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IMPACT OF FINANCIAL MARKETS ON THE ECONOMIC GROWTHOF EAST AFRICA

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ABSTRACT: *This paper aims at critically analyzing the impact of financial markets in trying to influence the magnitude and direction of economic growth as they purpose to intermediate funds between surplus spenders and deficit spenders within East Africa. Some of the past researches have revealed that the performance of financial markets have a significant impact on the growth of economy. We examine how the money markets, corporate and Government Bond markets, the stock markets impact on the growth of the economy within East Africa. We model our problem to incorporate financial markets operations, capital flows from foreign nations and the local market capital structure to depict their influence in the level of economic growth within East Africa. It involved conducting a systematic review of literature papers in the field of financial markets through content analysis to draw conclusion and recommendations. Governments especially in less developed countries need to enhance and develop robust financial markets in order to realize the full potential of foreign direct investment. Financial markets act as linkages between the foreign financial markets and the economy. With better managed financial markets, the spillovers from direct foreign investment are capable of influencing great economic development in host countries.*

KEYWORDS: Financial Markets, Economic Growth, East Africa

BACKGROUND OF THE STUDY

The East African region has a relatively shallow capital market compared to some markets in Northern and Southern Africa. Kenya has by far, the largest and most developed bond market in the region, comprising about 67% of the total outstanding government bonds in issue. In the recent years, corporate firms in Kenya have turned to the bond market to raise medium to long term debt following the moves by the Central Bank of Kenya (CBK) to maintain a stable interest rate policy. Currently, the Nairobi Securities Exchange (NSE) has over US$ 750 million dollars in listed corporate bond issues, most of which are tradable. Infrastructure bonds in Kenya have been taken up well by both local and foreign investors with the government lengthening the yield curve to 30 years in the March 2011 issue. This is the longest dated government bond in the region,(Africa Financial Markets initiative-FMDI 2014). East Africa regional Bond Market Initiative is achieved through the EASEA Strategic Plan (2011 -2013) which involves the following projects: East African Stock Broker guidelines, Smart Order routing system, regional investor awareness initiatives, regional IPOs and Inter-Depository linkages through the utilization of commercial banks with a regional presence for both the receipt of applications and

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transfer of funds and full implementation of CDS's in all the member states, then direct CDS inter-linkages implementation.

Empirical research on the impact of financial markets on the economy can be traced back at least to Schumpeter (1911) who emphasized the positive role of financial markets development on economic growth. The relationship between financial markets and economic growth has been a subject of great interest and debate among economists for so many years that even up to date researches are still contacting research on this subject. The debate has traditionally revolved around two issues. The first relates to whether development in the financial markets results in a faster economic growth, and the second relates to how financial markets affect economic growth. A large body of literature has emerged, both at the theoretical and empirical level, attempting to answer the above questions. Although many empirical studies have investigated the relationship between financial depth, defined as the level of development of financial markets and economic growth, the results are ambiguous (Pagano, 1993; and Levine, 1997, 2003). The theoretical relationships between financial markets and economic growth have been broadly analyzed in the literature and may be summarized under four hypotheses (Chuah & Thai, 2004). First, the conventional view of the supply-leading hypothesis postulates that the direction of causality flows from financial development to economic growth. In a world without frictions caused by transaction, information and monitoring costs, no financial intermediaries are needed. If those costs are sufficiently high, no exchanges among economic agents will take place. The need to minimize those costs for exchanges to take place has led to the emergence of financial institutions and markets constituting the financial sector. A good developed financial sector provides crucial services to reduce those costs hence increasing the efficiency of intermediation. It mobilizes savings, identifies and funds good business projects, monitors the performance of managers, facilitates trading and the diversification of risks, and fosters exchange of goods and services. These services result in a more efficient allocation of resources, a more rapid accumulation of physical and human capital, and faster technological innovation, thus inducing faster long-term economic growth(Songul kakilli Acaravci et all 2009).

Second, the demand-following hypothesis postulates that economic growth leads to financial development. The development of the real economy induces increased demand for financial services, which in turn, generate the introduction of new financial institutions and markets to satisfy that increased demand for financial services (Robinson, 1952; Patrick,1966; and Demetriades & Hussein, 1996).

Third, the bi-directional causality hypothesis is a combination of the supply-leading and demand following hypotheses. It postulates that financial deepening and economic growth are mutually or Bi-directionally causal (Greenwood & Jovanovic,1990; Saint-Paul, 1992; Berthelemy & Varoudakis,1996; Demetriades & Hussein, 1996; Greenwood & Smith, 1997; Blackburn & Hung, 1998; and Harrison, Sussman & Zeira, 1999). Financial deepening gradually induces economic growth and this, in turn, causes feedback and induces further financial deepening.
Fourth, the independent hypothesis postulates that financial deepening and economic growth are causally independent. Lucas (1988) argues that, at best, financial deepening plays a very minor role in economic growth; Stern (1989) ignores the role of financial development in the

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Growth process. The growing body of empirical research, using different statistical procedures and data sets, produces remarkably consistent results. First, countries with better-developed financial systems tend to grow faster and specifically, those with: large privately owned banks that funnel credit to private enterprises and and liquid stock exchanges. The levels of banking development and stock market liquidity each exert a positive influence on economic growth. Second, simultaneity bias does not seem to be the cause of this result. Third, better-functioning financial systems ease the external financing constraints that impede firm and industrial expansion (Songul kakilli Acaravci et all 2009). Thus, access to external capital is one channel through which financial development matters for growth because it allows financially constrained firms to expand (Levine, 2003). It is a wide spread belief that foreign direct investment (FDI) leads to positive productivity effects for the host country through various mechanisms including adoption of foreign technology, and direct capital financing (Alfaro et al, 2006). In the recent past, findings have shown that the capacity of a country to utilize externalities occasioned by FDI is limited by local conditions such as the local levels of education and financial markets development (Borensztein et al, 2000). The paper by Alfaro et all 2006, provides evidence to the fact that FDI only facilitates growth in countries which have well developed financial markets. Regionally, there currently does not exist a common stock/bond exchange. However, over the recent years, the East African partner states have made strides in formulating policy to integrate the markets. The East African Securities Exchange Association (EASEA) is there to help the Securities Exchanges of each member country in this integration. In 2010, the East African Community (EAC) Monetary Policy Committee, which includes the EAC Central Banks has commenced work on the interlinking of the EAC payment systems. Besides, African Regional Economic Communities are beginning to establish regional and sub-regional capital markets. Among the ongoing efforts to integrate financial markets is the East African Common Market Protocol (EACMP) which was signed and ratified on July 1st 2010. Furthermore, the East African Securities Regulatory Authorities (EASRA), which is the regional umbrella body for capital markets regulators, is drafting legislation that will allow for companies in Kenya, Uganda, Tanzania and Rwanda float bonds within the region.

Purpose of the study

The purpose of this paper is to critically review the literature on the financial market -growth nexus and the impact of the same to the Economic growth for 10 countries namely: Burundi, Tanzania, Kenya, Uganda, Rwanda, Djibouti, Eritrea, Ethiopia, Somalia, and Mozambique.

The paper contributes to the literature in exploring the growth-financial development nexus in the East African context and provides some empirical evidence. This paper will be guided by the following Research questions: What is the impact of money markets on economic growth of East Africa? What is the impact of corporate Government Bond markets on economic growth of East Africa? Finally, of what impact is the mortgage market on economic growth of East Africa?

METHODOLOGY

This paper conducts a systematic review of literature papers in the field of financial markets means of content analysis. Kassarjian (1977) stipulates that content analysis should follow a

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clear and purposeful process structure that enables researcher obtain informative and credible results to make research conclusion and recommendations.

RESULT AND DISCUSSIONS

Having comprehensively reviewed literature from multiple sources, it is established that financial markets have impact on the economic growth of a country. A financial market is a market in which people trade financial securities, commodities, and other fungible items of value at low transaction costs and at prices that reflect supply and demand. Securities include stocks and bonds, and commodities include precious metals or agricultural goods (kirseal 2007). Financial markets help to efficiently direct the flow of savings and investment in the economy in ways that facilitate the accumulation of capital and the production of goods and services. The combination of well developed financial markets and institutions, as well as a diverse array of financial products and instruments, suits the needs of borrowers and lenders and therefore the overall economy. Large financial markets with lots of trading activity provide more liquidity for market participants than thinner markets with few available securities and participants and thus limited trading opportunities (Leutnash1998).

Money markets

The segment of the financial markets in which highly liquid short-term assets trade; the money market is used by participants as a means to borrow and lend on a short-term basis from several days to just under a year. Money market securities consist of negotiable certificates of deposit (CDs), banker's acceptances, Treasury bills, commercial paper, municipal notes, federal funds, and repurchase agreements (repos).For the most part, money markets provide those with funds banks, money managers, and retail investors a means for safe, liquid, short-term investments, and they offer borrowers banks, broker-dealers, hedge funds, and nonfinancial corporations access to low-cost funds (Levine, Ross. 2004). The term money market is an umbrella that covers several market types, which vary according to the needs of the lenders and borrowers. One consequence of the financial crisis in East Africa Region has been to focus attention on the differences among various segments of money markets, because some proved to be fragile, whereas others exhibited a good deal of resilience. Money markets has played an integral part in building the economy of East Africa especially under the information technology platform where e -banking and mobile banking is almost overtaking any other form of financial transactions within the region. The mpesa whose brain child is Kenya is now overtaking many other forms of money transactions in the region and it has easened the mode of doing business even to the remotest part of the region. The borrowing can easily be done by the click of a mobile phone button, Kenya being ahead of other countries in the region as foremention, Kenya commercial bank has made it easy to borrow on personal mobiles, equity bank as well on M-kesho and Safaricom gives short term loans on M-Shwari plat form which is a mobile enabled application.

For the short term

These markets are described as “money markets” because the assets that are bought and sold are short term with maturities ranging from a day to a year and normally are easily convertible into cash. Money markets include markets for such instruments as bank accounts, including term certificates of deposit; interbank loans (loans between banks); money market mutual funds;

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commercial paper; Treasury bills; and securities lending and repurchase agreements (repos). These markets comprise a large share of the financial system in the East Africa, accounting for about one-third of all credit, according to World Bank Report 2000. These money market instruments, many of them securities, differ in how they are traded and are treated under financial regulatory laws as well as in how much a lender rely on the value of underlying collateral, rather than on an assessment of the borrower. The most familiar money market instruments in East Africa are bank deposits, which are not considered securities, even though certificates of deposit are commonly traded like securities in the region. Depositors, who are lending money to the bank, look to the institution's creditworthiness, as well as to any government programs that insure bank deposits. Interbank loans are not secured by collateral, so a lender looks exclusively to a borrower's creditworthiness to assess repayment probabilities. The most closely watched interbank market is in Kenya, where the Central Bank of Kenya is determined daily and represents the average price at which major banks are willing to lend to each other. Commercial paper is a promissory note (an unsecured debt) issued by highly rated banks and some large nonfinancial corporations (Beck et al 2004). Because the instrument is unsecured (no more than a promise to pay, hence the name), investors look solely to the creditworthiness of the issuer for repayment of their savings. Commercial paper is issued and traded like a security. But because it is short term by nature and not purchased by retail investors, it is exempt from most securities laws within East Africa.

The safest investment

Treasury bills, which are issued by the East Africa Governments, are securities with maturities of less than a year (Frank J. Fabozzi et al 2002). Treasury bills are usually sold at a discount from face value and actively bought and sold after they are issued, are the safest instrument in which to place short-term savings. The markets are deep and liquid, and trading is covered by securities laws within East Africa countries. Treasury bills are not only savings instruments; they can be used to settle transactions (Greselas et al 2003). Treasury bills, which are issued electronically, can be sent through the payments system as readily as money. Repos are an important large, but more complicated, segment of money markets in East Africa. Repos offer competitive interest rates for borrowing and lending on a short term basis usually no more than two weeks and often overnight. A borrower sells a security it owns for cash and agrees to buy it back from the purchaser (who is in effect a lender) at a specified date and at a price that reflects the interest charge for borrowing over the period (Mokena 2001). The security at the heart of the transaction serves as collateral for the lender. Besides making possible secure short term borrowing and lending in money markets, repo and other securities lending markets are critical to short selling when a trader agrees to sell a security he or she does not own. To come up with such a security, the short-seller must borrow it or purchase it temporarily through a repo transaction. When it is time to return the security to the lender, the short-seller again must buy or borrow it. If the price has fallen, the short-seller makes money on the transaction. Money market mutual funds (MMMFs) are securities offered by companies that invest in other money market instruments such as commercial paper, certificates of deposit, Treasury bills, and repos. Money market mutual funds are regulated as investment companies in the East Africa. They offer low risk return on a short-term investment to retail and institutional investors as well as corporations within the East Africa Region.

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Dysfunctional markets

There are some other sectors of the money market within East Africa that are not so plain and simple. These include asset backed commercial paper (ABCP) and certain triparty repo transactions .A firm with hard to sell (illiquid) financial assets, such as loans, mortgages, or receivables, might use ABCP to borrow at a lower cost or to move these assets off its balance sheet, (John O. Ledyard 2008). It creates a special purpose entity that purchases the illiquid assets from the firm and finances the purchase by issuing ABCP, which unlike normal commercial paper is secured or "backed" by the underlying assets. This type of commercial paper can obtain a high credit rating if the assets are rated highly and if the special facility has adequate capital and lines of credit, *(*Weimer et al 2004).

The stock Market

Phillip Bond et al (2011) reveal that a large amount of activity in the financial sector occurs in secondary financial markets, where securities are traded among investors without capital flowing to firms. The stock market is the archetypal example, which in most developing economies captures a lot of attention and resources. A stock market can be defined as financial establishment, which promotes capital formation and competence in capital allocation. The stock markets also enable the government and private firms to finance its new projects as well as establishing, modernizing and expanding commercial or industrial concerns through raising long term capital. Osinubi (2007) argues that capital resources should be provided to industries where such industries have the capacity and capability of increasing its production and productivity. Should the opposite happen the rate of expansion of the economy will suffer, thus clearly showing that stock market development is important to East Africa economic growth and is perceived to have a positive relationship with economic growth. Corporate entities within East Africa region benefit from the stock market in the form of provision of long term debt financing and equity capital and a continuous source of capital for development rather expansion and this has a positive impact on economic growth within the region . The real effect of financial markets stem from the informational role of market prices in this region. Theoretical literature shows that accounting for the feedback effect from market prices to the real economy significantly changes our understanding of the price formation process, the in formativeness of the price, and speculators' trading behavior (Baker et al 2003).A new definition of price efficiency is needed to account for the extent to which prices reflect information useful for the efficiency of real decisions rather than the extent to which they forecast future cash flows (Asker Jet al 2011). Since stock market provides secondary market for investors and other financial institutes, the empirical literature also shows that the stock market boost growth. The cost of mobilizing savings can be lower if the stock market is large enough and hence facilitate investments in the most dynamic technologies (Nowbutsing et al.2011).Literature from the past researches reveal that stock market has contributed significantly to the economic growth of East Africa region and this has been a motivator for direct investment. East Africa Stock market plays a fundamental role on providing the secondary market for investors and financial institutions that will be willing to trade their securities. A liquid market can be characterized as a market where large transactions can be executed without or less impact on security prices (Brunnermeier et al. 2009).

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Implications for financial markets and corporate finance

Considering a feedback effect from financial markets to firms' real decisions generates an array of implications for the study of financial markets and corporate finance. Often, phenomena that are believed to be puzzling can be rationalized in a model in which financial markets have real effects. There is a distinction with the "traditional" view of security prices, in which cash flows affect prices, but prices have no effect on cash flows. Our focus here is on models that exhibit endogenous feedback, i.e., via learning or incentives. Several papers in the literature generate related implications based on models with exogenous feedback, i.e., where firm value or the firm's investment decision is assumed to be mechanically tied to the price; Hanna and Sonti (2004) and Ozdenoren and Yuan (2008).

The Bond Market

Bond Market Development in East Africa Securities markets greatly contribute to mobilizing domestic savings for investment in a variety of key sectors, such as housing, infrastructure and SMEs. These help create jobs and support economic development. However, the securities markets in East Africa are still at a nascent stage. Equity markets are small with few listed securities and low liquidity, while bond markets are generally characterized by limited benchmarks for pricing securities, low liquidity, rigid regulatory frameworks and inefficient infrastructure. Since the financial crisis of 2008 loans from banks have become more difficult to obtain. African countries increasingly have explored alternatives to raise capital for their economic development projects.

Experience in some African countries and other developing regions indicates that bonds present opportunities to raise funds to finance capital-intensive projects, particularly infrastructural schemes, that take place over long periods of time. There are various types of bonds African governments can issue. Capital markets in many African countries, however, remain largely underdeveloped and lack the necessary regulatory structures to bolster the confidence of investors to attract investment in local bond markets. These bond markets are characterized by the issuing of bonds mostly by national governments. State, local government and corporate bond issues are almost non-existent. The lack of market infrastructure fundamental for the development of secondary markets on which bonds can be traded presents critical impediments to bond market development in African countries. Although there is evidence that bond markets in Africa are opening up, if governments and firms in African countries are to access capital for development through issuing bonds, financial and regulatory reforms are needed to accelerate the development of debt capital markets which in turn would contribute to the growth of bond markets in Africa,(Chijioke 2015)

Financing infrastructure in East Africa

The financial infrastructure within the region is majorly on the plat form of Banks which provide direct funding to the majority of East Africa corporates.Among the lowest rated countries in the world as pertains the quality of infrastructure is located within this region according to the latest Global Competitiveness report - poor roads and insufficient or unreliable electricity supply constitute significant bottlenecks to growth in large parts of the region. Since 2003, the Bank has committed over EUR 3.5bn to funding infrastructure projects in sub- Saharan Africa of which East Africa region is part of. The energy sector accounts for the largest share of this effort (close

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to 50%)– reflecting the poor state of electricity generation and distribution in many African countries. A special emphasis has been put on renewable energy sources, both as a means to reduce dependence on expensive imported fossil fuels and to contribute to the mitigation of climate change. The bank commits significant funds every year in direct lending to African corporate. In this way the Bank finances larger scale projects in a wide range of sectors, spanning from manufacturing to agriculture,(European Investment Bank report 2013)

CONCLUSION

From the above findings, its evident that many opportunities for further growth and development exist in the EAC financial markets, which in turn would contribute to better access to finance and economic growth. Financial market expansion has a great potential to spread across the region and transform the existing business models for providing services to currently underserved population and grow the economy drastically. This can only happen with the support of direct investment into the financial markets within the region by the investors. Making African financial markets work for investment and development will require significant efforts aimed at strengthening their legal and regulatory infrastructure, and lifting the quality and scale of their operations.

RECOMMENDATIONS

This is a virgin area for future researchers especially the bottlenecks that East African Region experience in Financial Markets. As well this information is very vital for the prospective investors who envisage to have foothold on East Africa region in terms of investment.

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