process to relinquish control. However, barring a few, stock exchanges witnessed little success much to the chagrin of stakeholders of financial markets.

High transaction cost is also another detrimental factor. High level of volatility in foreign exchange rate of many currencies and lack of equity risk management through derivatives are only adding to the woes. This is keeping many of the foreign investors and even big domestic investors away from the markets. Ghana is one of the

Table I: Overview of Financial Markets in Africa

Equity Market	Around 28 stock exchanges are currently in existence in Africa but no equity derivatives trading except in South Africa
Commodity Spot Market	A handful of commodity spot exchanges exist with limited success
Forex Market	Predominantly OTC market, except for two countries where exchange traded currency derivatives market is present
Bond Market	Limited secondary trading exists in around a dozen exchanges, dominated by Government bonds. South Africa got an established bond market
Multi-Asset Exchanges	Two exchanges exist one each in Mauritius and South Africa

Table II: Increase in turnover of Equity Market (cash segment) after introduction of Equity Derivatives* (value in US$ million)				
Period	BM & FBOVESPA, Brazil	JSE, South Africa	National Stock Exchange (NSE), India	Korea Exchange, South Korea
Post introduction of Derivatives (A)	39,581 (2002)	4,730 (1988)	198,706 (2003)	95,741 (1997)
Recent Period (2012) (B)	834,535	405,747	509,348	1,584,674
Growth from A to B (No. of times)	21	85.8	2.6	16.6
Average growth considering all the four Exchange in the emerging markets: **~32 times**				
* - Precise time period could not be considered due to certain data gaps				
Source: WFE & Bourse Africa				

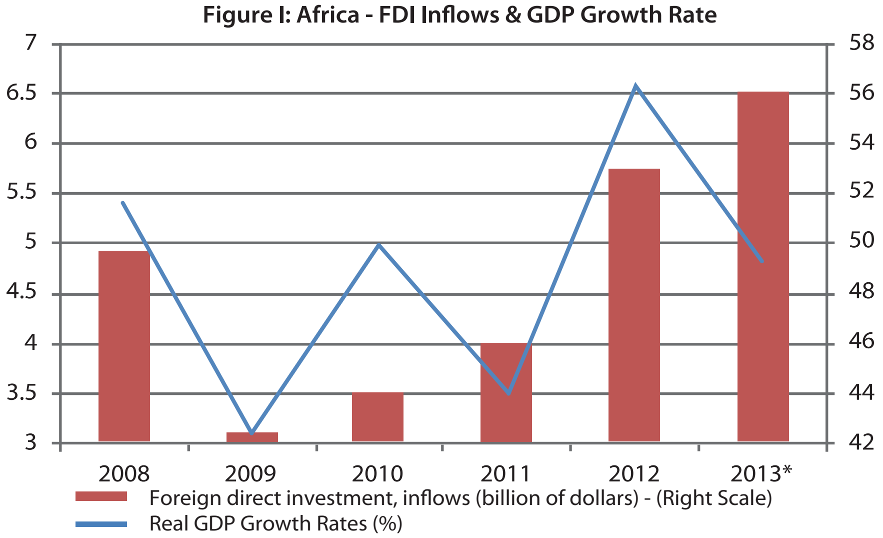
best examples as the US dollar adjusted returns fell drastically due to depreciation of Ghana cedi against the US dollar (~23 percent in 2013) though the benchmark stock index has outperformed other peer markets (GSE Composite Index rise ~79 percent y-o-y). Hence, futures contracts denominated in US dollar terms would able to address the direct forex risk thus paving way for increased participation of foreign investors.

Lack of derivatives products on exchanges, except on JSE and Bourse Africa, to an extent is also limiting the success of financial markets including commodity derivatives market. In fact, derivatives provide an opportunity to hedge price risk existing in physical market – stock, commodity and currency – thus enabling investor or trader to carry a higher exposure limit while trading in the physical market. A well established equity derivative market could accelerate volumes and increase liquidity in the cash market. Fund managers and investors from across the world will have an option to cover their positions in the cash market, which will give them the comfort to invest larger amounts. Indeed, the equity cash market turnover (US dollar terms) in Africa has come down in the last few years barring South Africa. Last year even South Africa was no exception.

In developing nations, emergence of derivatives boosted their respective equity market (cash market) turnover. Over a period of time, the cash market size increased by 30 times (average) if we consider emerging nations such as Brazil, India, South Korea and South Africa (refer table for details).

Understanding of derivatives products is limited especially among retail participants. Capacity building measures help investors and other stakeholders of financial markets understand the benefit of the markets and help in sustainable developed more importantly the retail segment. With the 2008 global financial crisis, wherein absence of robust laws to regulate derivatives trading was largely blamed for the crisis, policy makers in the continent have increasingly become sceptical about introducing derivatives trading. These problems, many of them inherent, cannot be fixed overnight. They require time and resources. In developed markets such as the US and Europe, regulatory reforms (Dodd-Frank Act and European Market Infrastructure Regulations (EMIR)) are brought-in to move OTC dealing to exchange platforms as centralized clearing on exchanges could avert such crisis in future.

Figure I: Africa - FDI Inflows & GDP Growth Rate



Source: African Development Bank and World Bank

Thus, few exchanges are exploring the idea of listing products of other exchanges to be traded on their platform. This is going to open a product for a much wider market, while from the investor perspective; it is set to provide enhanced investment options. Especially with two biggest impediments being technology and liquidity, the idea definitely, to an extent, addresses the challenges. Since many of the exchanges are not well equipped on technology front including launch of derivative products, the approach makes great sense. A pan African exchange with Africa centric products can bridge the accessibility gap by providing the real-time information about many African products to the world, hence, enhancing participation and thereby increasing liquidity. However, success of this concept depends on conducive policies.

Way Forward

If the progress of financial markets in developed markets such as Europe and the US is considered, in the last decade they went through an extensive transformation, adding exotic and innovative products, increased market participation base, and technology up gradation. Even in emerging economies, trade volumes increased over a period of time on the back of high GDP growth rate. This augurs well for African markets as many of them are set to clock double digit number in GDP growth rate thereby can expect a satisfactory boost in trade turnover.

While envisaging the growth and development of financial markets in Africa, a peek into the pace of financial market reforms in Africa will help. The recent past has been great for Africa on the back of accelerating economic growth backed by the perception of an African renaissance and technological developments.

Further, in many countries in the continent, there is increasingly a more cordial relationship being built between the government and the private sector thus bringing in greater business cohesiveness. Political stability now exists in many countries, despite recent setbacks in few countries such as Egypt and South Sudan.

Even there is increased investment flow to Africa due to improved macroeconomic stability (refer Figure I for more details). Interestingly, in certain key African stock markets, movement of stock indices got a direct bearing on the stock exchange turnover (refer Table III for details). Hence, increased investment flow set to boost performance of stock indices and thereby increased trade. Thus, fortunately, environment favorable to the growth of stock exchanges are beginning to take root in Africa.

Africa is a latecomer to derivative markets. However, with the recent growth dynamism on the continent, African economies are tapping to exploit the full potential of the commodity exchange and derivatives markets. Africa is the current frontier for commodity exchange development in the world, attracting the interest of various stakeholders both domestic and global. Further, offering currency futures will also make the commodity contracts offered by the exchange more attractive, as many commodity traders (exporters as well importers) are exposed to both currency and commodity price risks. Moreover, there are good opportunities in debt markets, which is in nascent stages of development. Apart from traditional debt instruments, an exchange can also offer ETFs.

Establishing or operating an exchange and its associated infrastructure require huge capital expenditure, hence, more the users, lower the cost. Therefore, the best way to develop the market is through greater penetration by lowering the cost of operating the exchange infrastructure. For instance, Bourse Africa through its multi-asset exchange platform is offering broad range of financial derivatives contracts and set to shift the horizon to new levels thereby lower the costs and attract more users.

Conclusion

With the competitive global business environment, it is high time for Africa to establish a robust pan African exchange infrastructure that offer the services demanded by the continent's economies. A Pan African exchange will provide African and International market participants with an efficient market for risk management, trading, investing and capital raising needs. It will also act as a catalyst for the growth and development of the underlying commodity, currency, equity and debt markets. This will enable the continent to internalize the associated valuable revenue opportunities, and to ensure that all African countries are carried along in their march towards economic development. To leverage on these opportunities, African countries need to make the right choices that too in the next few years.

African governments can play a facilitating role by developing institutional framework and improving the regulatory environment that will encourage stakeholders to make use of these financial instruments. The stakeholders need to deepen their understanding on the benefits of exchanges and the paradigm shift in economic benefits it can bring to African economies that can revolutionize African capital and commodity markets.

Offering a wider range of products also helps attract more players, who are seeing a larger potential market. Even if a particular segment accounts only for a small part of an exchange's turnover, it can be widely accessed and can be traded at relatively low cost. Policy makers should allow an exchange free to use its platform for products for which there is potential demand, as long as this does not go against government policies.

Table III: Performance of Stock Indices and Turnover (US$ million)

	Morocco		Kenya		Nigeria		Mauritius		Tunisia	
Year	Casablanca MASI Free Float Index	Casablanca Stock Exchange-Turnover	Nairobi All Share Index	Nairobi Securities Exchange-Turnover	Nigeria All Share Index	Nigerian Stock Exchange-Turnover	Mauritius Semdex	Stock Exchange of Mauritius - Turnover	Tunis SE TUNINDEX	Tunis Stock Exchange-Turnover
2009	10,443.81	7046	71.64	503	20,827.17	4655	1,660.87	409	4,291.72	1302
2010	12,655.20	9779	97.82	1369	24,770.52	5291	1,967.45	440	5,112.52	1826
2011	11,027.65	5981	68.03	918	20,730.63	4182	1,888.38	559	4,722.25	1048
2012	9,359.19	5833	94.86	1085	28,078.81	4232	1,732.06	353	4,579.85	1253
2013	9,114.14	4322	136.65	1732	41,329.19	6777	2,095.69	441	4,381.32	851

Source: ASEA;
Note: Extrapolated to derive turnover values for December 2013 (Mauritius, Morocco & Tunisia) and for Nov & Dec (Kenya & Nigeria)

Contributor Profile

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Mr. Prasad is a well-known personality in economic research, commodity market, derivatives markets, industry and company specific research, economic policies and trade issues. Mr. Prasad, who is Masters in Economics (MA) and Management (MBA), had many publications related to commodities & financial derivatives market and many of his write-ups received international acclaim. He published many articles and working papers in various reputed international publications, which includes a joint publication of UNCTAD (United Nations Conference on Trade and Development).

Prior to his association with Bourse Africa Ltd., he held vital positions at Multi Commodity Exchange of India (MCX), India and Reliance Power, Reliance Group, India. While at MCX, he played a pivotal role in the growth and development of commodity futures market in India by bringing in greater awareness about economic benefits of futures trading among all the stakeholders of commodity market through his write-ups and being a speaker in various forums. He contributed immensely for power sector reforms in India through his thought leadership.

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