

# Establishing a Stock Exchange in Emerging Economies: Challenges and Opportunities

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## ABSTRACT

*Stock exchanges have played a great role in the investment process in developed countries such as the United States, the United Kingdom, Japan, and so many others and have contributed to their development. Though the stock exchange market is necessary to the economic growth of Rwanda, its implementation will face many challenges that need to be addressed such as a low savings rate, a complex tax regime, a small economy and the structure of companies that are family owned and the absence of financial intermediaries, financial advisory services, investment banks and so on. The study explains the role and benefits of stock exchange markets in the development of an economy, and states possible challenges of establishing a stock exchange in Rwanda.*

**Keywords:** *Stock Exchange, African Stocks, Rwanda, Economic Growth Activities*

## INTRODUCTION

After the 1994 Genocide, Rwanda has made great strides towards making up for its economic loss, achieving growth of nearly 6% in 2000 and an average growth of nearly 10% since 1995 (Wameyo, 2005). To maintain and accelerate this effort, the Government of Rwanda has spelled out its development goals and has explicitly stated where it wants the country to be by the year 2020 in a policy document entitled "VISION 2020". One of the major goals is that the country will achieve middle-income status by 2020. In GDP terms, this means moving from its current level of around US\$ 230 to US\$ 960 per capita thereby making Rwanda a middle-income country. A target of US\$ 400 per capita is planned by 2010. The expected population at that time is to be 13 million and this implies that the actual GDP will increase from US\$ 1.8 billion in 2003 to US\$ 11.7 billions in 2020 (Mbaru, 2005). As one of the remedies to raise economic development, Rwanda has decided to establish a stock exchange market in order to improve investment. The creation of a vibrant stock market has been accepted as a necessary concomitant to the development agenda of the country. The Government of Rwanda has taken measures to expend and reinforce the financial sector and develop the Rwandan capital market. The Government has furthermore committed itself to putting in place specialized financial institutions and instruments for the mobilization of long-term savings by the means of a stock market. This paper explores and discusses challenges and opportunities of establishing a stock exchange market in Rwanda.

### Problem Statement

Stock exchanges have played a great role in the investment process in developed countries such as the United States, the United Kingdom, Japan, and so many others and have contributed to their development. Individuals in Rwanda have excess liquid cash at their disposal due to few available investment avenues. A stock exchange market is one of the investment avenues yet to be developed in the country. Its presence encourages investment in securities, thus economic development of the country in general. Rwanda, like other developing countries, is facing problems of poor economic growth. The establishment of a stock market in Rwanda will be one of the major initiatives taken by the Government in improving the national economic growth. Though the stock exchange market is necessary to the economic growth of Rwanda, its implementation will face many challenges that need to be addressed such as a low savings rate, a complex tax regime, a small economy and the structure of companies that are family owned and the absence of financial intermediaries, financial advisory services, investment banks and so on.

### Research Objectives

The overall objective of this study is to obtain an understanding of the mechanics and technical working of stock exchanges, to explain the role of stock exchange markets in the development of an economy (its benefits), and to state possible challenges of establishing a stock exchange in Rwanda.

### Significance of the Study

The study will be an addition to the pre-existing literature on the stock exchange markets, and it will provide a better understanding to individuals in business and other fields, which are not familiar with the financial sector, and recommendations will be helpful to the upcoming stock exchanges in Rwanda.

## STOCK MARKETS

The origin of stock markets is to be found at the beginning of the Industrial Revolution that began in Europe about four centuries ago. The early associations for trading were either individual owners or partnerships. The first modern shareholding enterprise is generally recognized as the proposal by Sebastian Cabot, the British explorer, to set up an enterprise to find a North East trade route to China and the Orient. Many of the pioneer merchants of the industrial age wanted to start huge businesses, which no single merchant could accomplish alone. It therefore became inevitable for them to come together, pool their savings and start their businesses as partners and co-owners. The contribution of each partner to the enterprise was to be represented by a unit of ownership. This was the precursor to what we call shares and through this, joint stock companies were born.

Initially, trading in shares began informally on the streets of London. As the volume of shares increased with more companies floating shares (giving people opportunities to buy their shares), the need for an organized market place for the exchange of these shares escalated. As a result, these traders decided to meet at the coffeehouse, which they used as the marketplace. Eventually, they took over the coffeehouse and changed its name to stock exchange; this was in the year 1773 and the first stock exchange, the London Stock Exchange, was founded (Valdez, 2003). Financial intermediaries (brokers, fund managers, investment advisors, investment banks, etc) and other instruments like bonds then followed suit as an evitable consequence.

Wall Street can trace its name back to 1653. Originally it was set up for defense and not for commerce. In 1792, a group of New York merchants met to discuss how to take command of the securities business. The merchants, a group of 24 men, founded what is now known as the New York Stock Exchange (Valdez, 2003). The exchange opened up shop on Wall Street. As for the New York Stock Exchange, it has since moved its humble beginnings to the point where its system now facilitates billions of dollars worth of trades each day. Over time, stock markets have become the very symbol of commerce in the modern world. They are unique in their scope and in the complexity of the number of transactions they handle each day.

There are a number of different stock exchanges in operation in the world through which securities can be bought or sold. The most popular exchanges include the New York Stock Exchange, the NASDAQ (National Association of Security Dealers Automated Quotation), the American Stock Exchange, the London Stock Exchange and the Hong Kong Stock Exchange.

### WHAT IS A STOCK EXCHANGE?

Stock Exchange or Stock Market is an organized market for the trading of stocks, bonds and other securities. It provides a mechanism through which companies can raise capital for expansion purposes by selling and issuing securities (stocks and bonds). According to Avadhani (2002), Stock Exchange means any body or individuals whether incorporated or not, constituted for the purpose of assisting, regulating or controlling the business of buying, selling or dealing in securities; it is an association of member brokers for the purpose of self-regulation and protecting the interests of its members. Stock exchanges are the most perfect type of market for securities whether of government, semi-government bodies or other public bodies as well as for shares and debentures issued by the joint-stock companies.

#### The Importance of Stock Exchange

The economy of the world relies on the stock exchanges to facilitate trade in the stocks of companies by connecting people who seek money with those who can provide it. While the typical role of the stock market as a centre of trading in securities is the raising of funds for investment in long term assets to the investing public, there are other roles that can be summarized as follows:

**Mobilizing savings for investment:** When people draw their savings and invest in shares, it leads to a more rational allocation of resources because funds, which could have been consumed or kept in unused deposits with banks, are mobilized and redirected to promote commerce and industry.

**Redistribution of wealth:** By giving many people a chance to buy shares of listed companies and therefore become part-owners of profitable enterprises, the stock market helps to reduce large income inequalities because many people get a chance to share in the profits of businesses that were set up by other people.

**Creating investment opportunities for small investors:** As opposed to other businesses that require a huge capital outlay, investing in shares is open to both large and small investors because a person buys the number of shares that he can afford. Therefore the stock exchange provides an extra source of income to small savers.

**Raising Government capital for development projects:** The Government and even local authorities may decide to borrow money in order to finance huge infrastructure projects by selling another category of shares known as bonds. These bonds can be raised through the stock exchange whereby members of the public buy them. When the Government or the local authority gets this alternative source of funds, it no longer has the need to overtax the people in order to finance development

**Control on company management:** The role of the stock exchange is also to monitor the market to ensure that it is working efficiently, fairly and transparently. Over the decades, the stock exchange has been raising requirements for new corporations seeking listing. These requirements relate to the submission of all financial information regarding companies whose securities are sold on the stock exchange. Such requirements exercise a control on a company management and keep its malpractice in check.

**Barometer of the Economy:** At the stock exchange, shares rise and fall depending, largely, on market forces. Share prices tend to rise or remain stable when companies and the economy in general show sign of stability. Therefore, the movement of share prices can be an indicator of the general trend in the economy.

### WHY SEEKING A STOCK MARKET LISTING?

The securities of all the companies are not bought and sold on a stock exchange. The stock exchange selects companies whose securities are to be traded by preparing an official list which contains their names for the purpose. The stock exchange requires an enterprise to meet certain conditions in order to qualify for listing on the stock exchange. The listing requirements may vary from one country to another. In general these requirements relate to the size of the company, earning records, number of years in the business, number of shares outstanding and their market value. Companies have to meet the requirements of the exchange in order to have their stocks and shares listed and traded there. To be listed on the New York Stock Exchange, for example, a company must have issued at least a million shares of stock worth of \$100 million and must have earned more than \$10 million over the last three years. The following are reasons why a company may seek a stock market listing:

**Access to a wider pool of finance:** A stock market listing widens the number of potential investors. It may also improve the company's credit rating, making debt finance easier and cheaper to obtain.

**Improved marketability of shares:** shares that are traded on the stock market can be bought and sold in relatively small quantities at any time. Existing investors can easily realize a part of their holding.

**Transfer of capital to other uses:** Founder owners may wish to liquidate the major part of their holding either for personal reasons or for investment in other new business opportunities.

**Enhancement of the company image:** Quoted companies are commonly believed to be more financially stable. Listing may improve the image of the company with its customers and suppliers, allowing it to gain additional business and to improve its buying power.

**Facilitation of growth by acquisition:** A listed company is in a better position to make a paper offer for a target company than an unlisted one.

If a company qualifies to list its stock on the stock exchange, it is generally felt that listing is beneficial both to the company and to the shareholders. Listed companies receive advertising and this probably has a beneficial effect on the sales of the product of the firm. A quoted company is one which has satisfied the stock exchange's requirements with regard to its financial information. Companies may seek to have their securities listed on the stock exchange since listing has an element of prestige; it indicates that the company has grown above local importance and attained a significant level in terms of size and profitability. Listing may also facilitate future security issues especially when investors are more willing to purchase the securities of companies whose securities are publicly traded on an exchange.

### STOCK MARKET AND ECONOMIC GROWTH

For an economy to grow, money needs to shift from less to more productive activities. The stock market is one of the most important sources for companies to raise money. Experience has shown that the price of shares and other assets is an important part of the dynamics of economic growth (Nsabimana, 2005). Stock exchange encourages investments by enabling unused money and savings to become productive by bringing the borrowers and lenders of money together at a low cost. More than a forum for trading in stocks, bonds, and shares and aside from the prospect of dividends and long-term capital growth, a stock exchange stands tall as the engine-room of the national economy.

Nsabimana (2005) addressed other advantages of a stock exchange such as: Enabling investor to diversify across a variety of assets hence reducing risk; Encouraging investor's confidence through transparency in trading and information disclosure; Promoting proper functioning of financial intermediaries to compliment existing banks; Monitoring the performance of managers thus improving corporate governance because of the high standards that must be made and maintained by listed companies; Promotion of the international negotiation and cross border experiences; Improvement in liquidity for share through exposure to large market place; Educating the public about the higher profits in shares and bonds, how and when to buy and; and providing a daily market report and price list to ensure that the investors know the worth of their assets at all times.

## THE EMERGENCE OF AFRICAN STOCK MARKETS

Most African stock markets are small, fragile, and have yet to become central financial institutions in national economies. In many African countries stock market development can be interpreted as part of a deliberate and rational strategy to reform their financial sectors, which is in turn a key component of wider economic restructuring efforts to encourage greater economic activity and generate higher levels of wealth. From this perspective, stock exchanges are expected to enhance market mechanisms for raising and distributing scarce financial resources. More specifically, stock markets are expected to attract foreign capital, mobilize dormant domestic capital, and more efficiently allocate resources to projects most likely to benefit the national economy. In many cases, stock markets are expected to facilitate the privatization of state-owned enterprises.

The most apparent features of African stock markets are their small size and low levels of liquidity. They are truly small by global standards. At the end of 2000 the capitalization of all exchanges in sub-Saharan Africa outside South Africa totaled less than \$ 13 billion. South Africa's equity market alone, itself only a medium-sized emerging market was more than fifteen times greater at about \$ 205 billion. By comparison, the UK market is valued at about \$ 2.5 trillion, or about 200 times all the African markets combined (excluding South Africa).

As a result of their small size, non-liquidity, and often unstable political and economic environments, returns on these markets tend to be somewhat volatile. Africa's smaller markets tend to float between 10 and 20 percent of GDP. The exchanges are small relative to their own economy. Even the older markets in Zimbabwe, Kenya, and Nigeria are typically less than one-third the size of the economy. African markets also remain highly illiquid as mentioned above, meaning that shares are rarely traded. In theory these small trading levels are reflective of local market conditions and the size of the local players. In practice, however, the scarcity of actual trading effectively prevents many institutional investors in developed countries from participating in African market.

## STOCK EXCHANGE IN RWANDA: OPPORTUNITIES

Stock exchange will encourage investments by enabling unused money and savings to become productive by bringing the borrowers and lenders of money together at a low cost. Specifically, the stock market will provide easy access to long term financing and allow the Rwandan government and industry to raise long-term capital for financing new projects, and expanding and modernizing industrial or commercial companies. The Rwandan stock market will furthermore attract investors, especially from East Africa, who wish to extend their shares by investing them in the new stock exchange.

### Foreign Direct Investment

Attracting Foreign Direct Investment is an advantage to be gained by the upcoming Rwandan Stock Exchange. The government of Rwanda could use the capital markets to increase Foreign Direct Investment by allowing foreign strategic investors to acquire major shareholding through take-overs in the stock market. The establishment of a stock exchange market in Rwanda will generate an interest in the minds of foreign investors.

The assumption is that the new market will attract the Foreign Direct Investments due to the favorable Rwandan environment which is justified by the macroeconomic stability. In addition, the new stock market will promote a good functioning of financial intermediaries to compliment existing banks in terms of investments.

### Market Monitoring

Stock exchange may play the role of market monitor to ensure that the said market is working efficiently, fairly and transparently. This will be done by setting up requirements related to the submission of all financial information regarding companies whose securities are sold on the stock exchange. Such requirements exercise a control on a company management and keep its malpractice in check thus improving corporate governance.

### Source of Capital

The stock market will also provide capital to entrepreneurs. The stock market will enable government and industries to raise long-term capital for financing new projects, and expanding and modernizing industrial or commercial firms. It is in this regard that the Rwandan stock market is expected to become a financing source for entrepreneurs who wish to run their projects in the country. Also, the creation of a stock market in Rwanda will attract investors, especially from East Africa, who wish to extend their shares by investing them in the new stock exchange as Rwanda is largely opening its doors to the East African Community.

### Commercial Banks

The creation of a stock market in Rwanda will compliment commercial banks in term of investments. Banks have developed expertise to distinguish between high risk and low risk borrowers and can deal with the two problems directly. Economies that have both well-developed banking sectors and capital markets thus have an advantage.

## Education

Furthermore, the capital markets through the brokerage community, investment advisers, security analysts, and well developed financial journalists serve to educate the investing public. Such institutions are critical to an economy. The exchange can in fact be mandated to educate the public on the benefits associated with trading on stock markets. Some other opportunities regarding the establishment of a stock market in Rwanda include: Regional integration, Diaspora resources to be channeled into the stock market, the entrepreneurial spirit of Rwandans and Geographic advantage with Rwanda being the center of East Africa.

## STOCK EXCHANGE IN RWANDA: CHALLENGES

Stock exchanges facilitate trade in the stocks of companies by connecting people who seek money with those who can provide it. The major role of the stock market as a center of trading in securities is the raising of funds for investment in long term assets. People in Rwanda have excess liquid cash at their disposal due to few investment opportunities available. A stock exchange market is one of the investment avenues yet to be developed in the country. The creation of a vibrant stock market has been accepted as a necessary concomitant to the development agenda of the country. Though the stock exchange market is necessary to improve the Rwandan economy, its implementation may face many challenges such as:

**Low Domestic Saving:** The low domestic savings rate is probably due to low income (real GDP per capita is around US\$ 230) used rather for consumption than for saving. The culture of domestic savings and deposits should be encouraged.

**Tax Regime:** Rwanda is said to have a complex tax regime from taxes on goods and services, taxes on external trade, taxes on income, taxes on property, customs taxes to value added taxes. This obstacle need to be addressed and the government should simplify the tax regime to attract more investors.

**Absence of Financial Intermediaries:** Not only lack of financial intermediaries is an obstacle but also lack of merchant banks, financial advisory services and investment banks which are vital to the successful functioning of stock exchange markets. An investment bank is an institution that acts as an advisor to institutions which may wish to raise money from capital markets by way of shares or bonds. At the present time there are no investment banks in Rwanda and therefore normal merchant banking services such as underwriting of equities and bonds, asset management and corporate advisory services do not exist. These need to be created in order to facilitate the upcoming Rwandan Stock Exchange.

**Lack of Adequate Accounting and Auditing Systems:** The existence of a reliable financial accounting system is an important factor in the development of stock exchanges. The authorities are conscientious of the necessity to address deficiencies in accounting and auditing system. The most pressing issues that need to be addressed include setting appropriate accounting standards for different categories of companies operating in Rwanda. One of the major requirements for any company wishing to list is that it will be required to provide a full disclosure of its financial and operating activities. Rwandan companies should be encouraged to adopt international accounting standards and to agree to report along the lines of international best practices if they wish to be listed on the stock exchange.

**Family Owned Companies:** The structure of companies that are family owned is also an obstacle to the creation of a stock market in Rwanda. Rwanda has a large number of businesses that are family owned and which are likely to have enough resources to issue shares but whose managers may fear losing control by opening up their businesses to public ownership. Generally, the main factors limiting the supply of equities include the unwillingness of small, family-owned businesses to reduce ownership and the perception by many companies that the risks associated with additional disclosure are not adequately compensated by additional returns. Since banks do not require public disclosure like the stock market does, many firms would prefer to remain unlisted and source their capital from banks. As a result, these firms cannot be for any use to the stock market. The government should encourage privately owned companies to go public.

**Lack of Information:** Most of the Rwandan public is not familiar with negotiable instruments. As the project of launching the stock exchange in Rwanda is under study, many people do not know enough about the stock market. Generally, there is lack of information on the roles, functions and operations of the stock exchange. The lack of public awareness with stock markets is the major barrier to corporate participation in many African stock exchanges. The public should be sensitized about benefits associated with the securities market and encouraged to participate in individual and collective investments. The government should also promote public education on investment.

**Infrastructure:** The market infrastructure is underdeveloped; especially the payment system is traditional and underdeveloped and could not facilitate transaction payments particularly with regard to trading, settlement and delivery using a manual system. This will indeed lead to low settlement and delivery of securities traded. The manual trading system is slow, costly and limits the range of products that can be provided. It also delays international integration of the market.

**Bond Market:** The inexistence of a bond market in Rwanda is another challenge to the establishment of a stock exchange. A bond market does not exist, yet it has the potential of mobilizing significant amounts of capital. It can also give to the stock exchange a tremendous increase in turnover, as bonds are usually more attractive to investors than stocks. There is a need for the government to establish a market in medium and longer term government bonds. These bond issues will ease a shortage for long term domestic financial assets and help in the further development of the local capital market and access to credit. In addition, trading on the stock exchange will require a lot of transparency and corporate governance, issues that are not well developed in the country.

**Capacity Development:**

The challenges to capacity building require a solid commitment to financial sector reforms on the part of the authorities, as well as continued support by external providers of technical assistance in some areas like monetary policy design and implementation, financial sector supervision ( including commercial banks, microfinance, and non bank financial institutions such as insurance companies ), capacity development in the microfinance sector, payment systems modernization, capital market development, improvement of the legal framework , and similarly improvement in the accounting and auditing framework.

## CONCLUSIONS AND RECOMMENDATIONS

Rwanda's economy has made considerable progress in overcoming the devastating consequences of the 1994 genocide, but economic performance is vulnerable to shocks, in particular a sharp fall in aid flows. In spite of improved macroeconomic performance over the past decade, the economy is still challenged by a high external debt burden, vulnerability in terms of trade shocks, and one of the lowest saving rates in Africa, at 3 percent of GDP (IMF, 2004). As a consequence, the economy is relying heavily on foreign currency dominated aid inflows. The domestic financial sector still faces a poor environment with economic activity concentrated in few sectors and a weak credit culture. There are serious shortcomings in the accounting and auditing systems, the institutional and legal frameworks. The program of recapitalization and privatization which started after 1994 has strengthened the short-term flexibility of banks but structural weaknesses remain. The domestic financial system remains low, especially outside the banking sector, and access to credit remains limited apart from a network of savings and loans cooperatives. Insurance penetration is low, and to date the sector has been unregulated and unsupervised. The securities market is limited to the issuance of short-term treasury bills. The National Bank of Rwanda (NBR), has restored all of its basic functions, but faces formidable challenges. As the main regulator and supervisor of the financial sector, NBR's key challenge has to do with a weak environment for effective supervision, instances of regulatory tolerance, and a shortage of human capital that has been compounded by weak internal governance in some financial institutions. There is no existence of the critical mass of businesses to allow the smooth development of a stock market. In particular, most of the enterprises in Rwanda are closely held, often family-owned businesses, which have little or no interest in ceding control to outside shareholders. In addition, modern concepts of good corporate governance are not widely known or practiced, and the small size of the business community makes it difficult to maintain arm's lengths relations and protect minority shareholder rights. Finally, neither the base of institutional investors, nor the market infrastructure has reached a level that would allow the stock market to be sustainable. Therefore, the culture of domestic savings and deposits should be encouraged. Rwanda's tax regime should be simplified to attract more investors. The public should be sensitized about benefits associated with the securities market and encouraged to participate in individual and collective investment. The government should promote public education on investment. People and the local financial system need to be prepared step by step. Financial intermediaries, merchant banks, financial advisory services and investment banks should be established before the launching of the Rwandan Stock Exchange. The government should set up an adequate accounting and legal framework systems in which the stock exchange would properly operate. Companies are requested to adhere to International Accounting Standards. The government should encourage privately owned companies to go public. The training of public accountants and auditors in Professional Accounting which has started should continue and should be extended to the private sector.

## FUTURE WORK

The survey to know the attitude of the Rwandan financial institutions and the private sector towards investment in the stock exchange should be conducted. This will help the government to know if the stock exchange is really needed at this moment and if it is a priority or not. Also, a study to examine if the stock exchange would be a subsidiary of the Nairobi Stock Exchange until sufficient infrastructure is put into place is necessary for the country.

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