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Importance of Capital Market as an instrument of Economic Development

In many countries, Capital market is an engine of economic growth and development…..

Introduction

A capital market is a market for long-term debt and equity securities, where business enterprises (companies) and governments can raise funds for long-term investment. It is normally divided into two broad categories - the stock market and the bond market.

The stock market is the market where equity securities such as stocks – representing ownership shares in particular corporations issuing the securities – are traded. These instruments are usually issued by big corporations and promise a return (in the form of dividends) based solely on performance of the issuing corporation. In addition, investors can gain from appreciation of stock prices.

The stock market securities are usually listed and traded on stock exchanges - corporations or mutual organizations which provide trading facilities for stock brokers and traders. Stock exchanges provide facilities for issue and redemption of securities as well as other financial instruments and capital events including payment of income and dividends. They are sometimes referred to as securities exchange to reflect these broad functions. Securities that are traded on a stock exchange include: shares issued by companies, unit trusts, derivatives, pooled investment products and bonds. To be able to trade a security on a certain stock exchange, it has to be listed there.

INSIDE:

On the contrary, bond market comprise of long-term borrowing or debt instruments such as treasury notes and bonds, corporate bonds, mortgages securities etc. Most of these instruments promise to pay either fixed streams of income or a stream of income that is determined according to a specific formula over its entire life and return face value upon maturity. As such, they are usually called fixed-income capital market instruments. Typical issuers of bonds include government and government agencies as well as private corporations.

Money Market: *a building block for development of Capital Market*

One of the building blocks for development of capital market is effectiveness and efficiency of money market. Money markets are arguably a precondition for development of sound bond markets. The money market facilitates smooth introduction of capital market, particularly bond market. It links capital market to the banking system, (the ultimate provider of liquidity) and helps anchor short-term end of yield curve, which is an essential tool in the pricing of debt securities. It also plays a critical role in price discovery and in the setting and transmission of interest rates.

The money markets are critical to financial stability and development. Well-functioning money markets enable other financial institutions to cover their short-term liquidity needs. Many banks and other financial markets' participants obtain a significant portion of their funding from the money markets and rely on rolling over short-term debt contracted. Therefore, if market participants become concerned about their access to money market funding, they can refrain from investing in the capital market, reducing funding to bond and stock issuers. This would ultimately affect the market for long-term funds and therefore the real economy.

Capital market and Economic growth and Development

Economic growth in a modern economy hinges on an efficient and effective financial sector that pools domestic savings and mobilises capital for productive projects. Absence of effective capital market could leave most productive projects which carry developmental agenda unexploited.

Capital market connects the monetary sector with the real sector and therefore facilitates growth in the real sector and economic development. The fundamental channels through which capital market is connected to economic growth and development can be outlined as follows:

- Capital market increases the proportion of long-term savings (pensions, funeral covers, etc) that is channeled to long-term investment. Capital market enables contractual savings industry (pension and provident funds, insurance companies, medical aid schemes, collective investment schemes, etc) to mobilise long-term savings from small individual household and channel them into long-term investments. It fulfils the transfer function of current purchasing power, in monetary form, from surplus sectors to deficit sectors, in exchange for reimbursing a greater purchasing power in future. In this way, capital market enables corporations to raise capital/funds to finance their investment in real assets. The implication will be an increase in productivity within the economy leading to more employment, increase in aggregate consumption and hence growth and development. It also helps in diffusing stresses on the banking system by matching long-term investments with long-term capital. It encourages broader ownership of productive assets by small savers. It enables them to benefit from economic growth and wealth distribution, and provides avenues for investment opportunities that encourage a thrift culture critical in increasing domestic savings and investment ratios that are essential for rapid industrialization.

- Capital market also provides equity capital and infrastructure development capital that has strong socio-economic benefits through development of roads, water and sewer systems, housing, energy, telecommunications, public transport, etc. These projects are ideal for financing through capital market via long dated bonds and asset backed securities. Infrastructure development is a necessary condition for long-term sustainable growth and development. In addition, capital market increases the efficiency of capital allocation by ensuring that only projects which are deemed profitable and hence successful attract funds. This will, in turn, improve competitiveness of domestic industries and enhance ability of domestic industries to compete globally, given the current momentum towards global integration. The result will be an increase in domestic productivity which may spill over into an increase in exports and, therefore, economic growth and development.

- Moreover, capital market promotes public-private sector partnerships to encourage participation of private sector in productive investments. The need to shift economic development from public to private sector to enhance economic productivity has become inevitable as resources continue to diminish. It assists the public sector to close resource gap, and complement its effort in financing essential socio-economic development, through raising long-term project based capital.

- It also attracts foreign portfolio investors who are critical in supplementing the domestic savings levels. It facilitates inflows of foreign financial resources into the domestic economy.

Recent empirical research linking capital market development and economic growth suggests that capital market enhances economic growth and development. Countries with well developed capital markets experience higher economic growth than countries without. Evidence indicates that, while most capital markets in African countries are relatively underdeveloped, those countries which introduced reforms that are geared towards development of capital markets have been able to grow at relatively higher and sustainable rates.

South Africa, the country whose capital market is the largest and most developed in Africa, in terms of market capitalization and trading volume, has been growing significantly since 2000. Its average per capita real GDP over the last 8 years has been at 3.2 %. Countries like Egypt, Ghana, Tanzania, Botswana and Mauritius, whose capital markets have been developing recently, were able to realize average per capita growth rates of more than 2.8% for the past 8 years.

However, some economies which did not have formal or effective capital market like Lesotho, Seychelles and Ethiopia could not manage to realize average per capita growth rates above 2.7 % over the past 8 years. Even those countries with small and less developed capital market like Swaziland and Uganda did not manage to realize average per capita growth rates above 2.7 % during the past 8 years.

Conclusion

The article has attempted to demonstrate an important role played by capital market in economic growth and development. Capital market enhances efficient financial intermediation. It increases mobilization of savings and therefore improves efficiency and volume of investments, economic growth and development.

2. Economic implications of developing Capital Market in Lesotho

Introduction

Implementation of many developmental projects in Lesotho is limited by inadequate funds. Some of these projects, particularly those outlined by the Growth Strategy - which are likely to have a significant impact on economic growth - are faced with challenges of inadequate funding. Most of these projects rely mostly on Government revenue and external donor funding, predominantly in the form of multilateral and bilateral loans and grants secured on concessional terms. However, the current situation is insurmountable; the Government is facing a projected decline in revenue emanating from projected decline in Southern African Customs Union (SACU) revenue. SACU revenue constitutes a significant portion of Government revenue. For the fiscal year 2009/10, SACU revenue accounts for more than 55 per cent of the overall government revenue.

In addition, due to the recent financial crisis, most countries reduced financial assistance to other countries in an effort to dispel the crisis. Moreover, the resulting uncertainty led to increased credit rationing by international banks. As a result, most countries which relied on international donor assistance were affected. These sources of funding expose a country to external shocks. Therefore, the importance of domestic debt as a supplement to external financing is increasingly becoming critical and attractive.

Even in the case of private sector, it is currently difficult to source long-term finance. Private sector relied mainly on commercial banks' financing. However, sourcing finance, especially long-term finance, from the banking system is difficult given tight credit extension criterion banks now employ. As of June 2009, commercial banks' credit-deposits ratio stood at 33.01 per cent, significant portion of which was for private sector enterprises. These, in effect, hinder private sector development as most projects, which could contribute to employment creation and hence economic growth, are left un-exploited. These developments could limit growth and development within the economy and, therefore, there is a need to explore other avenues for funding viable long-term (development) projects in the country.

State of Capital Market in Lesotho

Currently, there is no active capital market in Lesotho. Nevertheless, there is a Unit Trust - Stanlib Lesotho, formerly Standard Lesotho Bank Unit Trusts. It was established as a joint venture between Standard Lesotho Bank and Stanlib, the asset management arm of Standard Bank Group Ltd. It was established under *Lesotho Unit Trust Act* 8 of 2003 to ensure that private individuals could buy shares in large companies that were privatised. Unit trust investments are generally medium to long-term collective investments, constituted under a trust deed in which investors' funds are pooled and used to purchase various fixed interest instruments. The primary purpose of the Unit Trust was to encourage nationals to invest in privatised parastatals.

There is also no formal bond market as the Government only issues treasury bills for its monetary operations. However, the Government of Lesotho issued special purpose Treasury bonds in the past. The last time the government issued Treasury bonds – five and ten year bonds – was in 1999. The five year and ten year bonds were redeemed in 2004 and July 2009, respectively. These bonds were issued primarily to facilitate liquidation of state owned banks in Lesotho; Lesotho Bank as well as Lesotho Agricultural Development Bank.

In preparation for a gradual move towards development of capital market in Lesotho, the Central Bank of Lesotho undertook reforms geared towards development of money market in 2008. This included introduction of longer dated money market instruments (273-day and 364-day treasury bills), reduction of threshold of competitive segment of auction from M250 000 to M100 000, shorter settlement procedure (from two days to the same day) and increased frequency of auctions to bi-weekly.

Plans to introduce capital market in Lesotho and progress thereof

The Bank is currently undertaking a number of measures geared towards establishment of capital market in Lesotho. The plan is to introduce government bond market first. This will lay a good foundation for introduction of corporate bond market and ultimately stock market. Nevertheless, there are some pre-conditions which should be satisfied in pursuit of these objectives. These include, *inter alia*;

- Macroeconomic environment that is conducive for operations of capital market. Sound macroeconomic environment promotes business operations and therefore enhances participation in capital market. It is worth noting that macroeconomic environment in Lesotho has been identified as conducive for operations of capital market. Average per capita GDP growth rate has been around 2.5 % over the last 8 years. Moreover, inflation rate has, on average, been below 10 % over this period.

- Identification of the market – potential issuers and investors. There should be sufficient number of potential investors and issuers of capital market instruments which promise good prospects for the future; otherwise there would be little or no justification for establishment of capital market. In this regard, the Bank has already identified the Government and Government agencies as potential issuers of bonds. It has also identified some potential investors such as insurance companies. However, it is currently undertaking more market research on the matter.

- Development of appropriate legal and regulatory framework which will ensure that capital market operations are within parameters of the law. These include establishment of regulatory bodies and management bodies which will ensure smooth operations of capital market; development of rules, regulations as well as acts governing capital market's activities. To this end, Treasury securities' trading regulations have been amended to include Treasury bonds, since initially these regulations covered Treasury bills only. In addition, the Bank is currently establishing other legislations to be reviewed or introduced, reforms to be introduced as well as regulatory and other related bodies to be established.

- Development of Information Communication Technology (ICT) infrastructure that will support the efficient and effective operations of capital market. ICT infrastructure is vital in supporting the overall capital market trading activities – auctions, settlement, secondary market trading, clearing facilities etc. The Bank has identified Central Securities Depository System (CDS) as an important infrastructure and the process of procuring it is at an advance stage. CDS will facilitate de-materialisation of securities and faster and easier processing of transactions.

Nevertheless, the Bank is also in the process of establishing other necessary ICT infrastructure at the moment.

Implications on Lesotho's Economy

The development of capital market has a number of implications for Lesotho's economy. Capital market will provide long-term capital in the form of bonds or equity. This will enable implementation of developmental projects, which are geared towards promoting economic growth and development.

The bond market will enable the Government of Lesotho (GoL) and Government agencies to raise funds to finance long-term development projects, especially now that Government revenue is expected to decline. The expected decline in revenue (especially SACU receipts) is likely to undermine the Government's efforts to reduce poverty, therefore, alternative source of funds, such as issuance of Government bonds should be exploited. It may also minimize government's financial stress of funding government agencies in the form of subventions.

The development of capital market will also enable the private sector to raise funds to finance various long-term projects. In addition, given the fact that capital market facilitates efficient allocation of capital, based on the viability and profitability of the project, it is likely to stimulate private sector competitiveness. This will put domestic industries in a better position to compete globally and take advantage of opportunities brought about by Lesotho's membership in regional economic integration. As a result, domestic productivity, employment as well as exports will increase, leading to more economic growth and development. In addition, it will help to promote growth and competitiveness in line with advanced economies.

In a nutshell, development of capital market in the country will bring about an increase in the level of financial intermediation which is critical for efficient allocation of financial resources. The current situation is such that financial intermediaries mobilise funds in Lesotho for investment in SA. This is brought about by the fact that investment opportunities are limited in Lesotho as capital market is virtually non existent in Lesotho. Therefore aggressive development of capital market will go a long way in reversing this situation.

Conclusion

It has been shown that development of capital market in Lesotho will play a significant role in promoting growth and development within the country. It will increase the level of financial intermediation, leading to increased volume and quality of investments, and therefore economic growth.

Effective bond market will free up capital for investment in private sector; allow the Government access to finance and therefore pursue development objectives and fuel economic growth. It will also increase investments and flow of money within the country; and support the development of other financial markets like stock exchange. In short, it will increase sources of investment funds for the domestic economy.

3. Monetary Policy Operations Report for August 2009

During the review period, monetary policy operations undertaken by Central Bank of Lesotho (CBL) were successful in attaining desired objectives. The primary objective of monetary policy is to achieve and maintain price stability within the economy. As a result, the Bank employs Open Market Operations (OMO) to attain the stated objective. The initiative enables CBL to maintain the parity between the local currency, Loti, and the South African Rand which is important to price stability.

The report present economic and operational issues surrounding the monetary policy operations conducted during the review period to assess the success of the operations.

Table 1 below shows that the entire amounts of treasury bills (M40.0 and M30.0 million) announced during the auctions conducted on August 12 and 26, 2009, respectively, were ultimately issued. During the review period, the market responded relatively well to the 91-day treasury bills auction held in August, 2009 compared with the previous auctions conducted in July, 2009.

Competitiveness of the 91-day TBs auction (as measured by the number of bidders and bids received, over/under subscription of the auctions as well as the movements of discount rates) improved marginally during the review period. The number of bids received increased slightly from an average of 10 bids to an average of 11 bids in August 2009. Oversubscription increased from an average of M22.1 to M26.0 million in August. Nevertheless, the number of bidders remained unchanged at an average of 5 participants from the previous month.

Table 1: Treasury Bills Auctions

Type of Security	Auction Date	Maturity Date	Auction Amount (Million Maloti)	Amount Issued (Million Maloti)	Over/(under) subscription (million)	Discount Rate (%)	RSA Discount Rate (%)
91-day	***12-Aug-2009***	11-Nov-09	M12.0	M12.0	M30.2	6.80%	7.44%
182-day		10-Feb-10	M12.0	M12.0	M32.2	7.18%	7.51%
273-day		12-May-10	M8.0	M8.0	M19.8	8.00%	7.44%
364-day		11-Aug-10	M8.0	M8.0	M13.5	7.92%	7.28%
91-day	***26-Aug-2009***	25-Nov-09	M9.0	M9.0	M21.8	6.80%	6.97%
182-day		24-Feb-10	M9.0	M9.0	M18.0	7.18%	7.06%
273-day		26-May-10	M6.0	M6.0	M16.2	8.00%	7.08%
364-day		25-Aug-10	M6.0	M6.0	M12.1	7.92%	7.04%
Total for reporting period			**M70.0**	**M70.0**	**M163.8**	-	**-**

The intermediate target, the 91-day TBs rate (discount rate) remained steady at 6.80 per cent, as shown in figure 2 below. However, SA 91-day TBs rate declined by 47 basis points, from 7.44 per cent to 6.97 per cent at the end of August 2009. Therefore, the margin between the two rates (discount rates) narrowed by 47 basis points to 0.17 per cent at the end of August, 2009. This implies that there was a minimal incentive for undesirable cross border transfers of funds between the two countries.

In relation to the progress towards attaining Monetary Policy objectives, the minimum NIR limit set for the period under review was successfully met. The level of NIR at the end of August 2009 was US$906.4 million, above the upper limit of the target range of US$500 million to US$550 million set by the Monetary Policy Committee (MPC) by US$356.4 million. Therefore, the Monetary Policy operations undertaken during the review month were successful in attaining their desired objectives of financial stability by maintaining the target NIR level.

Figure 2: Measuring the Success of Monetary Policy Objectives: Performances of Lesotho 91-day T-bills vs RSA 91-day T-bills

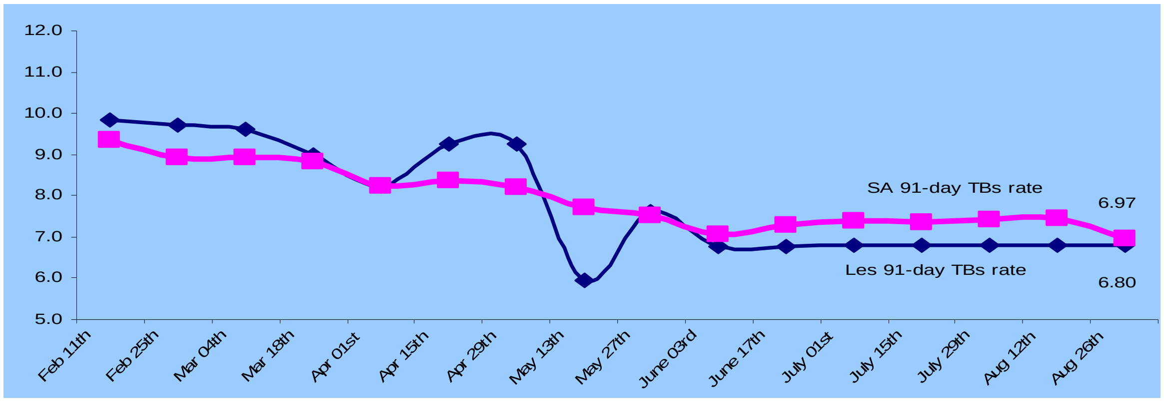

Table 2: Selected Monetary and Financial Indicators

	2009		
	June	***July***	***August***
1. Interest rates (Percent Per Annum)			
1.1 Prime Lending rate	*12.17*	*12.17*	*12.0*
1.2 Prime Lending rate in RSA	*11.00*	*10.50*	*10.50*
1.3 Savings Deposit Rate	*2.11*	*2.12*	*2.11*
1.4 Interest rate Margin(1.1 – 1.3)	*10.06*	*10.05*	*9.89*
1.5 Treasury Bills discount rate (91-day)	*6.76*	*6.80*	*6.80*
2. Monetary Indicators (Million Maloti)			
2.1 Broad Money (M2)	*5574.76*	*5754.69*	*6128.99*
2.2 Net Claims on Government by the Banking System	*-4308.11*	*-5138.00*	*-4489.48*
2.3 Net Foreign Assets – Banking System	*11293.98*	*12259.16*	*12104.17*
2.4 CBL Net Foreign Assets	*7928.31*	*8796.24*	*8081.93*
2.5 Domestic Credit	*-2758.77*	*-3533.80*	*-2598.53*
2.6 Reserve Money	*703.50*	*822.99*	*789.00*
3. Spot Loti/US$ Exchange Rate (Monthly Average)	***M8.0383***	***M7.9468***	***M7.9505***
4. Inflation Rate (Annual Percentage Changes)	***6.9***	***6.1***	***5.6***
5. External Sector (Million Maloti)	***2008***	***2009***	
	QIV	***QI+***	***QII+***
5.1 Current Account Balance	*330.59*	*322.98*	*356.20*
5.2 Capital and Financial Account Balance	*-184.20*	*132.85*	*607.24*
5.3 Reserves Assets	*-558.82*	*67.28*	*70.01*

+Preliminary Estimates.

**Prime and deposit (savings) rates are averages of all commercial banks' rates operating in Lesotho. The Statutory Liquidity Ratio in Lesotho is 25 percent of commercial banks' short-term liabilities*