The African Financial Markets Index

Institute of Economic Affairs

a. Introduction:

The Absa Africa Financial Markets Index (2020) is an instrument that documents the most supportive environment for effective markets in 23 countries across the region based on six focal pillars. These are market depth, access to foreign exchange, market transparency, tax and regulatory environment: capacity of local investors: macroeconomic opportunity; and enforceability of financial contracts. Each of these metrics is measured by many other underlying factors and the weight and performance of each is used to give the overall score.

The Official Monetary and Financial Institutions Forum (OMFIF) in partnership with ABSA bank conducted extensive research using data from central banks, securities exchanges and international financial institutions. The use of both quantitative and qualitative data was used as OMFIF surveyed over 50 policymakers, regulators and executives from financial institutions operating across the 23 countries, including banks, securities exchanges, central banks, regulators, audit and accounting firms, and international financial and development.

Initially, the total number of countries reported in the index was seventeen but this number has since gone up to 23 in 2020. It is anticipated that due to the objective of gathering this data to assist countries in the growth of the investment landscape in the continent, this number is set to increase in a few years.

Table 1: The Six Absa Africa Financial Markets Index Indicators (2020)

Pillars	1. Market Depth	2. Access to Foreign Exchange	3. Market Transparency, Tax and Regulatory Environment	4. The capacity of Local Investors	5.Macroeconomic Opportunity	6. Legality and Enforceability of Standard Financial Markets Master Agreement
Indicators	Production diversity Size of the market Liquidity Depth of markets Primary dealer system	Net portfolio flows ratio to reserves Foreign exchange liquidity Capital restrictions Official exchange rate reporting	Financial stability regulations Quality of financial reporting Tax environment Financial information availability Market development	Local investor asset concentration	Gross Domestic Product (GDP) growth Living standards Competitiveness Macroeconomic data standards Budget Release	Netting and collateral positions Use of financial market master agreements Insolvency framework

Well-functioning markets are important for any country as they create economic efficiency. Among the features of a well-developed financial market are transparency in the market, contract enforceability, attractive returns on assets, ease in selling assets, and the repatriation of investments.

Pillar 1: Market Depth

This pillar evaluates the size and liquidity of domestic capital markets, along with the diversity of listed asset classes and the existence of standard features that enhance market depth. Under this indicator, it measures factors such as product diversity, size of the market, liquidity, depth of markets and primary dealer system.

Pillar 2: Access to Foreign Exchange

Observes factors that impact markets' accessibility to international investors. These include the existence and severity of capital controls, exchange rate reporting standards and the level of foreign exchange liquidity. This pillar also assesses countries' ability to manage volatility resulting from openness. This is measured by central banks' readiness to meet the demand for currency by looking at the ratio of net portfolio flows to reserves. It, therefore, assesses all these based on four sub-indicators that is official exchange rate reporting, capital restrictions, foreign exchange liquidity and net portfolio flows ratio to reserves. Access to foreign exchange is important as it helps in the facilitation of trade between countries. For example, exporters are either in a better or weak position if the domestic currency is weak or strong as this affects the cost of goods eventually. This then makes goods expensive or cheaper for consumers.

Pillar 3: Market Transparency, Tax and Regulatory Environment

Market transparency describes the extent to which a country makes public the details of its market activities. Transparency is vital in fostering potential investor confidence. The regulatory environment influences the financial decisions local and international investors make in the operations of their business in a particular market. This pillar assesses a country's regulatory and tax environment for financial markets. It also assesses the transparency and enforcement of accounting rules and this will involve assessing a markets accounting and auditing capacity. This pillar has five more sub-indicators under it, that is financial stability regulations, quality of financial reporting, tax reporting, financial information availability and market development. All these then score the countries on the conduciveness of the regulatory environment for local and foreign investment, gauged through tax incentives, reporting standards and market transparency.

Pillar 4: Capacity of Local Investors

The capacity of local investors is the ability of local firms to engage foreign investors and absorb the goods and services being provided. The higher the capacity of the local investors to absorb the products, the higher the confidence of the foreign investors in the markets. The capacity of local investors is evaluated in terms of the policies and business practices that have been put in place by the host countries to strengthen their local investors to meet the demand and supply of assets while supplementing with those from foreign investors.

Pillar 5: Macroeconomic Opportunity

This pillar focuses on the performance of an economy and how the different sectors perform in contributing to the GDP. This is done by evaluating the host country's economic performance, the financial risks, and financial transparency which is demonstrated by the availability of data, open monetary policy communications and the timely release of state budgets. These allow the investors to predict and plan for investments by understanding the probable future and how the outcomes would impact their financial decisions. In a bid to assess the macroeconomic opportunities, this index looks at factors such as the Gross Domestic Product (GDP) growth, living standards, competitiveness and macroeconomic data standards and budget release.

Pillar 6: Legality and Enforceability of Standard Financial Markets Master Agreements.

The Master Agreements are standard documents that provide a set of common terms with legal implications that play a key role in safeguarding the interests of the financial institutions within a market. This pillar assesses how well a country has adopted and is implementing the internationally accepted legal standards, the enforcement of netting and collateral positions and the adequacy of the insolvency regime. It does so by looking at different indicators, which are categorized as netting and collateral position, use of financial market master agreements and the insolvency framework.
Importance of well-functioning markets:

Part of the reason why this was important was to help in measuring the market depth and show how much well capital markets should perform. From an investors perspective the more transparent and well-functioning the market is, the better it is to operate in that particular economy. Some of the reasons why it is important for countries to have well-functioning financial markets include

I. Increased foreign and domestic investments lead to long-term growth and stability of the economy. This in essence helps in bridging the gap between the people who need the capital and the people who have the capital

II. Well-functioning markets help enhance savings and investments as people can see the positive returns that one derives from the investments and so want to venture into it

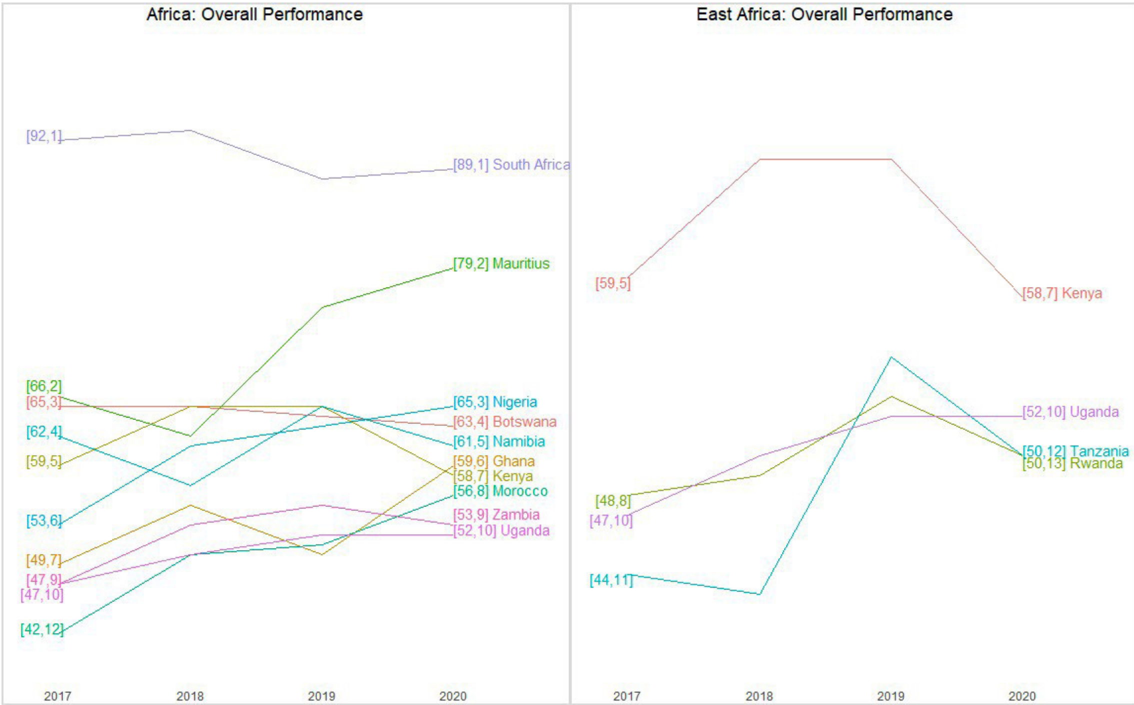
III. Create discipline and positive competition as people ensures that the capital is allocated to the regions, sectors and companies that need this capital the most and those that will generate the highest positive return,

IV. Help reduce the countries self-reliance by attracting capital into businesses instead of having them rely on foreign aid and borrowings.

b. The general performance with a key focus on East Africa with regards to the growth of the capital markets

i. Overall Performance

Figure 1: Countries Performance in the Africa Financial Markets Index



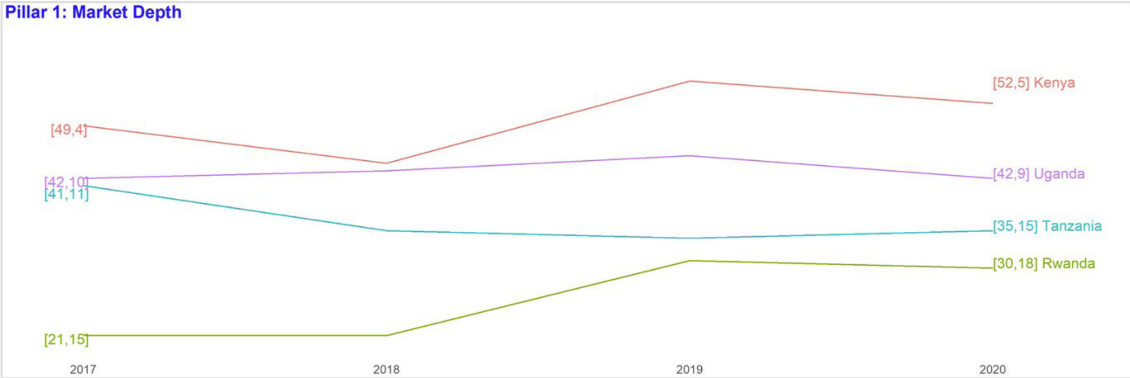
Source: Absa Financial Markets Index 2020

The financial markets are important in that they facilitate market efficiency. To gauge and compare the performance of several African financial markets, the Absa Africa Financial Markets Index provides an assessment of financial market developments within 23 African markets. The index also serves as a basis for recommendations on the trajectories that given financial markets can take to improve their performance. The index has produced five different iterations. In 2021, South Africa exhibited the strongest performance on this index. South Africa's 2021 score of 86% represented a 2% drop from its 2020 performance of 89%. Overall, since the 2017 launch of the index, South Africa's performance on this index has seen a gradual deterioration. Kenya's 2020 score of 58.7% represented a drop from its 2019 position. Overall, however, Kenya's performance has only seen extremely slight improvements of no more than 2% points over the last few years and an overall drop of about 1% since 2017. Its overall first place performance within the East African Community could be ascribed to the size of its economy, its larger industrial footprint, and its higher level of development. This implies a correlation between financial size and total productivity.

ii. Performance Per Pillar for the East African Countries

Pillar 1: Market Depth

Figure 2: Market Depth



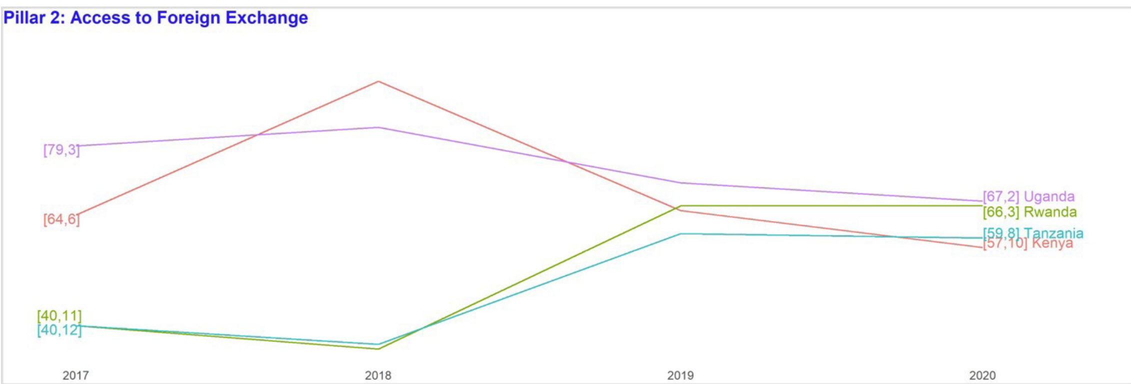
Source: Absa Financial Markets Index 2020.

Within the securities markets, market depth is defined as the ability of a given market to absorb a market order without experiencing large changes in market prices of securities. A market that can absorb a $2 billion market order without registering large price changes has greater market depth than one market in which a $2 billion order would cause a dramatic rise in those securities.

The ABSA index measures market depth on five pillars namely product diversity, size of market, liquidity, depth and primary dealer system. In 2021, Kenya's 52% score made it the top performer in the region. This represented an improvement over its 2017 score of 49.4%. Rwanda's score of 30.18% was also a marked improvement from its 2017 score of 21.15%. Within the EAC region, Kenya and Rwanda exhibited the strongest improvements in performance. Overall, Kenya's first-place rank could be ascribed to its larger economy, higher per capita level of development. A larger, more productive, wealthier nation demands a level of market depth.

Pillar 2: Access to Foreign Exchange

Figure 3: Access to Foreign Exchange

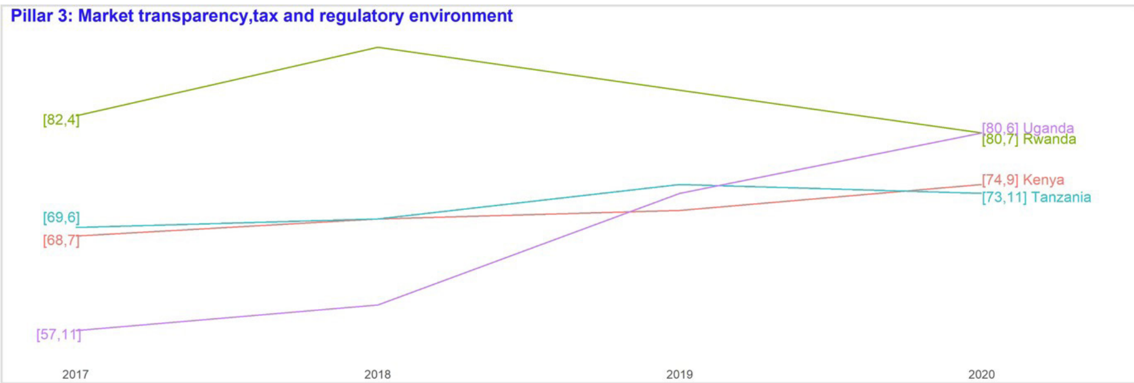


Source: Absa Financial Markets Index 2020

The access to foreign exchange indicator measures the ease with which foreign capital can gain entry and depart from a given region. The sub-indicators used to build this indicator included the ratio of net portfolio flows to reserves, foreign exchange liquidity, capital restrictions and official exchange rate reporting. Overall, the access to foreign exchange indicators is dictated by the availability and quality of exchange rate reporting, the friction created by requirements and restrictions, the quantum of foreign exchange already transacted within a market and the relationship between the net quantum of portfolios and a nation's stock of foreign reserves. Ugandan and Rwandan scores of 67.2% and 57.1% respectively ranked them first and second, best performers in the region and second and third best performers among the 23 countries assessed. Relative to 2017, however, Uganda's score has seen a gradual drop to its current position. Kenya's score of 57.1% also ranked it last in the region and 10th among the 23 countries sampled. This represented a drop from its strong 2018 performance. Kenya's relatively abysmal performance can be ascribed to a lack of transparency around Kenya's foreign exchange rates and capital restrictions that were characteristics of its foreign exchange market between the period 2018 and 2020.

Pillar 3: Market Transparency, Tax and Regulatory Environment

Figure 4: Market Transparency, Tax and Regulatory Environment



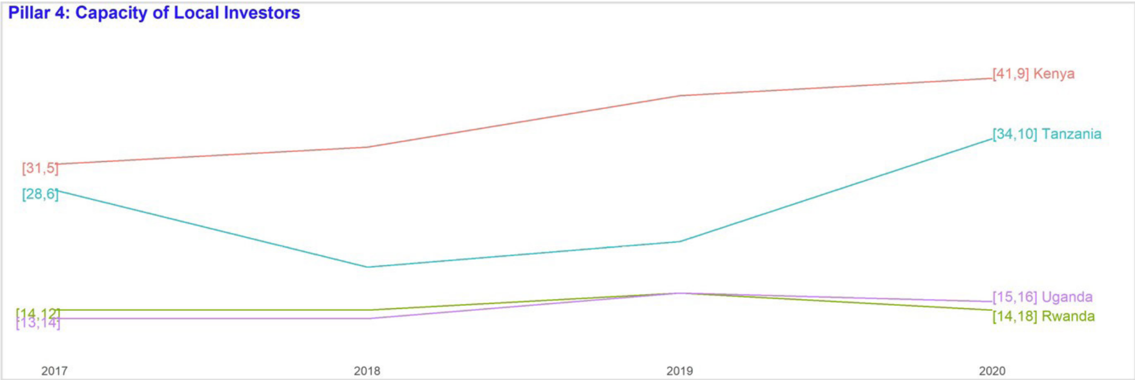
Source: Absa Financial Markets Index 2020

The market transparency, tax and regulatory environment indicator assesses the support that the regulatory environment gives to the financial market. A regulatory environment can be assessed on a spectrum of its conduciveness to the efficiency of the financial system. Regulations have important implications on financial stability. They include directives with which financial intermediaries must comply. Combined with the capitalization of a given market, the regulatory environment will also imply the overall market environment and the global and international interactions that the market experiences. South Africa's 94% score on this indicator made it the strongest performer in the whole group. Lesotho's 33% score made it the worst performer in the whole group. Uganda's 60.6% score ranked it 6th best in the whole group and the best in the region. Kenya's 74.9% made it the 3rd best performer in the region and 9th best in the group. Kenya's position represented a slight improvement over the four years since the index was first created.

Kenya's performance might partially be explained by erratic changes in tax structure and changing debt dynamics and their effects on sovereign ratings. Uganda made the most important improvement in that period.

Pillar 4: Capacity of Local Investors

Figure 4: Capacity of Local Investors



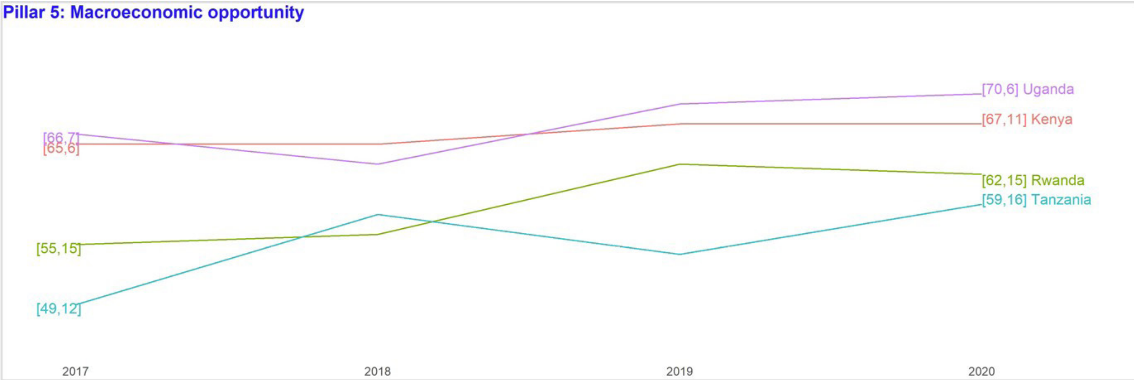
Source: Absa Financial Markets Index 2020.

The capacity of local investors is an indication of local demand against supply in the given market. The capacity of local investors was determined by an indicator called local investor asset concentration. Asset concentration is a measure of the diversity of a portfolio of assets. In this case, this was determined by the value of pension assets per capita, and the pension and insurance fund assets, ratio to the total market capitalization of equities and bonds listed on exchanges. The ratio indicates the reliance of local investors on traditional pensions. Local investors with a low capacity would have a high concentration of pensions in their portfolios. Local investors with a high capacity would have a low concentration of pensions in their portfolios and would include a large share of equities and bonds.

With a score of 92%, Namibian investors had the highest capacities in the group. Kenya's 41.9% score earned it the rank of 9th best in the group and first in the region. Rwanda's score of 14.18% made it the worst in the region and 18th in the whole group. Kenya's position has seen a 10% improvement in its score since the index was first taken in 2017. In that same period, Rwanda's performance did not improve by a single percentage point. This seems to imply that local investors from these regions had a greater reliance on pensions. Kenyan firms are among the largest in the region. Kenya also has a stronger concentration of large firms than its regional peers. Finally, Kenya's equity markets have a greater capitalization than its regional peers. This could explain its strong performance on this indicator. With the lowest rank in the whole group, Ethiopia may ascribe its score to an underdeveloped equity market that offers little in the way of opportunities for its citizens. Finally, this pillar considers a few sources of investment funds. This can conjure concerns around measurement.

Pillar 5: Macroeconomic Opportunity

Figure 5: Macroeconomic Opportunity

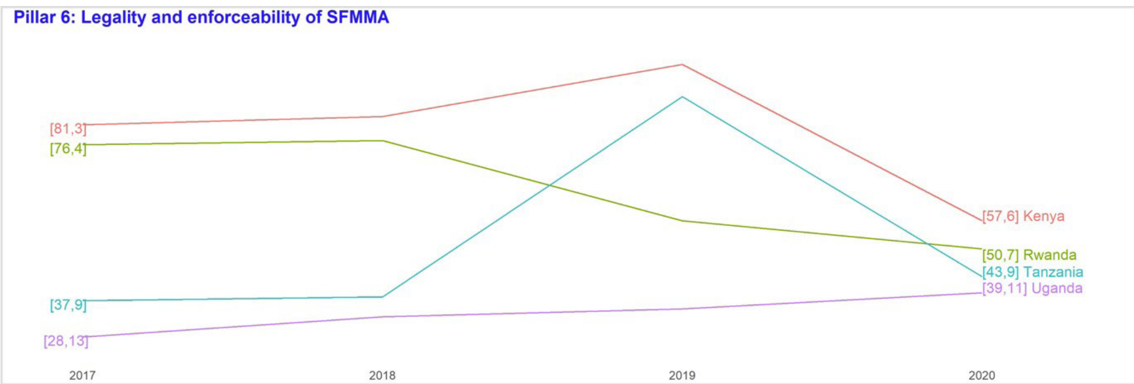


Source: Absa Financial Markets Index 2020

The macroeconomic opportunity indicator was used to assess what opportunities households and firms could expect from their economy. This index assessed the prospects of a given economic system through its growth, debt, export competitiveness, banking sector risk and macro data availability. Economic growth prospects were determined by a 5-year GDP average growth and a two-year forecast. Living standards were determined by per capita GDP. Competitiveness was a function of absolute export market share and growth in export market share over the previous 5 years. The availability and frequency of reporting on GDP, inflation and interest data and the regularity of budget release were also important considerations. In that year, South Africa's score of 78% gave it the highest macro-economic opportunity while Angola's 41% gave it the lowest. Uganda's 70% gave it the highest rank in the region and 6th rank among the selection of 23 of the African continents' economies. Kenya's score of 67% ranked it 11th on the African continent and 2nd in the East African region. In the period since the launch of the index, Uganda and Kenya both saw improvements of 4% and 2% respectively. It is possible that were not for its adverse debt dynamics, Kenya could have had a stronger performance on this metric.

Pillar 6: Legality and Enforceability of Standard Financial Markets Master Agreements

Figure 6: Legality and enforceability of Standard Financial Markets Master Agreements



Source: Absa Financial Markets Index 2020.

The international financial market system is regulated by a collection of agreements that bind signatories to basic standards. Financial markets master agreements that regularize transnational financial transactions. The enforcement of netting and collateral positions helps regulate the risks that banks take with depositors' funds. The final feature of this indicator is the insolvency framework sub-indicator. Based on a World Bank score, this sub-indicator assesses the strength of insolvency measures. Mauritius score of 98% gave it the first-place rank among the continents 23 countries assessed. Angola's score of 10% gave it the last place rank in that same group. Kenya's 57.6% score gave it the first place rank in the EAC and the 6th place rank in the group of countries selected. After experiencing very strong improvements over the 2018-2019 period, Tanzania saw a significant drop in performance. This trend mirrored that of top performers in Kenya and Rwanda that each saw respective drops in their performance. Kenya did not outperform Rwanda by a significant margin. Kenya may owe its performance to its standard of regulatory framework and enforcement. Rwanda's performance also signifies the fact that a highly developed financial market is not a necessary prerequisite for a high standard of regulations and enforcement.

c. Key policy recommendations

The openness of any respective economy and income per capita determines largely the depth and the breadth of the financial markets. This is demonstrated by the number of countries in the top ten in Africa. Countries such as South Africa and Mauritius have higher incomes. Mauritius' GNI per capita for 2019 is US$12,740[1] while South Africa's economy GNI per capita is around US $6,614[2]. Openness plays an important role by being an indispensable enabler of growth, job creation, and poverty reduction[3]. The fragility or stability of the state of institutions plays an important role in the extent of the development of the financial markets. The more open and larger economies perform well. The ranking is more related to how formal an economy is.

Some of the key issues affecting Kenya's growth of the financial market include the lack of tax certainty, Overregulation in other sectors and openness which has hampered progress in improving Market transparency, tax and regulatory environment. The lack of tax certainty is a convergence of fiscal policy issues where Kenya has run huge fiscal deficits ranging between 7%-9.2% of GDP in the last decade. This has affected the national savings and capital formation, and in the long run, will affect economic output and wealth . Shaping fiscal and regulatory policy, therefore, remains imperative in improving Kenya's economic performance and development of the financial markets. Specific decisions that government makes that affects the ranking and therefore a need to have policy reforms that will back this growth.

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[1]Bank of Mauritius. 2020. "World Bank Classifies Mauritius as High-Income Country." July 3, 2020. https://www.bom.mu/media/media-releases/world-bank-classifies-mauritius-high-income-country

[2]Knoema. 2021. "South Africa GNI per Capita Based on PPP, 1960-2020 - Knoema.com." 2021. https://knoema.com/atlas/South-Africa/topics/Economy/National-Accounts-Gross-National-Income/GNI-per-capita-based-on-PPP.

[3]Selina Jackson, "Growth and Development: Why Openness to Trade Is Necessary but Not Sufficient," Brookings, November 23, 2015,

[4]Illustration of the effects of debt on the Economy from Ball, Laurence, and N Mankiw. "What Do Budget Deficits Do?",1995, and Gale, W. and P. Orszag. 2003. "The Economic Effects of Long-term Fiscal Discipline." Urban-Brookings Tax Policy Center Discussion Paper No. 8. Washington, DC: The Brookings Institution.

There are some of the issues in Kenya's economic policy sphere that affect the macroeconomic opportunity and they include public debt, the balance of payment challenges and its risks. Kenya's public debt has increased threefold in the stock, shortened in terms of the repayment period, and mopped up credit from the financial markets, therefore, crowding out the private sector. Kenya has breached its debt solvency indicators and resolving the public debt issue is a policy imperative for the economy in general and the financial markets.

The difference in performance between South Africa, Mauritius and the rest of the African economies in the African Markets Financial Index shows the level of progress that still needs to be made in Financial Markets. Government can take lead in the market formation role for the financial markets. They are several financial market targeted reforms that need to accompany an improved macroeconomic performance for the size, extent of the financial markets to deepen.

It is also important for regulatory authorities and national statistical agencies in African economies to generate extensive publicly available data to be inputted into such an important index that's the story of financial markets development in Africa. There is a need for African Economies to pursue a coherent economic policy that delivers an excellent macroeconomic opportunity that allows for growth, and an increase in specialization in the financial markets.

NOTES

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