THE ROLE AND IMPACT OF CAPITAL MARKETS IN DEVELOPING ECONOMIES

A CASE STUDY OF NAIROBI STOCK EXCHANGE.

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DECLARATION

This research project is my original work and has not been presented elsewhere for any award

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DEDICATION

I would like to dedicate this project to my family for their endless support, friends, colleagues at work and my fellow classmates for their encouragement.

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ABSTRACT

The stock market provides an important alternative source of long-term finance for long-term productive investments. This helps in diffusing stresses on the banking system by matching long-term investments with long-term capital. Stock markets in the world individually and collectively play a critical role in their economics. They provide an avenue for raising funds, for trading in securities including futures, options and other derivatives which provide opportunities for investors to generate returns.

The performance of the stock market is influenced by a number of factors the main ones among them being the activities of governments and the general performance of the economy.

It provides equity capital and infrastructure development that has strong socio-economic benefits like roads, water and sewer systems, housing, energy, telecommunications, public transport, ideal for financing through capital markets via long dated bonds and asset backed securities. Stock markets are very important because they play a significant role in the economy by channeling investment where it is needed and put into the best use.

In the world the stock markets have seen a massive growth since it is easier to take a company public because the market is so sophisticated that is it is east to obtain information and they are clear policies which govern the running of such capital markets therefore this helps the economy grow since it provides a boost to companies wishing to grow very large because investors are attracted to such markets.

Although a flow of global investor interest in the 1980s and 1990s Africa has been left behind by the massive international capital flowing to developing economies, it has remained the only developing region in which development assistance flow exceeds private capital flows. This can

be attributed to a lack of well developed financial market and lack of clear policies that govern such markets.

International organizations, governments in developed countries and international financial institutions seem to pay more attention to the Asian and Latin American emerging capital markets in contrast to the African markets (particularly in Sub-Saharan Africa) as evidenced by few studies and literature on the development of capital markets in Sub-Saharan Africa.

This study therefore, focuses on capital market development in Africa, with the Nairobi Stock Exchange (NSE) as a case study. The NSE has continued to increase in importance in economic growth and capital market development in the country and indeed the whole of East Africa region. African countries, particularly those in Sub-Saharan Africa (SSA) remain the only developing region in which development assistance flows exceed private capital flows. Except a few countries (such as South Africa, Mauritius, Botswana), most of the economies in the SSA region do not yet have strong capital markets.

In Kenya the stock market has been grown particularly after liberalization of the economy by the government. This was as a result of the government making most of the government owned to public companies by floating shares in the stock market this gave most people opportunities to own them.

The purpose of this study is to examine the role and impact that capital markets have on the economy, the benefits of the stock exchange on the economy, the challenges facing efforts to develop market of stock market development in Africa, and the lessons learnt as well as governments can use some of them to develop and ensure the growth

ABBREVATIONS

AIM Alternative Investment Market

CMA Capital markets Authority

FISM Fixed Income Securities Market

IFC International Finance Corporation

IMF International Monetary Fund

IPO Initial Public Offer

MIM Main Investment Market

NSE Nairobi Stock Exchange

SSA Sub Saharan Africa

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CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

Stock markets all over the world play a critical role in most economies and are used to implement privatization programs, and often play an important role in the development of emerging economies. They carry out a number of functions both politically and economically. They are used for trading, investment, hedging as well as arbitrage opportunities.

Promotion of economic growth led by the private sector requires the creation of an enabling environment within which the private sector can flourish. A key factor is the healthy growth of a nation's financial sector, which in turn improves the private sector's access to services such as bank credit, equity capital, payments and risk management services.

For long term financing, companies opt to raise the capital through the stock exchange rather than borrowing from banks. Stock markets help companies acquire finances without necessarily borrowing from banks. This is an advantage to both the companies and investors given the uncertainties of the economic growth, it is an advantage because if the companies do not perform well they are not obligated to pay share holders dividends. The stock exchange ensures the shortest and most efficient circuit between the economies or temporary surplus of capital for those who want to invest on medium or long term (be it companies, funds, banks, insurance companies or plain private individuals) and the need for financing of the enterprisers or of the commercial companies. The stock exchange becomes thus a strong competitor for the banks, representing a serious alternative to the bank loan, often times more expensive and difficult to obtain.

Equity financing involves the buying and selling of shares where both share the outcome whether positive or negative unlike the financing from banks where the banks may be reluctant in providing loans owing to the risk profile of the firms or companies and greater exposure in a negative outcome on a loan contract. The stock market plays an important role for these companies in raising funds or capital however, the lack of liquidity particularly in the African markets remains a serious challenge. The lack of liquidity mainly in underdeveloped or poorly functioning markets deters foreign investors since trading becomes expensive.

Today most economies around the world are judged by the development and performance of their capital markets. The development and performance of the capital markets is usually measured by stock market index, market capitalization and the stock turnover For example the aggregate market capitalization of the countries classified by the IFC as emerging markets rose from $488 billion in 1988 to $2,225 billion in 1996. Trading on these stock markets rose in similar magnitude, growing from $411 billion to $1,586 billion in that period. The stock turnover between 1994-2003 for emerging markets increased at an average of 9 percent a year while developed countries it increased at 22 percent a year. This

Capital markets play an important role in the economic growth and prosperity of nations. Most African countries including those in Sub-Saharan Africa (SSA) have recently under gone financial sector reforms such as restructuring and privatizing of state owned banks and establishment of capital markets. For example the Nigeria stock exchange has experienced remarkable growth in the last two decades. In June 2004 the share index stood at 27,692.36 points from 100 in 1984.The market turnover doubled in 2003 from N60.3 Billion to N120.70 billion while the value of new issues rose from N67.4 Billion in 2002 to N 185.02 Billion in 2003. (The Nigeria Stock Exchange, The stock market Performance 1990-2010)

Even though the capital markets of least developed countries have undergone sector reforms they are still very low in terms of capitalization because of a limited number of listed companies and limited participation of households (savers) either due to lack of capacity or lack of awareness as to the capital markets. An example is the Mauritius stock exchange which had 120 listed companies by the end of 2003

Poor performance of the public sector, market distortions and misallocations of resources lead to negative economic growth in developing countries. In the past 20 years according to Rwelamira (1993) liberalization and privatization have become the key issues in development strategies particularly in Africa partly due to the need to facilitate private sector development in Africa.

1.2 Statement of the research problem

Kenya and other African countries have invested in developing the stock market as an institution for capital mobilization as well as domestic savings. Kenya over the years has performed poorly compared to emerging markets like the Asian Markets which have become big economies to reckon with and promoted the stock exchange as a pillar for economic progress. There are different factors or variables that accelerate economic growth of a country Financial sector reforms such as establishment and development capital markets are believed to be one of the major variables that accelerate the economic growth of a country. International organizations like International Monetary Fund (IMF) and World Bank (WB) as part of an effort of financial sector liberalization have been pressuring Kenya and other African countries to privatize the state owned banks and establish strong capital markets so as to integrate with the rest of the world.

It is therefore important to examine whether the stock market is merely a casino where people place bets or whether it is linked to economic growth. Most of the existing literature on capital markets has looked at the linkage between financial development and economic growth. However despite the fact that the stock market plays an important role in financial development, economic growth and prosperity the issue has received little attention. This study attempts to fill the gap by looking at the extend of whether capital market establishment is an alternative to economic growth in least developed economies and the role of government in establishing policies that help the growth and governing structures of capital markets.

1.3. Objectives of the Study

This study will examine on the following:

1. Whether there is causality between stock market development and economic growth
2. The stock market as an alternative source of economic development.

1.4 Justification of the study

The financial markets serve a vital purpose in the growth and development of a company that wants to expand. For such companies with expansion plans and new projects in need of funding and investors looking for a better return, the financial market is the best platform.

This study attempts to find possible connection between stock market development and economic growth with reference to Kenya. The study deepens the approach in understanding better ways of enhancing the effectiveness of capital markets in helping the growth of economies and what measures and polices the government can use so as to ensure a steady growth of the markets.

The government could utilize findings from this study to come up with policies that will enhance the development, growth and hence making capital market as an alternative source of economic growth. The study should encourage the banking and insurance sector to invest excess funds in the capital markets by buying infrastructure bonds as this will increase the growth of the financial market The study is expected to add new insight to the existing academic knowledge and debates by contributing to better understanding on the role and impact of capital markets in developing economies particularly in Kenya therefore the information should help looking at the role and impact of capital markets in the economy as an alternative source of economic growth.

1.5 LITERATURE REVIEW

Introduction

The study looks at the works related to studies on the capital markets and its role and will therefore give a clear picture on the areas where gaps exist.

Definitions of key Terms

Financial sector: The Reserve Bank of Australia (www.rba.gov.au/Glossary/text_only.asp), defines financial sector as "the sector of the economy that comprises financial institutions and financial markets".

Financial institution: "A company whose primary function is to intermediate between lenders and borrowers in the economy". (www.rba.gov.au/Glossary/text_only.asp). Financial Institutions perform the essential functions of channeling funds from those with surplus funds to those with shortages of funds (e.g. commercial banks, savings banks, credit unions, savings associations, and insurance companies, mutual funds, pension funds, stock and bond markets) (Saunders and Cornett, 2004). As per Saunders and Cornett financial markets such as stock and bond markets are also part of institutions.

Financial market: The Reserve Bank of Australia (www.rba.gov.au/Glossary/text_only.asp), defines financial markets as "a generic term for the markets in which financial instruments are traded Financial instruments have no intrinsic value of themselves. They represent a claim over real assets or a future income stream. The four main financial markets are the share or equity market, the fixed interest or bond market, foreign exchange market, and the derivatives market".

Capital markets: "a market where debt or equity securities are traded" (Investorwords.com). The capital markets consist of primary markets and secondary markets. Newly formed (issued) securities are bought or sold in primary markets. Secondary markets allow investors to sell securities that they hold or buy existing securities.

Stock markets: "a general term for organized trading of stocks through exchanges and over-the-counter" (Investorwords.com).

Bond markets: "a market consisting of bond issuers, underwriters, buyers, and brokers/dealers" (businessdictionary.com)

Commodity markets/Commodities exchanges: "Open and organized marketplace where ownership titles to standardized quantities or volumes of certain commodities (at a specified price and to be delivered on a specified date) are traded by its members; such as fuels, metals, and agricultural commodities exchanges". (businessdictionary.com)

Money market: "network of banks, discount houses, institutional investors, and money dealers who borrow and lend among themselves for the short-term (typically 90 days). Money markets also trade in highly liquid financial instruments with maturities less than 90 days to one year (such as bankers' acceptance, certificates of deposit, and commercial paper), and government securities with maturities less than three years (such as treasury bills), foreign exchange, and bullion". (businessdictionary.com)

Derivatives markets: "provide instruments for the management of financial risk. The main types of derivatives are futures, forwards, and options'.

Market Capitalization Ratio (MCR): This measure equals the value of listed shares divided by GDP. The assumption behind this measure is that overall market size is positively correlated with the ability to mobilize capital and diversify risk on an economy-wide basis.

Total Value of Shares Traded Ratio (STR): This measure equals total value of shares traded on the stock market exchange divided by GDP. The total value traded ratio measures the organized trading of firm equity as a share of national output and therefore should positively reflect liquidity on an economy-wide basis.

Overview of Financial Markets

Saunders and Cornett (2004) define financial markets as structures through which funds flow. They include bond and stock markets and are important in channeling funds from people who don't have a productive use for them to those who have shortage and who do. A primary function of financial markets is one of facilitating responsible governance within the firm. Poor performing financial markets are reasons why many countries in the world remain poor while well performing markets are important in producing high economic growth.

Sheffrin (2003) defines a capital market as a market for securities (debt or equity), where business enterprises, companies and governments can raise long-term funds. It is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on other markets like the money market. The capital market includes the stock market that is equity securities and the bond market (debt). Financial regulators, such as the UK's Financial Services Authority (FSA) or the U.S. Securities and Exchange Commission (SEC), oversee the capital markets in their designated jurisdictions to ensure that investors are protected against fraud, among other duties. Capital markets may be classified as primary markets and secondary markets. In primary markets, new stock or bond issues are sold to investors via a mechanism known as underwriting. In the secondary markets, existing securities are sold and bought among investors or traders, usually on a securities exchange, over-the-counter, or elsewhere.

The economic functions of financial markets include provision of a mechanism for an investor to sell financial securities and therefore it offers liquidity, it determines the price of the traded security and the required return on the financial instrument as well as reducing the cost of search and information of transacting that is done through advertizing (Fabozzi and Modigliani, 2003)

Financial Markets are divided into two segments, Primary versus Secondary markets and Money versus Capital markets. Financial markets can be categorized into domestic and foreign markets. Domestic market is where issuers domiciled in the country issue securities and subsequently traded while foreign markets is where securities of issuers are not domiciled in the country where they are sold and traded.

The promotion of economic growth by the private sector requires the creation of an environment that will allow prosperity of the private sector and this means the private sector must be able to access finance easily using certain facilities such as bank credit, equity, payments and risk management services. The development of the financial sector follows a trend whereby savings and investments are channeled through the bank leading to the development of the capital markets where savers look for higher returns and companies seek cheaper capital.

Financial markets usually consist of several institutions which include banks, insurance companies, mutual funds, mortgage firms, finance companies and stock markets. According to Adjasis and Biekpe (2005) a well-developed financial system promotes investment by identifying and financing lucrative business opportunities, mobilizing savings, allocating resources efficiently, helping diversify risks and facilitate the exchange of goods and services. In Africa financial markets are dominated by commercial banks, which have proved to be unreliable sources of long term financing. The regulatory reserve requirements as well as the nature of their Assets and Liabilities have made it difficult for them to supply long term capital. The use of treasury bills by the governments has resulted in the crowding out effect of the private sector as most of the commercial banks asset portfolio is held in the government bills.

While determinants of cross-country economic growth have been of great interest to development economists and economic growth theory, the role of financial markets and institutions has traditionally received very little attention. Recent finance literature reports strong relations between indicators of financial development and economic performance in the real sector, indicating a positive role for capital markets and institutions. Levine and Zervos (1998) find a strong correlation between financial development, and growth in per capita GDP and productivity.

Economic growth in a modern economy centres on an efficient financial sector that pools domestic savings and activates foreign capital for productive investments. This means that productive projects may remain untapped if the financial institutions are ineffective and inefficient therefore reducing the capacity of competing globally with other economies.

Even though there has been progress in exploring this area, there is still no clear understanding to the precise mechanisms through which the financial system could affect economic performance in the real sector. As Zingales (2003) notes, this lack of understanding has been one of the reasons why it has been so difficult to draw policy conclusions from the finance-growth literature. Identifying the channels of influence is also important for instilling confidence in the accepted first-order relations between finance and growth by strengthening the argument for causality running from the financial to the real sector.

Having different non financial institutions protect economies from financial shocks and therefore making capital markets to be better options in mobilizing domestic and international capital. Stock wealth plays a role in most mainstream econometric models of a country's economy. For example, according to the Federal Reserve Board's model in the USA, a 20 percent decline in stock prices lowers GDP by about 1.25 percent after one year. Financial markets, particularly stock markets, have grown greatly in developed and developing countries over the last two decades and several factors have aided in their growth and this include improved macroeconomic fundamentals, such as more monetary stability and higher economic growth. General economic and specific capital markets reforms, including privatization of state-owned enterprises, financial liberalization. The improved institutional framework for investors, have further encouraged capital markets development. The increase of investment particularly in developing countries by international investors is due to progressive ease on the barriers of entry that restricted participation of foreign investors, direct restriction on foreign ownership of shares been relaxed as well as the introduction of new or revised legislation and governance structures.

According to World Bank capital market integration report (Washington, DC: 2002) African Stock markets are extremely small by world standards, with the exception of South Africa. South Africa accounts for 80% of African stock market capitalization. In Kenya the performance of the Nairobi Stock Exchange changed in the early 1990s with the onset of liberalization and economic reforms. Over the last two decades capital markets in developing countries have experienced tremendous growth with the aggregate market capitalization of the countries rising from $448 billion in 1998 to $2,225 billion in 1996 as classified by the IFC, while trade on stocks rose from $41 billion to $ 1,586 in the same period. Capital markets have the potential to meet the fixed capital needs of the private sector therefore they can ensure the efficient and sustainability funding of the governments, corporations, banks and large scale or long term projects. The effective functioning of capital markets requires the existence of an exchange clearing and settlement system, existence of legal systems to enforce contracts as well as the availability of information on financial soundness and future prospects of companies.

Despite a surge of global investor interest in the 1980s and 1990s, Africa has been bypassed by the massive international capital flowing to developing economies. Aggregate capital flows to developing countries have been rapidly exceeding official development assistance flows since 1980s. However, according to (Senbet and Otchere 2006) Africa remains the only developing region in which development assistance flows exceeds private capital flows. This was mainly attributed to the lack or absence of a well developed financial sector (capital markets, banks, finance companies, and insurance companies) and the poor economic policies and institutions in African countries. Capital markets are a vital part of an economy making it possible for industry, trade and commerce to flourish without any obstacle in terms of resources.

Sharpe, et al (1999), defines the stock market as an instrument through which the transaction of financial assets with a life span of greater than one year takes place. Financial assets may take different forms ranging from the long-term government bonds to ordinary shares of various companies. Stock market is a very important component of capital market where the shares of various firms are traded.

According to Sing (1997) the channels through which stock markets influence economic development are the savings rate, the quantity of investment and the quality of investment.

In His research paper stock market (2007) Lawrence Nyalle discussed the stock market as one of the most closely observed economic and development phenomena in the world. Traders and investors buy, sell and hold decisions in the market with the sole objective of increasing their current wealth.

According to Reilly(1997) and Fabbozi(1995) A stock market is an institution that deals in exchange of securities issued by publicly quoted companies and the government . The stock market is part of the broader market referred to as financial market.

Gulley and Shaw (1997) looked at the relationship between financial markets and real economic activity and argued that developed and developing countries differed in the financial system and conclude that financial markets foster development through enhancing physical capital accumulation.

Greenwood and Smith (1996) demonstrate that large stocks can lower cost of savings and therefore facilitated investment in most productive sectors.

Kyle (1984) argued that liquid stock markets can increase incentives to get information about firms and improve co-operate governance.

Faboozzi (1995) argued that stock markets provide investors with a well-organized mechanism to liquidate their investments. The very fact that investors are certain of the possibility of selling out what they hold as and when they want, is a major incentive for investment as it guarantees mobility of capital in the purchase of assets .The interactions of buyers and sellers in a stock market determine the price of traded assets or equivalently the required return that investors demand and is this feature of stock market that signals how funds in the economy should be allocated among financial assets.

Earlier research emphasized on the role of the banking sector in the economic growth of nation. In the past decade, the world stock markets surged, and emerging markets accounted for a large amount of this boom. Recent research has begun to focus on the linkages between the stock markets and economic development. New theoretical work shows how stock market development might boost long-run economic growth and new empirical evidence supports this view.

Adjasi and Biekpe (2005) found a significant positive impact of stock market development on economic growth in countries classified as upper middle-income economies. Despite of alternative views empirical works continue to show largely some degree of positive relationship between stock markets and growth. These studies were largely based on developed countries only. They discuss that the Stock market development in Sub-Saharan Africa has had Critical issues and challenges African stock market facing challenge of integration and need better technical and institutional development to address the problem of low liquidity.

Atje and Jovanovic (1989) compare the impact of the level of stock market development and bank development on economic growth and discover that a large effect of the stock market development as measured by the value traded divided by the GDP has a positive impact on the economy but bank development had no effect.

King and Levine (1993) researched on the relationship between economic growth and stock market They found that all financial indicators have strong positive correlation with economic growth. Using cross country regression countries with higher indicators of financial development had higher real GDP (Gross Domestic Products) growth rates at one point.

Hamadi Mohtadi and S. Agarwal (2001) examined the relationship between stock market development and economic growth for 21 years and the results suggested a positive relationship between several indicators of stock market development and economic growth both directly and indirectly by boosting private investment behavior.

Levine and Zervos (1998) investigate the relationship between economic growth and various stock market development indicators in a sample of 47 countries over the period of 1976-1993 their results show that various measures of equity market activity have a positive and significant influence on economic growth

Bolbol, Fatheldin, and Omran (2005) analyzed the effect of financial markets (measured by the ratio of market capitalization on GDP and the turnover ratio) on total factor productivity and growth (the per capita GDP growth rate) in Egypt (1974-2002); they demonstrated that capital market development had a positive influence on factor productivity and economic growth.

Rousseau and Wachtel (2000) confirm these findings using data for 47 countries over the period 1980-1995. They find the components of financial intermediary development to be positively associated with economic growth.

Demirguc-Kunt and Levine (1996), Singh (1997), and Levine and Zervos (1998) find that stock market development is playing an important role in predicting future economic growth. The Stock Market plays an important role in the economy. It determines the economic strength of the country and has a pivotal role in mobilizing resources for development of capital market.

Murinde (1999), mentioning the work of (Tayler 1991 and Murinde 1993) suggests that the financial system has a doubtful role to play in the growth of the economy especially given the financial difficulties in most African economies. The financial sector is small relative to the size of the economy and consists of small ranges of institutions mainly commercial banks.

Stock exchanges are expected to increase the amount of savings channeled to corporate sector. Some evidence can be found in the work of Greenwood and Jovanovich (1990) Furthermore, the study concluded that the stock markets play an important role in allocation of capital to corporate sector that in turn stimulates real economic activity. Many countries are facing financial constraints particularly developing countries, where bank loans are restricted to some favorable groups of companies and personage investors. This limitation can also reflect constraints in credit markets (Mirakhor and Villanueva, 1990).

Bell and Rousseau evaluated the relationship between individual macroeconomic indicators and measures of financial development in India and revealed that the financial sector has been instrumental in promoting economic performance.

Levine in his work(1998) argued that the ability to trade equity easily plays a key role in economic growth although profitable investments require long run commitment to capital and savers prefer not to surrender control of their savings for long periods.Studying the effect of different components of financial systems on economic growth in Taiwan, Korea and Japan, Liu and Hsu (2006) emphasized the positive effect of stock market development (measured by market capitalization as percentage of GDP, turnover as percentage in GDP and stock return) on economic growth.

Ben Naceur and Ghazouani (2007), studying the influence of stock markets and bank system development on economic growth on a sample of 11 Arab countries, concluded that financial development could negatively influence the economic growth in countries with underdeveloped financial systems; they stressed the role of building a sound financial system. Fabozzi and Modigliani (2003) analyzed that stock markets also help to reduce investment risk due to the ease with which equities are traded. Capital markets make financial assets and securities tradable and thus reducing the liquidity risks.

Senbet and Otchere (2006) have found that well-functioning capital markets, along with well-designed institutions and regulatory systems, foster economic development where the government sets up systems and institutions that will help protect investors from losing their investments and as a result this boosts investor's confidence in the market.

Yartey and Adjasi (2007) believe that the development of stock markets in Africa is expected to boost domestic savings and increase the quantity and quality of investment. They further disagreed with critics who stated that stock markets might not perform efficiently in developing countries and that they might not be feasible for all African countries to promote stock markets, given the huge costs and the poor financial structures. Yet, corporate financing patterns in some African countries suggest that stock markets are an important source of finance.

The stock market in Ghana financed about 12 percent of total asset growth of listed companies between 1995 and 2002, 16 percent in South Africa between 1996 and 2000, and 8 percent in Zimbabwe between 1994 and 1999. In all these countries, the stock markets were the single most important source of long-term external finance. They also mentioned that the problem of most capital markets in Africa is that they have only a limited number of listed companies in their stock exchanges; trading occurs in only a few stocks which account for a considerable part of the total market capitalization and supervision by regulatory bodies is Inadequate.

Rindal (1990) analyzed data from 1985-1997 for high, middle and low income countries. The measures of stock market development were market capitalization, turnover velocity and found a stronger relationship between future economic growth and stock market development in the countries and the study provided a significant positive relationship between stock market development and economic growth particularly In low income countries.

Tunler B (1998) examined the causality relationship between stock market and economic growth based on time series data from 20 countries 1981-1994. The stock market indicators used were liquidity, volume of transactions, and degree of concentration, legal and institutional factors that determine the overall performance of a stock exchange, informational efficiency, volatility and depth. He used Granger causality test and concluded that there was a relationship between stock market development and economic growth.

The study of St. Hill (1992), cited by Murinde (1999) finds moderate support for the supply leading hypothesis for a sample of 37 least developed countries (LDCs) which is in line with the positive correlation between capital market and economic growth linkage. The demand following hypothesis is established for a sample of 19 industrial countries.

Hondroyiannisa et al. (2005) examine empirically the relationship between the development of the banking system as well as stock market and economic performance for Greece over the period 1986–1999. Their empirical findings using VAR models suggest that there is a bi-directional causality between finance and growth in the long run. While their results from using error-correction models show that both bank and stock market financing can promote economic growth in the long run.

Study done by Platt (1998) investigated whether the stock market is a component of economic growth for a country. The study concluded that stock market countries showed a better GDP growth than those countries without stock markets but the study showed that the risk index of a country and a country's income level are the best predictors of a functioning stock market. The higher the country risk index and the lower the income level of a country the lesser is the functioning of a capital market of a country and vice-versa. He also noted that this study could be a warning for lower incoming countries.

Relation of the stock market to modern financial system

The financial systems in most western countries have undergone a remarkable transformation. One feature of this development is disintermediation. A portion of the funds involved in saving and financing flows directly to the financial markets instead of being routed via the traditional bank lending and deposit operations. The general public's heightened interest in investing in the stock market, either directly or through mutual funds, has been an important component of this process.

Statistics show that in recent decades shares have made up an increasingly large proportion of households' financial assets in many countries. The major part of this adjustment in financial portfolios has gone directly to shares but a good deal now takes the form of various kinds of institutional investment for groups of individuals, example pension funds, mutual funds, hedge funds, Insurance investment of premiums. The trend towards forms of saving with a higher risk has been brought about by new rules for most funds and insurance, permitting a higher proportion of shares to bonds. Similar tendencies are to be found in other industrialized countries. In all developed economic systems, such as the European Union, the United States, Japan and other developed nations, the trend has been the same, saving has moved away from traditional bank deposits to more risky securities of one sort or another.

Stock Market Performance Indicators

The prices of stocks around the world do not move together in an exact manner. This is because the economic systems have different environments in which they operate in for example terms of taxation, industrial growth, political stability and monetary policies among other factors differ from one country to another. Stock markets may experience a general increase in price level referred to as a bull market or general decrease in price level referred to as bear market. Stagnant prices or sudden big price movements downward is referred to as stock market crash.

Stock market indexing, market capitalization and stock turnover are among the main measures of stock performance. Stock market indexing is one of the most widely used measures of stock performance. Investors hold portfolios of many assets but it is cumbersome to follow progress on each security in the portfolio. Thus it is practical to observe the entire market under the view that their portfolio moved in the same direction as the aggregate market. According to Simiyu (1992) the market index such as the NSE index is used to observe total returns for an aggregate market and these computed returns are to judge various performances of individual portfolios.

Market Capitalization is also a measure of the stock performance. This measure is used to measure market movements by measuring the total value of stock in a particular stock market by aggregating the market value of the quoted stocks.

According to Otuke(2006) Changes in market capitalization occur due to fluctuations in share prices or issuance of new share prices or issuance of new shares and bonus issues. This implies that high activity at the stock market may indicate more investments in the stock markets. Market turnover indicates inflows and outflows in the stock market and is based on the actively traded shares. A change occurs due to the actively traded shares and to fluctuations in share prices or number of shares traded in a given day.

A study by Reilly (1997) reveals that other determinants of stock market performance include fiscal policies, monetary policies, inflation, performance of the economy change of investor preferences and market sentiments. Activities of government and general performance of the economy influence stock market activity and therefore the performance of stock markets.

Fiscal and monetary policies influence the economies of those countries resulting in economic conditions which will influence the companies either positively or negatively and in turn affect the performance of the stock market.

Fiscal policy involves incentives such as tax cuts which will increase spending while increase in government spending through taxation will reducing spending. This means that an increase or decrease in government spending will influence the economic activity by triggering the multiplier effect.

Changes in investor composition also affect stock performance and this can be seen when there is a change in supply and demand for various securities which will result in attracting different types of investors. This will mean that the required rate of return will shift if the risk preferences of the investors are not as those of the current ones.

The uncertain mass reaction of individuals to developments affecting the stock market is one of the factors that handicaps stock market forecasting. This is known as market sentiment and is also known as psychology of market participants which affects stock market performance. This especially happens for example when individuals anticipate the rising of share prices of a certain company and this results to everyone rushing to get the maximum profit out of it. Also a mild stock market outbreak caused by a surge in business activity may generate a wave of buying enthusiasm that raises prices to blossom levels.

Inflation affects the performance of stock markets as it causes differences between real and nominal interests' rates thus changing the spending and saving behaviour of consumers and corporations. Unexpected changes in the rate of inflation make it difficult for firms to plan, which inhibits growth and innovations .Beyond the impact of the domestic economy, differential inflation and interest rate influence the trade balance between countries and exchange rate of currencies (Reilly, 1997)

Theoretical Framework

Much work remains to be done to better understand the relationship between stock market development and economic growth however. Levine (1991) did a study that developed a theoretical framework on the relationship between stock market development and economic growth and tested it empirically. A time series cross section data for 21 countries from 1977-1997 suggested that stock market development is positively associated with economic growth.

The empirical relationship between stock market development and the long-run growth remains strong even after controlling for lagged growth, initial level of GDP, Foreign Direct Investment The paper suggested that stock market development contributed to economic growth both directly and indirectly. He analyzed that market liquidity (turnover ratio) had a positive impact on growth. Indirectly, market size (capitalization ratio) affects investments which, in turn, affect growth. The empirical results do support the theoretical literature in suggesting that the stock market development leads to higher growth because it reduces both liquidity and productivity shocks. Most countries that had a positive economic growth rate had a high level of market capitalization ratio as well as shares traded. For example Korea had a long growth rate of 8.09% while the market capitalization ratio was at 22.83% of the GDP and the share traded ratio was at 24.75%. The following table shows statistical data on emerging markets.

Table 1.1 Statistical data on Emerging Markets (1977-1997)

COUNTRY	Growth Rate	Investment % of GDP	GDP Mil of $	Education	FDI Mil of $	MCR % of GDP	STR % of GDP	TR
Argentina	2.24%	20.13%	$ 146,006	64.75%	$1,585	5.68%	1.88%	32.54%
Brazil	2.79%	21.03%	$ 375,114	41.73%	$3,244	13.51%	7.00%	52.50%
Chile	5.88%	22.22%	$ 33,293	66.36%	$ 928	48.09%	4.06%	7.48%
Colombia	4.00%	19.47%	$ 46,619	55.09%	$ 987	6.90%	0.07%	9.14%
Egypt	5.07%	23.79%	$ 34,567	64.36%	$ 741	6.85%	0.97$	9.30%
Greece	1.78%	21.60%	$ 57,491	87.89%	$742	10.12%	2.43$	16.42%
India	5.10%	22.89%	$ 240,606	38.86%	$ 463	13.87%	4.50%	48.91%
Indonesia	7.11%	28.74%	$ 113,592	38.55%	$ 1,318	7.48%	2.96%	24.69%
Korea	8.09%	32.82%	$ 191,217	85%	$ 2,326	22.83%	24.75%	94.36%
Malaysia	7.22%	32.84%	$ 43,912	55.18%	$ 2,285	112.08%	48.68%	30.61%
Mexico	2.97%	22.37%	$ 224,599	53.09%	$3,673	15.50%	6.30%	51.21%
Nigeria	2.25%	18.53%	$ 51,230	22%	$ 692	4.42%	0.05%	0.86%
Pakistan	5.64%	18.84%	$ 37,909	16.83%	$ 232	8.87%	3.70%	24.15%
Peru	2.00%	21.89%	$ 240,606	65%	$ 526	8.24%	1.70%	20.77%
Philippines	2.93%	24.03%	$ 113,592	70.10%	$ 515	24.31%	6.97%	25.67%
Portugal	2.90%	27.82%	$ 191,217	65.22%	$ 1950	6.88%	2.02%	17.79%
South Africa	1.81%	21.04%	$ 43,912	80%	$ 143	128.41%	8.89%	6.21%
Thailand	7.40%	33.34%	$ 224,599	33.18%	$ 1104	25.76%	18.37%	74.37%
Turkey	4.13%	20.93%	$ 51,230	47.36%	$ 372	6.72%	9%	66.57%
Venezuela	1.70%	22.26%	$ 62187	36.27%	$ 665	8.37%	1.41%	14.03%
Zimbabwe	1.08%	19.53%	$ 5806	35.18%	$ 9	14.85%	1.17%	6.16%

Source: Statistical Data International Finance Statistics 1997

1.6 Hypotheses of the study

1. Economic Growth in Kenya has been influenced by the country's capital market development.

2. The intervention of the government in the stock market has had a positive impact in the market.

1.7 Scope of Study

The target population is the capital markets authority, the Nairobi stock exchange, Investments banks, finance companies and the government of Kenya The study looks at the Nairobi Stock exchange and data collected is within a time series of between 1997-2010

1.8 Research methodology

The study involved the use of both the primary and secondary data. Primary data involved direct interaction with the respondents through direct unstructured interviews, telephone interviews. The primary source of data was collected through interviews from investments banks; Nairobi stock exchange and Commercial banks. The respondents were investment managers and bank officers who work in the custodial department which is under the alternate business of the bank.

Secondary data will involve the use of books, NSE annual reports and statistical bulletins, World Bank journals and articles. Most of the data related to economic growth and stock market development will be collected from annual report and official reports of concerned organization. The required information will be supplemented by Ministry of Finance, Department of Industries, Commerce and Supplies, economic surveys.

1.9 Chapter Outline

Chapter One: Introduction

The chapter introduces the topic of the research study by setting the broad context of the research study, statement of the problem, objectives to be achieved, justification of the study, literature review, theoretical framework, hypothesis, scope of the study and methodology.

Chapter Two: A Global Overview of Capital Markets

It examines the global view of capital markets and its trends, historical overview of capital markets in Africa, stock market indicators capital markets in Africa and the challenges facing capital markets in Africa. The growth of capital markets and the comparison in developed and developing countries.

Chapter Three: History and Development of the NSE

he chapter starts off by examining the historical and development of the NSE, listed companies in the NSE, its benefits, how the stock market operates and the studies that have been done on it.

Chapter Four: Impact of Capital Markets on Economic Growth

The chapter discusses the growth of the stock market and its relationship with the economic growth; analyze the data collected in relationship to the objectives and hypothesis.

Chapter Five: Summary, Conclusion and Recommendations.

The chapter provides a summary conclusions and recommendations arising from the study.

CHAPTER 2

A GLOBAL OVERVIEW OF CAPITAL MARKETS

2.1 Introduction

A stock market is an entity which provides trading facilities for stock brokers and traders, to trade stocks and other securities. Stock markets also provide facilities for the issue and redemption of securities as well as other financial instruments and capital events including the payment of income and dividends. The securities traded on a stock market include: shares issued by companies, unit trusts, derivatives, pooled investment products and bonds. To be able to trade a security on a certain stock market, it has to be listed there. Usually there is a central location at least for recordkeeping, but trade is less and less linked to such a physical place, as modern markets are electronic networks, which gives them advantages of speed and cost of transactions. Trade on a market is by members only.

Primary markets are markets in which users of funds (e.g. corporations) raise funds through new issues of financial instruments such as stocks and bonds. Fund users issue securities in the external primary markets to raise funds for new projects or expand existing ones. New issues of financial instruments are sold to the initial suppliers of funds (e.g. households) in exchange for funds (money) that the issuer or user of funds needs. Primary market transactions between the issuing corporations (fund users) and investors (fund suppliers) are arranged through financial institutions such as investment banks who serve as intermediaries.

Once financial instruments such as stocks are issued in primary markets, they are then traded that is rebought and resold in secondary markets. Buyers of secondary market securities are economic agents (households, businesses and governments) with excess funds. Sellers of secondary market financial instruments are also economic agents in need of funds. Secondary markets provide a centralized market place where economic agents know they can transact quickly and efficiently. These markets therefore save economic agents the search and other costs of seeking buyers and sellers in their own.

The improved flow of all important financial information and the strengthened investor laws and regulations have only beckoned the foreign investors to developing countries. Foreign investors see this as a great opportunity to gather in some money and carry it home happily. There is usually no compulsion to issue stock via the stock market itself, nor must stock be subsequently traded on the market. Such trading is said to be off market or over-the-counter. This is the usual way that derivatives and bonds are traded. Increasingly, stock markets are part of a global market for securities.

The initial offering of stocks and bonds to investors is by definition done in the primary market and subsequent trading is done in the secondary market. Supply and demand in stock markets is driven by various factors which, as in all free markets, affect the price of stocks. Stocks markets across the world have seen a massive growth. The recession that we are facing today has played spoilsport and has hindered growth, and this applies to the stock market sector as well. Emerging countries too are seeing a dramatic growth in the stock market Investments. Better profits are the main reason for the investors to look into stock markets as a viable option. In developing countries risks are low, and returns are generally higher. Bank research and statistics also prove that the stock markets in developing countries give better returns so it makes sense to diversify your investments not only across various sectors with the country but also diversify your portfolio across various developing nations. Developing countries are showing structural reforms, economic and legislative changes, governments have either eliminated or liberalized capital restrictions and this has been a boom to the foreign investor.

Stocks are how companies get funded to grow larger. Usually, when someone wants to start a business, they pay for it with loans or even their own credit cards. Once they grow the company enough, they can get bank loans, or even float their own bonds to individual investors. But, eventually they will need a lot of money to really take the business to the next phase. In the US the stock market is so sophisticated; it is easier in this country than in many others to take a company public. This helps the economy grow, since it provides a boost up to companies wishing to grow very large. The stock market's sophistication means that information on companies is easy to obtain, and this increases the trust of investors from around the world. As a result, the US stock market attracts more investors, making it even easier for a US company to go public (Gilson, Ronald J.; Black, Bernard S. 1998).The stock market is also an economic indicator of how well the economy is doing. If investors are confident in the economy, they will buy stocks.

Financial markets usually consist of several institutions which include banks, insurance companies, mutual funds, mortgage firms, finance companies and stock markets. According to Adjasis and Biekpe (2005) point out that a well-developed financial system promotes investment by identifying and financing profitable business opportunities, mobilizing savings, allocating resources efficiently, helping diversify risks and facilitate the exchange of goods and services. In Africa financial markets are dominated by commercial banks, which have proved to be unreliable sources of long term financing. The regulatory reserve requirements as well as the nature of their Assets and Liabilities have made it difficult for them to supply long term capital. The use of treasury bills by the governments has resulted in the crowding out effect of the private sector as most of the commercial banks asset portfolio is held in the government bills.

As the global equity markets have experienced their most explosive growth over the past decade, emerging equity markets have experienced an even more rapid growth, taking on an increasingly larger share of this global boom. For example, the overall capitalization globally rose from \$4.7 trillion to \$15.2 trillion, the share of emerging markets jumped from less than 4 to 13 percent in this period (CMA handbook 2002).

Trading activity in these markets surged equally fast: the value of shares traded in emerging markets climbed from less than 3 percent of the \$1.6 trillion world total in 1985 to 17 percent of the \$9.6 trillion shares traded in all world's exchanges in 1994. (CMA handbook 2002).

The promotion of economic growth by the private sector requires the creation of an environment that will allow prosperity of the private sector and this means the private sector must be able to access finance easily using certain facilities such as bank credit, equity, payments and risk management services. The development of the financial sector follows a trend whereby savings and investments are channeled through the bank leading to the development of the capital markets where savers look for higher returns and companies seek cheaper capital.

Having different non financial institutions protect economies from financial shocks and therefore making capital markets to be better options in mobilizing domestic and international capital. Stock wealth plays a role in most mainstream econometric models of a country's economy. For example, according to the Federal Reserve Board's model in the USA, a 20 percent decline in stock prices lowers GDP by about 1.25 percent after one year. Financial markets, particularly stock markets, have grown greatly in developed and developing countries over the last two decades and several factors have aided in their growth and this include improved macroeconomic fundamentals, such as more monetary stability and higher economic growth.

General economic and specific capital markets reforms, including privatization of state-owned enterprises, financial liberalization. The improved institutional framework for investors, have further encouraged capital markets development. The increase of investment particularly in developing countries by international investors is due to progressive ease on the barriers of entry that restricted participation of foreign investors, direct restriction on foreign ownership of shares been relaxed as well as the introduction of new or revised legislation and governance structures.

2.2 A historical overview of Capital Markets in Africa

In Africa the banking system is the predominance source of finance. Financial markets have reduced the dependency on banking which has not been a reliable source of long term financing and most companies opt to raise capital through the stock exchange by offering shares. It has been noted that heavy reliance on banks increases vulnerability of financial systems as exemplified by the Asian financial crisis in the 1990s. Capital markets have the potential to meet the fixed-capital needs of the private sector. They can ensure the efficient and sustainable funding of governments, corporations, banks, and large-scale or long-term projects. In Africa most countries set up stock exchanges as a precondition for the introduction of market economies under the structural adjustment programs which were propagated by the IMF so as to facilitate the privatization of the state owned companies. Prior to 1989 there were only eight stock markets; five in Sub-Saharan Africa (SSA) and three in North Africa. At present there are over twenty stock exchanges in the continent. However in the recent Angola, Cameroon, Cape Verde, Libya, Mozambique, Rwanda, and Sudan are some of the African countries that have proposed or established domestic stock exchanges. (http://www.uneca.org/eca_resources publication).

Table 2.1: Number of firms listed on African stock exchanges, by country. (1990-2007)

Country	Year of Establishment	Number of listed firms
Algeria	1997	3
Botswana	1989	44
Côte d'Ivoire	1998	27
Cameroon	2001	2
Egypt	1883	656
Ghana	1990	28
Kenya	1954	50
Libya	2007	7
Malawi	1995	8
Mauritius	1988	40
Morocco	1929	81
Namibia	1992	3
Nigeria	1960	223
Rwanda	2005	4
South Africa	1887	410
Swaziland	1990	10
Tanzania	1998	11
Tunisia	1969	56
Uganda	1997	14
Zambia	1994	16
Zimbabwe	1993	81

Source: The African Securities Exchanges Association (ASEA)

Table 2.2 Statistical Data on African Stock Markets (excluding South Africa

	1988	1997	2002
No of Stock Exchanges	6	14	18
Market Capitalization of African Stock Markets (US$ Billion)	5.5	49	66
Value traded (US$ Billion)	0.16	8.6	6.5
No of listed companies	788	1180	1760

Source: Sunil Benimadhu, *Assessing African Equity Capital Markets: The Mauritius Stock Market*. Presentation at Corporate Council on Africa (New York, February 26, 2004)

Table 2.3 Market capitalization of stock exchanges in Africa at the end of 2002

	Country	Name of Stock Exchange	Stock Market Capitalization for the end of Dec. 2002 (USD. Millions)
1	South Africa	JSE Securities Exchange	182,616
2	Egypt	Cairo and Alexandria Stock Exchange	26,245
3	Zimbabwe	Zimbabwe Stock Exchange	11,689
4	Morocco	Bourse de Casablanca	8,319
5	Nigeria	Nigeria Stock Exchange	5,989
6	Tunisia	Bourse de Tunis	1,810
7	Botswana	Botswana Stock Exchange	1,717
8	Kenya	Nairobi Stock Exchange	1,676
9	Cote d'ivore	Bourse Re'gionale Des Valeurs Mobilieres S.A	1,329
10	Mauritius	Stock Exchange of Mauritius	1,324
11	Tanzania	Dar-es-Salaam Stock Exchange	695
12	Ghana	Ghana Stock Exchange	382
13	Zambia	Lusaka Stock Exchange	231
14	Namibia	Namibia Stock Exchange	201
15	Swaziland	Swaziland Stock Exchange	146
16	Algeria	Bourse d'Alger	145
17	Malawi	Malawi Stock Exchange	107
18	Uganda	Uganda Securities Exchange Ltd.	52

Data obtained from United Nations Development Program, African Stock Exchanges Handbook 2003

Most African stock markets are relatively small though many have grown rapidly in recent years and there have been very rapid increases in capitalization and turnover over the past decade. Turnover between 1994-2003 increased at an average annual rate of 22 percent compared to 9 percent a year for emerging markets as a whole (Galper J 1999) number of factors have contributed to the expansion and growth of the African stock markets. Many countries have been undergoing economic reform programmes that have involved a reduction in the role of the state in the economy and the stretching of the private sector. Many of the barriers to entry that have previously restricted the participation of foreign investors in many African markets have been eased progressively and many countries have liberalized exchange controls on both current and capital account, making entry and exit easier. African countries have sought capital markets not only as a means of mobilizing domestic recourses but also to attract foreign direct investment as well.

There has been a considerable development in the African capital markets since the early 1990s. Prior to 1989, there were just five stock markets in sub-Saharan Africa and three in North Africa. Today there are 19 stock exchanges ranging from starts ups like Uganda and Mozambique stock exchanges to the Nigeria and Johannesburg stock exchanges.2 With the exception of South Africa, most African stock markets doubled their market capitalization between 1992 and 2002. Total market capitalization for African markets increased from US$113,423 million to US$ 244,672 million between 1992 and 2002.(International Financial Statistics IMF).

The following table shows the indicators of Stock market development and number of listed companies in Africa in 2004

Table 2.4 Indicators of stock market development in Africa 2004

Country	No of listed companies	Market Capitalization (percent of GDP)	Value Traded (% of GDP)	Turnover (%)
Botswana	18	29.4	0.6	2.1
Egypt	792	51.3	7.5	17.1
Cote d'Ivoire (BRVM)	39	13.6	0.3	2.5
Ghana	29	30.7	0.8	2.2
Kenya	47	24.9	2.1	8
Malawi	8	9	1	11.1
Mauritius	41	39.3	1.6	4.4
Namibia	13	8.1	0.3	4.7
Nigeria	207	20.1	2.3	13.5
South Africa	3	214.1	76.5	45
Swaziland	6	9.3	0	0
Tanzania	6	6.2	0.2	2.5
Uganda	5	1.4	0	0.2
Zambia	11	8	0.1	1.1
Zimbabwe	79	87.9	14	5.5
Average Africa	113.6	36.9	7.2	8
Average SSA*	39.2	22.1	1.8	[illegible]

Source: World Bank, World Development Indicators and authors' calculations.
***Excluding South Africa**

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Source: World Bank, World Development Indicators and authors' calculations.
***Excluding South Africa**

The rapid development of stock markets in Africa does not mean that even the most advanced African stock markets are mature. In most of these stock markets, trading occurs in only a few stocks which account for a considerable part of the total market capitalization.

Beyond these actively traded shares, there are serious informational and disclosure deficiencies for other stocks. Further, supervision by regulatory authorities is often far from adequate. The less developed of the stock markets suffer from a far wider range of such deficits.

The average number of listed companies on sub-Saharan African markets excluding SouthAfrica is 39 compared with 113, with the inclusion of Egypt and South Africa. Market capitalization as a percentage of GDP is as low as 1.4 in Uganda. The Johannesburg Securities Exchange in South Africa has about 90 percent of the combined market capitalization of the entire continent. Excluding South Africa and Zimbabwe the average market capitalization is about 27 percent of GDP. This is in contrast with other emerging markets like Malaysia with a capitalization ratio of about 161 percent.

African stock markets suffer from the problem of low liquidity. Liquidity as measured by the turnover ratio is as low as 0.02 percent in Swaziland compared with about 29 percent in Mexico. Low liquidity means that it will be harder to support a local market with its own trading system, market analysis, brokers, and the like because the business volume would simply be too low.

Despite the problems of small size and low liquidity, African stock markets continue to perform remarkably well in terms of return on investment. The Ghana Stock Exchange was adjudged as the world's best-performing market at end of 2004 with a year return of 144 percent in US dollar terms compared with 30 percent return by Morgan Stanley Capital International Global Index (Databank Group, 2004). Within the continent itself five other bourses—Uganda, Kenya, Egypt, Mauritius and Nigeria apart from Ghana—were amongst the best performers in the year.

The growth in market capitalization in Africa has been remarkable as more countries venture into the development of their capital markets. The growth has also been due to innovation such as integration of regional markets for example in West Africa 8 French countries created a regional market Regionale des Valeurs Mobilieres (BRVM). The member countries are Senegal, Togo, Mali, Ivory Coast, Benin, Burkina Faso, Niger, and Guinea Bissau(United Nations Development Program, African Stock Exchanges Handbook 2003) Most of the countries establishing new markets have established legal and regulatory regimes. For example in Kenya we have the Capital Market Authority which oversees the capital markets in their designated jurisdictions to ensure that investors are protected against fraud and among other duties.

The study done by Murinde (1999) indicated that most African countries are eager to develop capital markets as a direct way of mobilizing risk capital for the corporate sector. African countries should play a key role of attracting foreign portfolio investment therefore integrating domestic economies to the global economy. However, in Africa the markets are not closely linked to the international markets as in the case of Asia. This has been a disadvantage to their growth but has made them attractive to investors because of their independence since they are not majorly affected by shocks to the world markets for example in the 1990s during the Asian crises and the recently world global economic crises. Activity in a number of African capital markets has increased due to an increase in the listings of companies mostly made by privatization of state owned companies.

Table 2.5 Number of listed companies

Country	2006	2007	2008	2009
Botswana	18	30	31	31
Cote d'Ivoire	40	40	40	40
Egypt	595	435	373	313
Ghana	32	32	35	35
Kenya	52	54	56	55
Mauritius	41	41	40	40
Malawi	11	13	15	15
Morocco	63	73	73	73
Namibia	28	27	29	29
Nigeria	202	212	213	216
South Africa	401	422	425	396
Swaziland	6	6	5	5
Tanzania	10	10	14	15
Tunisia	48	48	50	52
Uganda	11	12	13	13
Zambia	16	17	19	21
Zimbabwe	83	85	90	96
Sudan	51	53	53	53
Mozambique	5	7	6	6
Libya	4	6	6	6
AFRICA TOTAL	1717	1623	1586	1510

Source: International Financial Stastistics (IMF) Senbet& Otchere (2008)

On the global front. African stock markets accounted for approximately 3% of listed companies as at end of 2009. In this particular year, the net effect of new listings and de-listings was -76 companies.

2.3 Challenges of Stock Markets in Africa.

Lack of liquidity remains a serious problem for African markets but returns on investment in the markets have been impressive despite of the weakness experienced in the markets. Low liquidity means that it is harder to support a local market with its own trading system, market analysis and brokers because the business volume would be low. Liquidity is measure by the turnover ratio which in Table 2.4 shoes Uganda at 0.2 while Swaziland at zero compared to 45.0 in South Africa which has less liquidity issues.

Political uncertainties and economic policies in most African countries have lead to the decline in the confidence of the stock markets because of the risk of determination in the business climate. In Kenya before the last general elections in 2002. the stock market declined in performance due to political and economic policies adopted by the government that led to the withdrawal of donor funding however, the market improved performance when a new government came into power in 2003 and this is due to the renewed confidence by investors. In Zimbabwe the loss of confidence brought about by the present political regime and economic policies have lead to a decline in turnover and market capitalization since 1998.

Low saving rates in many countries have constrained demand and supply of equity in stock markets. Most citizens live on less than a dollar a day therefore constraining savings. This means therefore that most companies are unable to get long term financing from such markets this can be seen in Table 2.5 where Swaziland by end of 2009 had 5 listed companies and Mozambique had 6. Most of the citizens in these countries survive on less than a dollar there they are unable to save for investment purposes.

Poverty, war and political unrest have also lead to poor saving abilities. Since there is no order and lack of peace distorts the stability of a country. For example war torn countries like Somali have no functioning capital market.

The bond markets are underdeveloped and yet have the ability in mobilizing significant amounts of capital. The bonds are more attractive than stocks to investors and there is a need to provide accurate financial information so as to develop the bond markets.

Liquidity has been a major hindrance to the development of the stock markets which results in low trading volumes. The markets are mainly concentrated by local pension funds, banks and insurance firms that do not want to sell their shares because they have few alternatives assets to buy with their sales proceeds.

Stringent rules have discouraged local investors and entrepreneurs who would like to raise capital through the capital markets. For example in the NSE barriers have been created to possible entrants such as to family owned business which makes it difficult to raise capital. This makes the stock exchange operate like closed membership organizations.

Lack of a trained and inexperienced man power has also been a challenge to the growth of the capital markets in Africa. Most Minority shareholders have lost confidence in the markets because of lack of regulatory organizations that control the markets as well as poor governance structures in most listed companies.

2.4 Capital markets and Economic growth linkage

Many emerging markets are segmented meaning that foreign participation in the local market is limited while local residents are the main investors. This makes it difficult for such markets to be integrated into global capital markets because of dominance by the local investors.

For a country to establish and develop a well functioning capital market it has to strengthen financial institutions. Banks (saving, investment), mutual funds, pension funds, credit unions, saving associations are the most important Financial Institutions that could mobilize financial resources from households and inject fund back to the capital market. However, there are no as such developed set of financial institutions in most African countries. Commercial banks, insurance companies and financial institutions such as Microfinance Institutions (MFIs) are the only institutions in most African countries including Kenya. Financial institutions such as

Micro Finance Institutions usually in the form of saving and credit organizations and co-operative banks are the common Financial Institutions in rural areas of most African countries particularly those in Sub-Saharan Africa.

The problem of most capital markets in Africa is that they have only a limited number of listed companies in their stock exchanges; trading occurs in only a few stocks which account for a considerable part of the total market capitalization.

Murinde (1999) in most African countries the informal financial sector has a leading role in the mobilization of domestic financial resources that are out of reach for the formal sector (banking). The informal sectors are based on traditional foundations and they are not subject to control. For African governments to exploit all possible domestic resources for the mobilization of development finance the informal sector needs to integrate with the formal financial sector. The formal sector (banking) has also capital inadequacy and inefficiency and the insurance sector, performance problems. Thus, the central banks should be made better at bank regulation and supervision and strengthening the informal sector as well.

Rosenberg and Birdzell (1986) in their book "How the West Grew Rich: the economic transformation of the industrial world" that explains the cause of the growth of the western economy; put the western institutions as the pivot of the development of the western economy. They explained that institutions adopted by western nations in the different eras (for example feudalist, capitalist) of their undertaking played a significant role in the development history of the western economy.

CHAPTER 3

3.1 History and Development of the Nairobi Stock Exchange.

Dealing in shares and stocks started in the 1920's when the country was still a British colony. The market was not formal and had no rules or regulations to administer stock broking activities. Trading took place on gentlemen's agreement in which standard commissions were charged with clients being required to honour their contractual commitments of making good delivery and settling relevant costs. The stock was a minor business done by accountants, auctioneers, estate agents and lawyers who met to exchange prices over a cup of coffee who were engaged in other areas of specialisation, therefore the need for association did not arise.

In 1951 an Estate Agent by the name of Francis Drummond established the first professional Stock broking firm and approached the then finance minister of Kenya, Sir Ernest Vasey and gave the idea of setting up a stock exchange in East Africa. The tow decided to approach officials of the London Stock Exchange in July of 1953 and the two agreed to recognize the setting up of the Nairobi Stock Exchange as an overseas stock exchange. The Nairobi Stock Market (NSE) was established in 1954 as a voluntary association of stockbrokers registered under the Societies Act. In the first three years of independence the market had a number of highly oversubscribed public issues and the economy was steady. However in 1972 growth was halted by the oil crises which introduced inflationary pressures in the economy which low share prices.

In 1980 the Kenyan Government realized the need to design and implement policy reforms to foster sustainable economic development with an efficient and stable financial system. In particular, it set out to enhance the role of the private sector in the economy, reduce the demands of public enterprises on the exchequer, rationalise the operations of the public enterprise sector to broaden the base of ownership and enhance capital market development. This so the first privatisation through the NSE the sale of the government's 20% stake in Kenya Commercial Bank. In 1991 NSE was registered under the Companies Act and phased out the "Call Over" trading system in favour of the floor based Open Outcry System. The NSE was rated by the International Finance Corporation in 1994 as the best performing market in the world with a return of 179% in dollar terms. The NSE in 1994 moved to a more spacious premise at the Nation centre, setting up a computerized delivery and settlement system (DASS) and a modern Information Centre. This so a growth of the number of stockbrokers and the licensing of 8 new brokers. In 1995 the Government lowered the limitations on foreign ownership in locally controlled companies and allowed a limit of 20% while an individual to 2.5% (CMA statistical bulletin 2000) these were later doubled to 40% and 5% respectively in June 1995 so as to encourage foreign portfolio investments. In the same year the entire Exchange Control Act was repealed and seven more stockbrokers were licensed, bringing the number to twenty (www.nse.co.ke)

In 1996 the NSE saw one of the largest share issues of about 110,000 share holders acquiring a stake in the privatization of Kenya Airways. The team that spearheaded the privatization was awarded the World Bank Award for Excellence as a result of setting a model showing the successful privatization of state owned companies.The following table shows the number of new issues and the value of shares in the NSE from 1990-2007

Table 3.1 Number of new issues and value

Year	No. Of New Issues	No. Of New Issues	Value of New Shares (Kshs bn)
1990	1	9	0.3
1991	1	3.2	0.04
1992	3	42 63	0.05
1993	2	3 6	0 06
1994	3	98	2.8
1995	0	0	0
1996	5	366 9	4.93
1997	3	63 89	1.94
1998	2	37.42	2.1
1999	1	26.58	0.37
2000	3	22.61	0.45
2001	3	404.97	2.4
2002	1	60	1
2003	0	0	0
2004		62	1
2005	0	0	0
2006	4	215.5	46.4
2007			

Source: The CMA annual reports 1990-2007

Over the past 15 years, the NSE attracted thirteen (13) rights issues and twenty-one (21) Initial Public Offerings (IPOs) that raised Kshs.20 billion. Of these issues, only eight were for IPOs in the private sector which raised only Kshs.1.95 billion. Many of the new issues were driven by the Government's privatization process. (CMA annual reports 1990-2007).

In the past four years, the stock market in Kenya has grown by leaps and bounds with stock prices appreciating to record levels. On the average, the prices of quoted shares have more than quadrupled in as many years, a performance that is difficult to replicate in conventional types of investments savings and deposit accounts, real estate. Naturally, this has generated exceptional interest in the stock market by investors of all hues. In an area traditionally considered the preserve of the sophisticated investor, it is gratifying to see virtually an increase for investment in stocks and shares from ordinary Kenyans of all social strata. One direct result of the new interest in the stock market is that all the recent six public offering of shares have been massively oversubscribed. KenGen, despite its large size, was oversubscribed more than three times; Scangroup, a little understood concept company, was oversubscribed six times; Eveready, a provincial company, was oversubscribed eight times and despite the relatively high minimum subscription threshold for retail investors, AccessKenya was oversubscribed four times. More recently, Kenya Re IPO was a resounding success with oversubscription of more than four times as well as the Safaricom IPO. It is clear that investors are eager for viable investment opportunities and thousands of ordinary people who never gave shares a thought a few years ago are buying them today. There is no doubt that the stock market provides an excellent investment vehicle for putting extra money to work so that it earns good returns , either in the form of a regular income from dividends or in the form of capital appreciation or both.

The government in 1998 wanted to extend the capacity and growth of the NSE particularly on foreign investment by introducing incentives like the setting up of tax free venture Capital funds this means that companies that are listed in the stock exchange could invest in companies that are not listed, removal of Capital Gains Tax on insurance companies investments which particularly had set up investment funds, allowance of beneficial ownership by foreigners in local stockbrokers and fund managers and requiring dealing firms to have licences in order to improve market liquidity.

The NSE currently has 54 companies with equity listings in the Main and Alternative Investment Market Segments (MIMS and AIMS). (www.nse.co.ke). There is also a third segment for trading of government & corporate bonds and other fixed-income securities - the FIMS. A fourth segment for trade of derivative instruments is envisioned for the near future.

The Nairobi Stock Exchange deals in both variable income securities and fixed income securities. Variable income securities are the ordinary shares which have no fixed rate of dividend payable as the dividend is dependent upon both the profitability of the company and what the board of directors decides. The fixed income securities include Treasury and Corporate Bonds, preference shares, debenture stocks which have a fixed rate of interest or dividend which is not dependent on profitability.

Table 3.2 Listed companies in the NSE as at 2010

Agricultural sector

Symbol	Listing	Notes
KAZU	Kakuzi Limited	Coffee, tea, passion fruit, avocados, citrus, pineapple, others
RVP	Rea Vipingo Sisal Estate	Sisal
STC	Sasini Tea and Cofee	Tea, coffee

Commercial and Services

ACES	Access Kenya Group	Internet Service Provider
CARG	Car & General Kenya	Automobiles, engineering, agriculture
CMC	CMC Holdings	Automobile Distribution
HBL	Hutchings Biemer Limited	Furniture
KAL	Kenya Airways	Kenya's flagship airline; cross listed at Uganda Securities Exchange and Dar es Salaam Stock Exchange
MSHA	Marshalls East Africa	Automobile Assembly
NMG	Nation Media Group	Newspapers, magazines, radio stations, television stations
SCOM	Safari com	Mobile Telephony
SCAN	Scan Group	Advertising and Marketing
STDN	Standard Group Limited	Publishing
TPS	TPS Serena	Hotels & resorts
UCHU	Uchumi Supermarkets	Supermarkets

Industrial and allied

Symbol	Listing	Notes
ARM	Athi River Mining Limited	Cement, fertilizers, minerals; mining and manufacturing
BAMB	Bamburi Cement Limited	Cement
BOC	BOC Kenya	Industrial gases, welding products
BAT	British American Tobacco Limited	Tobacco Products
CARB	Carbacid Investments Limited	Carbon dioxide manufacturing
CRWN	Crown Berger (Kenya)	Paint Manufacturing
CABL	East African Cables Limited	Cable Manufacture
EAPC	Eveready East Africa	Cement Manufacture and Marketing
EABL	Kengen	Beer, spirits; crosslisted at Uganda Securities Exchange and Dar es Salaam Stock Exchange
EVRD	Kenya Oil	Batteries
KGEN	Kenya Power and Lighting Company	Electricity generation
KOCL	Mumias Sugar Company Limited	Petroleum importation, refining, storage & distribution and retail sale
KPLA	Sameer Africa Limited	Electricity transmission, distribution and retail sale
MSCL	Total Kenya Limited	Sugar cane growing, sugar manufacture & Marketing
FEAL	Unga Group	Tires
TOPL	Total Kenya Limited	Petroleum importation & distribution
UNGA	Unga Group	Flour milling

Finance and Investment

Symbol	Listing	Notes
BARC	Barclays Bank (Kenya)	Banking, finance
ICDC	Centum Investment Company	Investments
CFCO	CFC Stanbic Holdings	Banking, finance
DTK	Diamond Trust Bank Group	Banking, finance
EQTY	Equity Bank Group	Banking, finance; crosslisted at the Uganda Securities Exchange
HOUS	Housing Finance Company	Mortgage financing
JUBI	Jubilee Holdings Limited	Insurance, investments; crosslisted at the Uganda Securities Exchange
KCBK	Kenya Commercial Bank Group	Banking & finance. Crosslisted on the Uganda Securities Exchange, the Dar-es-Salaam Stock Exchange and the Rwanda Over The Counter Exchange
KRIN	Kenya Re-Insurance Corporation	Reinsurance
NABK	National Bank of Kenya	Banking, finance
NINC	Olympia Capital Holdings	Banking, finance
OLYM	Pan Africa Insurance Holdings	Construction and building materials insturance
PAIC	Standard Chartered Bank Kenya	Insurance
SCBK	Trans Century Investments	Banking, finance
TRCY	Trans Century Investments	Investments

Alternative markets investment segment

Symbol	Listing	Notes
BAUM	A Baumann and Company	Machinery distribution and marketing, investments
BRWI	City Trust Limited	Financial Services
EGAD	Eaagads limited	Coffee growing and sales
EXPK	Express Kenya Limited	Logistics
KAPC	Kapchorua Tea Company Limited	Tea growing, processing and marketing
KOL	Kenya Orchards Limited	Fruit growing, preservation and distribution, fruit-juice manufacture and marketing
LIMR	Limuru Tea Company Limited	Tea growing
GWKL	Williamson Tea Kenya Limited	Tea growing, processing and distribution

Table 3.3 Performance of the NSE between 1990 and 2010

Year	Shares Volume (Ksh Millions)	Market Capitalization (Kshs Billions)	Index (End of Year)	Bond Turnover (Kshs Billion)
1990	11	10.9	915	
1991	16.6	12.7	958	
1992	14.8	23	1167	
1993	27.3	72	2514	
1994	42.8	137	4559	
1995	62.1	107	3469	
1996	114	98.7	3114	
1997	143	114	3115	15.08
1998	111	129	2962	8.22
1999	157	107	2303	8.07
2000	149	105	1913	26.4
2001	127	98.4	1675	5.6
2002	106	83.3	1087	33.21
2003	198	181	1935	36.31
2004	525.9	274.4	2640	48.38
2005	579.9	420.7	3972	14.3
2006	1228	623	5646	48
2007	1498	744	5445	61.5
2008	4257.5	1230.7	5185	78.0
2009	4260.9	821.8	3294	150.4
2010	4919.5	1109	4339	370.2

Source: The capital markets and NSE annual reports 1990-2007

The Kenyan economy has been reinventing itself. From virtual stagnancy in 2001, the economy has expanded steadily to register a remarkable growth of more than 6% in 2006. This economic dynamism is expected to continue for the foreseeable future, fueled by capital formation and favorable macroeconomic environment (www.cma.org)

One of the obvious beneficiaries of this economic recovery is the stock market. In the past four years, the stock market in Kenya has grown by leaps and bounds with stock prices appreciating to record levels. On the average, the prices of quoted shares have more than quadrupled in as many years, a performance that is difficult to replicate in conventional types of investments savings and deposit accounts, real estate. The stock market has gathered exceptional interest by investors small and great who would like to get benefits of trading in shares and getting maximum profits and this has seen an increase for investment in stocks and shares yet in the pas it was an area traditionally considered the preserve of the sophisticated investor.

Studies carried out in the developed markets have shown that over the years investments in the capital markets, especially in equities, consistently out-perform all other investment classes. Sound stocks, purchased for investment not for speculation when their prices are low and held for the long pull, are likely to produce high profits through dividends and increases in capital value. However the risk is found in all types of investments including stocks and share and for many people, the natural risk in stock market investments can be greater than it needs to be because investors, especially small retail investors do not take the time to understand the companies they are buying into and therefore end up making losses from such investments.

3.2 How the stock market operates.

The origin of stock markets goes back a couple of centuries. The roots of stock markets are to be found at the beginnings of the Industrial Revolution that began in Europe about four centuries ago. Many of the pioneer merchants of the industrial age wanted to start huge businesses, which no single merchant could raise alone. It therefore became inevitable for them to come together, pool their savings and start these businesses as partners or co-owners. The contribution of each partner to the enterprise was to be represented by a unit of ownership. This was the originator of what we call shares. And through this, 'joint stock' companies were born.

Participants in the stock market range from small individual stock investors to large hedge fund traders, who can be based anywhere, their orders usually end up with a professional at a stock market, who executes the order. Some stock markets are physical locations where transactions are carried out on a trading floor, by a method known as open outcry. This type of auction is used in stock markets and commodity markets where traders may enter verbal bids and offers simultaneously. The other type of stock market is a virtual kind, composed of a network of computers where trades are made electronically via traders (www.capitalmarkets.com)

In the NSE the exchange has pre-market sessions from 09:00am to 09:30am and normal trading sessions from 09:30am to 03:00pm on all days of the week except Saturdays, Sundays and holidays declared by the Exchange in advance.(www.nse.com)

The NSE's offices and trading floor are located at the Nation Centre along Kimathi Street. Trading is done through the Electronic Trading System (ETS) which was commissioned in 2006. A Wide Area Network (WAN) platform was implemented in 2007 and this eradicated the need for brokers to send their staff (dealers) to the trading floor to conduct business. Trading is now mainly conducted from the brokers' offices through the WAN. However, brokers under certain circumstances can still conduct trading from the floor of the NSE.

Stock markets perform an important role in a country's economy. They encourage investment by providing places for buyers and sellers to trade securities. This investment, in turn, enables corporations to obtain funds to expand their businesses.

Corporations issue new securities in what is known as the primary market, usually with the help of investment bankers. These investment banks purchase the initial issue of the new securities from the corporation at a negotiated price and then make the securities available for its clients and other investors. This is called an initial public offering (IPO).

Stock markets are very important because they play a significant role in the economy by channeling investment where it is needed and put into the best use. The stock market is working as the channel through which the public savings are channeled to industrial and business enterprises. Mobilization of such resources for investment is certainly a necessary condition for economic take off, but quality of their allocation to various investment projects is an important factor for growth. This is precisely what an efficient stock market does to the economy.

3.3 Role of the Stock Market in the Kenyan Economy.

The stock market provides an important alternative source of long-term finance for long-term productive investments. This helps in diffusing stresses on the banking system by matching long-term investments with long-term capital. It provides equity capital and infrastructure development that has strong socio-economic benefits like roads, water and sewer systems, housing, energy, telecommunications, public transport, ideal for financing through capital markets via long dated bonds and asset backed securities.

Provides avenues for investment opportunities that encourage a thrift culture critical in increasing domestic savings and investment ratios that are essential for rapid industrialization. Encourages broader ownership of productive assets by small savers to enable them benefit from the country's economic growth and wealth distribution. Equitable distribution of wealth is a key indicator of poverty reduction.

Promotes public-private sector partnerships to encourage participation of private sector in productive investments. Pursuit of economic efficiency shifting driving force of economic development from public to private sector to enhance economic productivity has become inevitable as resources continue to diminish.

Assists the Government to close resource gap, and complement its effort in financing essential socio-economic development, through raising long-term project based capital.

Improves the efficiency of capital allocation through competitive pricing mechanism for better utilization of scarce resources for increased economic growth.

Provides a gateway to countries like Kenya for global and foreign portfolio investors, which is critical in supplementing the low domestic saving ratio.

3.4 Benefits of the Stock Market in the Kenyan Economy

The mobilization of savings for investment in productive enterprises as an alternative to putting savings in bank deposits, purchase of real estate and outright consumption. The benefit of the growth of related financial services sector like insurance, pension and provident fund schemes which nurture the spirit of savings. The check against flight of capital which takes place because of local inflation and currency depreciation. Encouragement of the divorcement of the owners of capital from the managers of capital; a very important process because owners may not necessarily have the expertise to manage capital investment efficiently. Encouragement of higher standards of accounting, resource management and public disclosure which in turn affords greater efficiency in the process of capital growth.

Facilitation of equity financing as opposed to debt financing. Debt financing has been the undoing of many enterprises in both developed and developing countries especially in recessionary periods. Improvement of access to finance for new and smaller companies. This is now possible on the Alternative Investments Market Segment (AIMS). This can also be realized through Venture Capital institutions which are fast becoming key players in financing small businesses. Encouragement of public floatation of private companies which in turn allows greater growth and increase of the supply of assets available for long-term investment.

3.5 Studies on the Nairobi Stock Exchange.

Munga (1974) looked at the Historical and operational aspects of the NSE. He analyzed the NSE using descriptive statistics and concluded that both economic and political factors were important in explaining the trend in share prices from 1955-1996 and the trend after that is mainly explained by the economic per share, capital rate and earnings as a percentage of net assets. The study was based on stocks for two companies Kenya Breweries and Brook Bond.

Pattinson (1971) tested a model of relationship between stock market prices and economic aggregates and described that the level and adjustment of stock prices by equations. The first equation linked stock market price index and industrial production.

Kinandu(1997) addressed the issue of stock providing a proper financial forum for the pricing of financial assets particularly in the secondary market using serial correlation test and supported his findings using the runs test.

Muyondo Martin (2003) looked at the causal link between the stock market development and economic growth and found that stock market development drives the development in the real sector and vice versa and concluded that there was a positive relationship between stock market development and economic growth.

Wahome Matu (2007) Concluded that the stock market influenced economic growth. Illustrated from his research findings that the size of the stock market as indicated by market capitalization ratio positively affects growth, turnover ratio while volatility negatively affects economic growth as proxied by GDP growth rate. The effect of these measures of stock market development or growth may be direct or indirect but relationship is weak since NSE is an emerging market and few observations were due to unavailability of consistent time series data and due to stock market being poorly developed in the country like other developing countries.

CHAPTER FOUR

IMPACT OF CAPITAL MARKETS ON ECONOMIC GROWTH

4.1 Introduction

The Kenyan economy has undergone a series of upheavals since the 1990s and most of these changes have been linked to a volatile political climate. A lot more stability and growth was witnessed after the ousting of the previous regime in 2002 and the administration which followed promised sweeping reforms in Kenya's financial markets. With increasing economic and financial reforms, the Nairobi Stock Exchange placed itself in a position where it could access the growing allocation of global investments.

The Kenyan economy has undergone a series of upheavals since the 1990s and most of these changes have been linked to a volatile political climate. A lot more stability and growth was witnessed after the ousting of the previous regime in 2002 and the administration which followed promised sweeping reforms in Kenya's financial markets. With increasing economic and financial reforms, the Nairobi Stock Exchange placed itself in a position where it could access the growing allocation of global investments. The high macro-economic and political instabilities which used to define Kenya's economic landscape were never eliminated but they were minimized. The volatility of Kenya's financial markets was exposed in the post-election violence of 2008. Despite such setbacks, the Capital Markets Authority has been increasingly active especially after the collapse of some market intermediaries and has since issued regulations covering the corporate governance structures as well as conduct of business codes for market intermediaries.

A major impediment in the development of capital markets of emerging economies in Africa is illiquidity. In Kenya for instance despite a number of government privatizations and private listings, the number of counters trading in the Nairobi Stock Exchange has not dramatically increased over the 1990's. Turnover is also relatively low compared to emerging and developed markets; in 2008 for instance turnover of the Nigerian Stock Exchange was 21.9% while the Nairobi Stock Exchange's turnover was 11.4%. JSE's turnover for a similar period was 71.8% having achieved a turnover rate of 142.7% in 2007. Fostering regional integration of exchanges through cross-listings and pooling of issuances will help develop markets and again; it is promising to see the East African States looking to establish an East African Exchange. The performance of the NSE in the last financial year was mixed and this was attributed to the global financial crisis. Adding to this, the Kenyan economy also underperformed with food inflation increasing to record levels and the price of petroleum rose to over Sh. 100 per litre. In a bid to establish the link between the performance of the NSE and its effects on the Kenyan economy, financial data from the Central Bank of Kenya which is published in the monthly economic reviews will be analyzed.

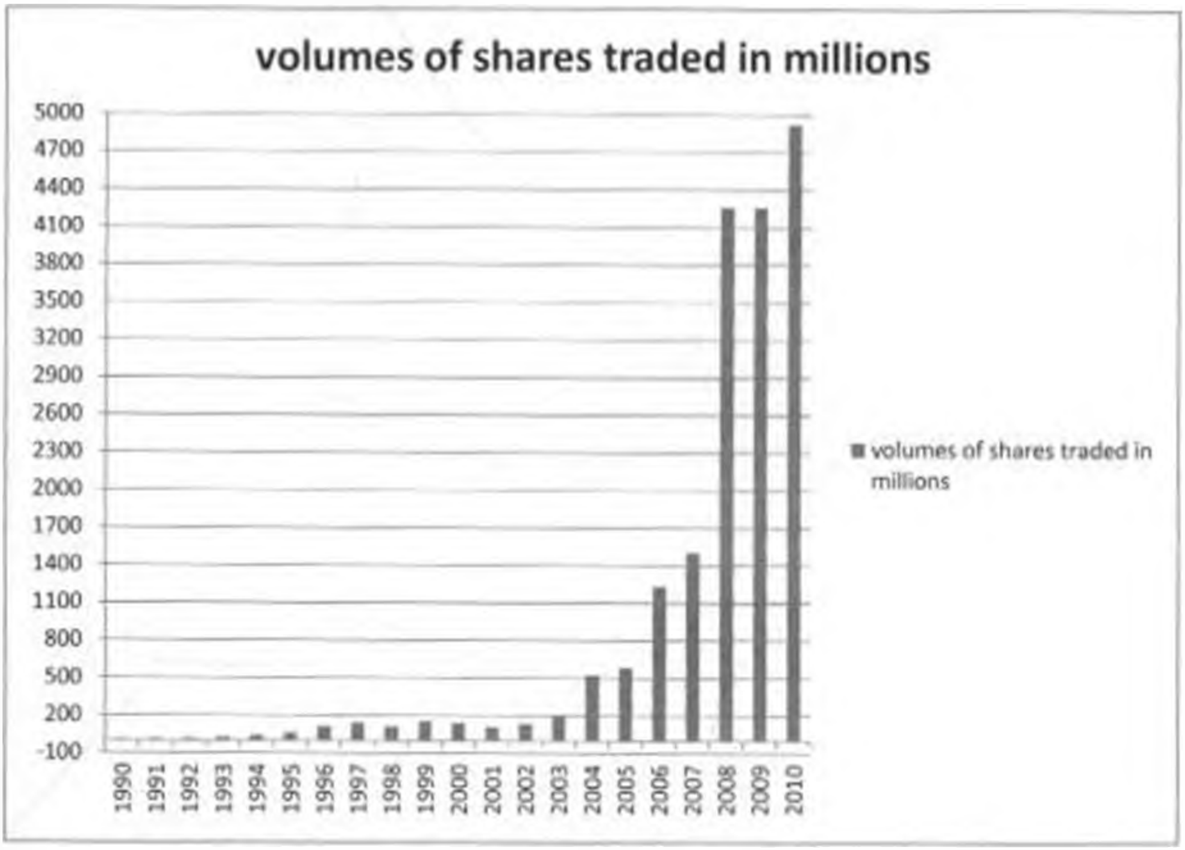
Table 4.1Key Market indicators and economic performance between 1990 and 2010

Year	Shares Volume (Kshs Millions)	Market Capitalization (Kshs Billions)	GDP Growth Rate %	Index (End of Year)
1990	11	10.9	4.3	915
1991	16.6	12.7	2.6	958
1992	14.8	23	0.5	1167
1993	27.3	72	0.1	2514
1994	42.8	137	3	4559
1995	62.1	107	4.8	3469
1996	114	98.7	4.6	3114
1997	143	114	2.4	3115
1998	111	129	1.8	2962
1999	157	107	1.4	2303
2000	149	105	-0.3	1913
2001	127	98.4	0.5	1675
2002	106	83.3	0.3	1087
2003	198	181	2.8	1935
2004	525.9	274.4	4.6	2640
2005	579.9	420.7	5.9	3972
2006	1228	623	6.4	5646
2007	1498	744	7	5445
2008	4257.5	1230.7	1.3	5185
2009	4260.9	821.8	2.6	3294
2010	4919.5	1109	5	4339

Source: Capital markets and Nse annual reports 1990-2010

Central Bank Economic Reviews

Graph 4.1 Shares in volume Kshs Millions 1990-2010



Source: Capital markets and NSE annual reports 1990-2010

The stock market has witnessed tremendous growth from 1990 in terms of annual turnover, capitalization and index level. The share volume increased from 11 million in 1990 to 1,498 billion Kenya shilling in 2007. The turnover level during the period 1990 was only KShs.230 million, which rose to a level of KShs.3.08 billion in 1994 and an all time high level of Shs.6.15 billion in 1997(Capital markets Authority annual report, 1999). The volume of shares traded at NSE increased from 106 million to 198 million in 2003 representing a growth of 86.8%. The annual turnover however declined in 1998 to a level of KShs.4.56 billion. The market turnover realized during 1999 was Kshs. 5.1 billion. In 2005 Share volume rose by 10% to 580 million compared to the previous year's level of 526 million.

while turnover rose to a new historical high of Kshs 22.03 billion, reflecting a growth of 8% from the previous period's figure of Kshs 20.35 billion.

Graph 4.2 Market Capitalization in Kshs billion 1990-2010

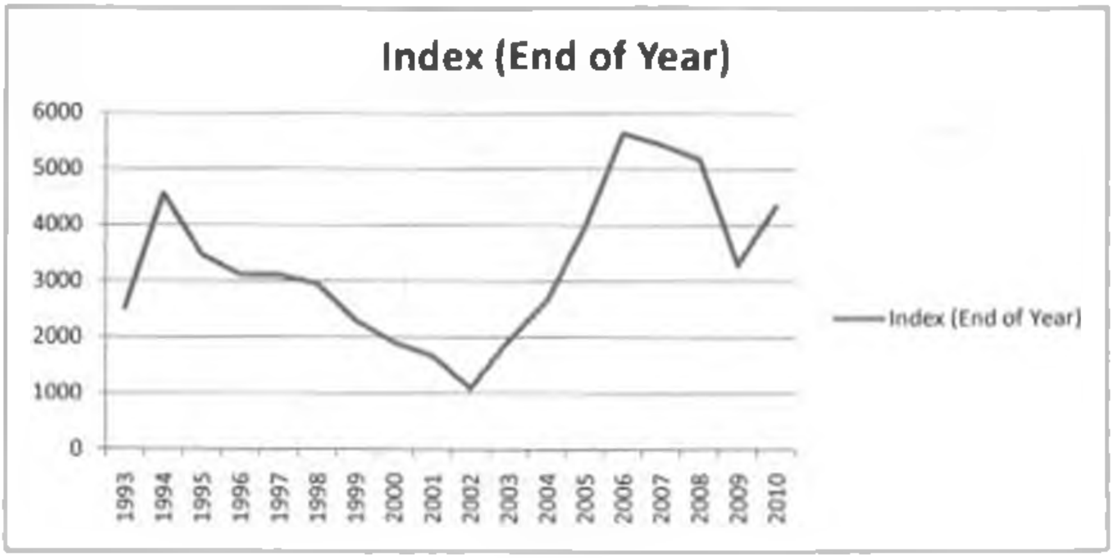
Source: Capital markets and Nse annual reports 1990-2010

The market capitalization level has also grown from a level of KShs.10.9 billion in 1990 to KShs.136 billion in 1994 (Capital markets Authority annual report, 1999).

The total equity market capitalization of these 54 companies as at 31 August 2002 was KShs85.4 billion (US $ 1.1 billion). In 1994, the NSE was at its peak and was rated by the International Finance Corporation (IFC) as the best performing market in the world with a rate of return of 179% in US Dollar terms. At that time, the NSE had a market capitalization of Kshs 137 billion (equivalent to US $ 3.1 billion at the then prevalent market rate of Kshs 45to 1 US$) (www.nse.co.ke)

However, the level of capitalization during the period 1995 to 1999 ranged between KShs.100 billion and 128 billion.

Graph4.3 Share Index 1990-2010



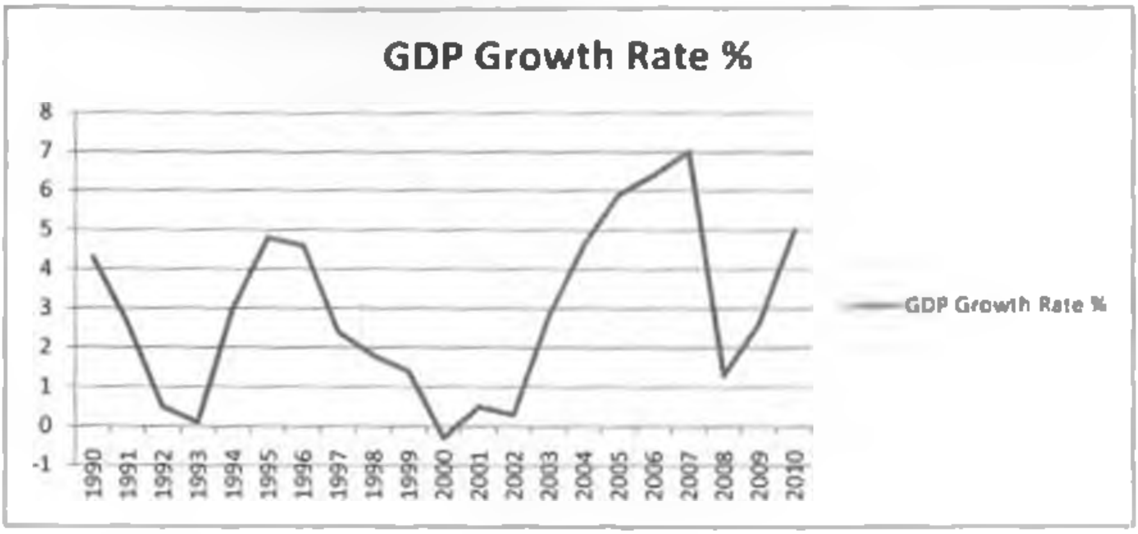
Source: Capital markets and Nse annual reports 1990-2010

The index level rose from 915 in 1990 to an all time high level of 4,559 by 1994. The index level, however, averaged between 3,000 and 3,400 between 1995 and 1997 (Capital markets Authority annual report 2000)

During 1997 and 1998 the index level significantly declined to below 3,000 and closed at about 2,300 level by end of December 1999.

The NSE Index gained 1332 points representing a growth of 50% to move to a high of 3972 points in June 2005 from a low of 2640 points recorded in June 2004. The overall rise in the prices of most stocks and an additional supply of shares prompted by three bonus issues and one share split pushed market capitalization to Kshs. 421 billion at the end of June 2005, a significant leap equivalent to 53% growth over Kshs. 274 billion in 2004.

4.4 GDP growth rate in % 1990-2010

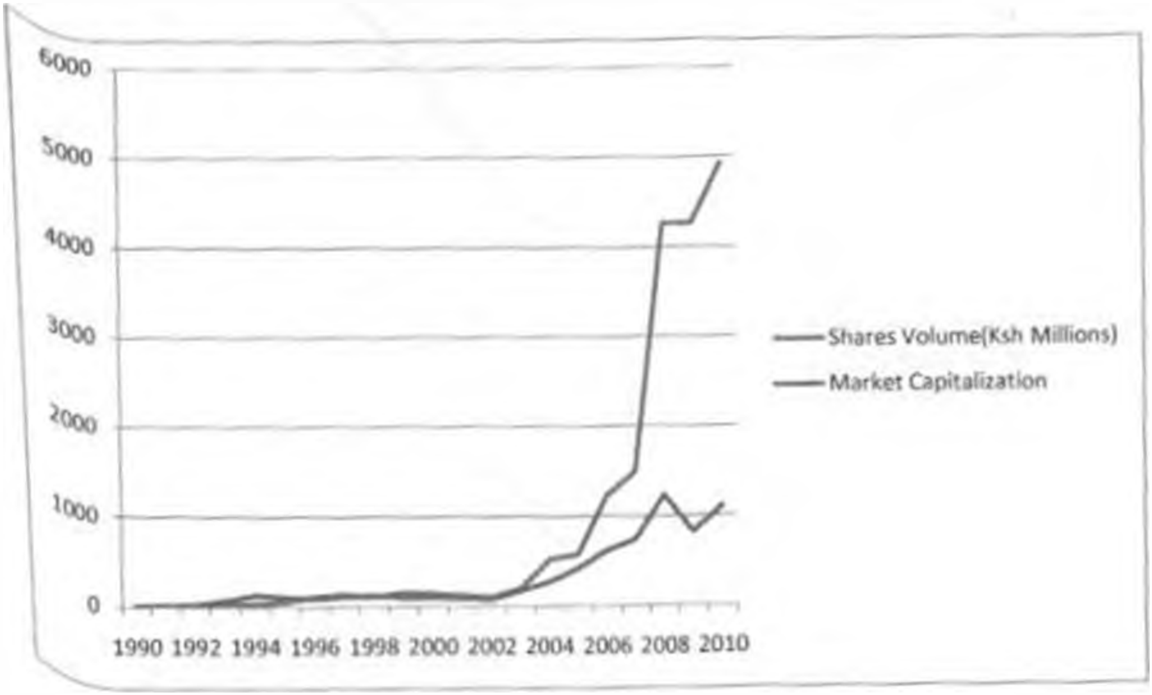


Source: Capital markets and Nse annual reports 1990-2010

In 2000 Kenya's GDP declined to negative 0.3% from 4.8% in 1995 this was reflected in all sectors of the economy but agriculture was the most affected due to drought that the country experienced which also resulted to power rationing (Capital Markets Authority annual report 2000) However, in 2001 and 2002 Kenya's economy improved slightly due to favourable weather conditions that so the agriculture sector improves as well as normalization of the power sector.

In 2003 Kenya experienced general economic growth that had a positive effect on the securities market. The real GDP growth was 1.8% in 2003, up from 1.2% in 2002 The growth was attributed to a number of factors that facilitated improved macroeconomic conditions this included the smooth transition of the new government that come into power which boosted investor confidence, the economic policies and commitment to boost investments and improve infrastructure as well as stamping out corruption lead to market confidence.

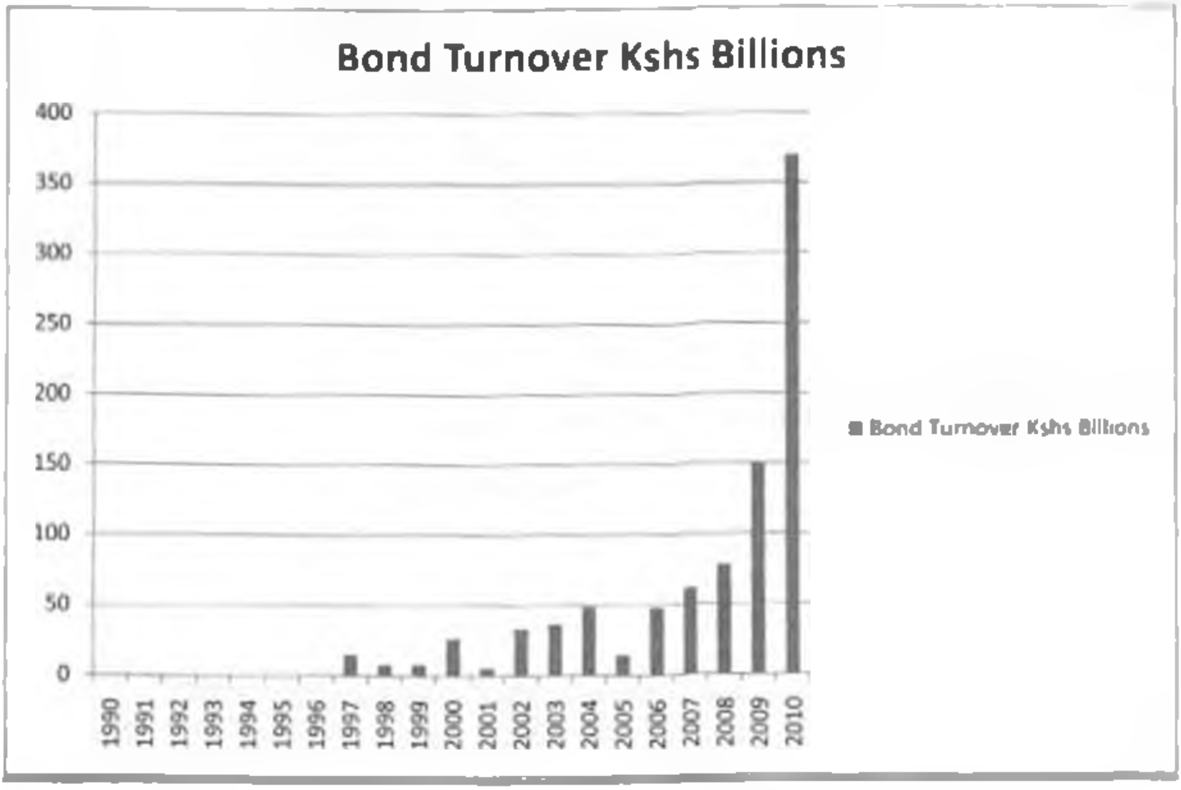
Graph 4.5 Shares in Kshs millions and Market capitalization in Billions 1990-2010



Source: CMA and NSE Annual Report 1990-2010

The graph shows a positive correlation as the number of shares volume traded increased the market capitalization also increased.

Graph 4.6 Bond turnover in Kshs Billion 1990-2010



Source: CMA Annual reports 1990-20010, Economic Survey 2004

The bond market emerged as an important source of funding for both the Government of Kenya and the corporate sector. During the year 1999, the Government of Kenya issued Floating Rate (FR) Bonds amounting to Kshs 26.4 billion, which are listed on the Nairobi Stock Exchange (Capital markets Authority annual report 1998) The corporate sector however, concentrated on the issue of Commercial Paper (CP), which also began to constitute a major source of working capital financing. The total amount of Commercial Papers issued since 1997, when the Authority issued guidelines on the same, is Kshs 11.6 billion(Capital markets Authority annual report 2000)

The performance of the stock market is a mirror of the performance of the economy and hence the level of performance during 1999 is attributed to economic downturn during the last two years that has continued to significantly affect corporate earnings, dividend payout and turnover. The high level of interest rates also continued to favour money market instruments especially Treasury bills. Another depressing factor for the capital markets is in the Finance Act of 1999 requiring insurance companies to invest 20 per cent of their assets in long-term Government securities (Capital markets Authority annual report 2000).

The year 2002 A total of 20 Treasury bond issues were listed at the NSE, including a ten-year tenor treasury bond that raised Kshs 2.7 billion. From July 2000 to June 2001, bonds of 1 to 3 year tenor valued at Kshs 47.12 billion were issued. In line with the Government restructuring of its domestic debt into longer-dated securities, the maturity period increased in 2002 with treasury bonds issued of up to 6 years.

The year 2005 saw the bond market gradually improve as interest rates increased. However, the uncertainty in interest rates that prevailed in July through October 2004, forced cancellation of two issues in September and October. The one-year Treasury bond issues dominated the period accounting for about 40% of the total issues in value. As the interest rates improved on the 91-day Treasury bills to between 5% and 8% during the period January June 2005, treasury bonds of tenors 3-5 year were issued although some did not receive full subscription.

In 2006 19 bonds were issued raising a total of 48 billion while in 2007 17 bonds were issued giving a raise to 78 billion.

Bond turnover for the year 2009 increased by 93 % registering Kshs 150 billion compared to Kshs 78 billion for a similar period in the year 2008. This was mainly occasioned by the depressed status prevailing in the equity market resulting in the re-positioning of funds by investors into fixed income securities for stable and guaranteed returns.

CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 SUMMARY AND CONCLUSION

This paper looked at the relationship between stock market development and Long-run economic growth. A time series cross-section data from 1990s to present suggests that stock market development is positively associated with economic growth.

The paper suggests that stock market development contributes to economic growth both directly and indirectly and shows a positive correlation. Following the direct channel, we see that market liquidity (turnover ratio) has a positive impact on growth. Indirectly, market size (capitalization ratio) affects investments which, in turn, affect growth.

The changing attitude towards the role of the private sector in the development of African economies has facilitated the development of the capital markets because of the likely potential of these markets to meet the fixed-capital needs of the private sector. Capital markets can ensure the efficient and sustainable funding of governments, corporations and banks for large-scale or long-term projects. In this regard, developing countries are working towards reforming and deepening financial systems, through the expansion of capital markets in order to improve their ability to mobilize resources and efficiently allocate them to the most productive sectors of the economy.

Significant progress has been made in the development of many stock markets in Africa. The growth in market capitalization in Africa has been described as remarkable in the last decade, new legal and regulatory regimes are being set up and progress is being made in the development of market infrastructure such as the automation of trading and settlement. However, emerging stock markets face significant challenges to their development and growth as exemplified in the NSE and other African markets. Hence the need to ensure that legal, technical and operational structures are in place so that African and other emerging capital markets function like their counterparts in more developed countries.

The finding of a strong association between economic performance and the effectiveness of financial markets suggests the importance of financial development as a policy for accelerating economic growth. this provides evidence that financial sector policies that promote financial market's functional capacities lead to better real economic performance. It points out the incompleteness of long-established development strategies that exclusively focus on real-sector reforms to induce economic development.

The importance of the financial market is given by the significant role it plays in the financing of the enterprises and of the state, by the percentage the direct financing has more the methods for financing.

The well functioning of the financial market is a strong fundament for ensuring a lasting growth, on the long term, of the national economy; the financial market and firstly the capital market represent in many countries If to a certain extent they can be replaced as financing sources, it must not be understood that financing through the banking system and financing through the capital market are perfectly replaceable, but rather complementary. In most cases, the issuing of shares or bonds tend to sooner supplement, than replace the bank loans, especially when the allocation of some important resources is wanted for sustaining some large investment plans, when a farther horizon for the maturity of the loan is sought, or even obtaining non-refundable funds for the price of dilution of capital and future dividends.

More and more issuers turn to financing instruments which long ago seemed too sophisticated.the ability of the capital market to mobilize important financial resources now is no longer in doubt and any company listed on the stock exchange will consider the issuing of bonds or shares among its financing options.

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5.2 Recommendations.

Research findings from this study indicate that capital markets play an important role in the growth of a country's economy. The government should therefore facilitate the development of capital markets by encouraging the growth of the private sector because of the inherent potential of these markets to meet the fixed-capital needs of the private sector. Capital markets can ensure the efficient and sustainable funding of governments, corporations and banks for large-scale or long-term projects which commercial banks may not be able to offer long term financing and therefore the government can raise these funds through treasury bonds or sale of shares. Capital markets are a vital part of an economy making it possible for industry, trade and commerce to flourish without any obstacle in terms of resources.

Investor education may also be done through incorporating information on investment and the capital markets in the high school and college curriculum to enhance the awareness by the younger generation of Kenyans who make up more than half of the total population. Out of a total population of about 30 million in Kenya, it is estimated that only about 580,000 are investors in the NSE. This is a very low rate and the number can be increased as more Kenyans are informed of the investment opportunities available to them at an early stage of their lives.

The Government through the central bank should ensure a sound macroeconomic environment like low inflation rates, high income levels where people are able to save and invest in capital markets like in the buying of the IPO shares in hope of getting returns by receiving dividends or selling them at a higher price.

Continued macroeconomic stability and lengthening of maturity of government debt will encourage the development of the bond market which will assist the government to meet its budgetary needs and finance long term projects that require a hig amount of funding. For example from the data collected on bonds shows that the government has been increasing the issuance of bonds so as to meet its financial needs.

Economic and political policies directly affect confidence and activity in the market, hence the need for close public-private partnership between the government and the private sector to ensure that policies are formulated with consultation from both sectors with an objective to ensure the overall economic welfare. The government should encourage the free flow of capital through regional integration of capital markets in East Africa. This should encourage investors to invest in either of the local markets so as to inject capital in companies that require funding or an investment company that needs to raise funds in either of the markets.

There is therefore need for further research to provide more insight as to how the stock market affects the growth of the economy, the enhancing of a well developed financial market and environment so as to encourage more investments by both the local and foreign investors.

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