MASTER THESIS

Development of a National Stock Market in Lesotho: A Response to Structural Challenges.

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Abstract

This study examines the determinants of stock market development in a broader sense, in an effort to investigate the positive or negative impact they can have on the establishment of the national stock market in Lesotho. The focus is on the benefits enjoyed by other African countries from the establishment of stock markets, in particular, in Sub-Saharan Africa, whose effects can also be enjoyed by the Lesotho economy. I have concluded that Lesotho can also benefit from the establishment of a stock market and reforms to strengthen the institutional infrastructure are essential.

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CHAPTER 1.0 INTRODUCTION

1.1 Background

Capital markets have evolved over time in sub-Saharan Africa with countries particularly focusing on the development of stock markets. The concept has gained popularity as it has been supported by international development institutions such as the International Monetary Fund (IMF) and the World Bank with programmes that are designed to assist developing countries promote sustainable economic growth that will eventually alleviate poverty (Hearn and Piesse, 2009). The development of the stock market is expected to boost domestic savings as it will enable companies to raise capital with the public, giving them opportunity to invest in the stock market of listed companies. In general, stock markets are seen as a mechanism or a platform that will improve capital markets and hence, the domestic financial system (Kenny and Moss, 1988). However, some critics have argued that it may not be realistic for all African economies to promote stock markets and that stock markets in developing countries might not perform efficiently given the huge costs of stock market development and the poor financial structures, as well as weak performance of the private sector (Singh, 1999).

There is still some debate as to the benefits that developing countries can gain from the establishment of stock market in contrast to those of developed countries. This debate intensifies the question of whether or not it is necessary for African countries to promote stock markets, depending on the size of their economies and the level of economic activity taking place therein. A different view from the advocates of banking sector development emphasizes that stock markets are a costly irrelevance to poor countries (Singh, 1997, 1999). This is supported by the fact that banking systems have grown from the era of colonialism and they can support economic growth (Kenny and Moss, 1998). Therefore, this proposes improvement or efficiency of banking system to support economic development, rather than incurring huge costs of stock market development in countries which are already poverty-stricken and where wealth remains in the hands of a few elites.

In Lesotho the idea of stock market development surfaced around 1994/5 as part of privatisation programme; but it had to be put on hold at the request of the World Bank on the ground that Lesotho's economy was too small to warrant such a facility. The arrangement at that time was in such a way that the envisaged stock market would connect to the platform in Mauritius as per SADC initiative. However the International Monetary Fund (IMF) has since resuscitated capital markets development in Lesotho around 2010 though a phased approach, with the ultimate goal to have a stock market after other capital markets instruments were introduced.

Various studies have indicated a trend in Africa of the establishment of stock markets. Lesotho is not an exception as it is also making efforts to have in place its own stock market. Notwithstanding the envisaged role of contributing to economic growth, stock markets in small countries are confronted with a number of special challenges. Lesotho being part of Sub Saharan region is expected to face similar challenges such as those pointed by Hearn and Piesse (2009) who articulated barriers to the development of small stock markets with special focus on the Kingdom of Swaziland and the Republic of Mozambique.

Due to its size and location, Lesotho's economy, depends to a large extent on the South African economy and thereby, creates a perception that perhaps the existence of capital market platforms in South Africa influenced Lesotho's financial market structure with regard to the fact that financial markets participants are largely foreign companies/subsidiaries. The banking system in Lesotho is largely dominated by South African bank subsidiaries. This study is intended to establish specific benefits that Lesotho as a country can derive from establishing a stock market and how the current structural challenges in the economy can be addressed in order to allow smooth operation of a stock market. Lesotho could perhaps benefit from its geographical position in the sense that it could adopt the model of Namibia, which has harnessed a more capable information technology infrastructure provided by the Johannesburg Stock Exchange (JSE) as their platform.

1.2 Problem Statement

Given the background presented, it is important to indicate that Lesotho has been facing a challenge of absence of capital markets platforms/vehicles, leading to the entrapment and/or vulnerability of depositors to Ponzi schemes, in search for better returns and alternative instruments. This research thesis will therefore, investigate the advantages and disadvantages of the establishment of the stock market in Lesotho, and whether such establishment will bring with it solutions for investment platforms and instruments in which Basotho can invest their savings and earn better return.

1.3 Objectives

- The study is intended to enrich the researcher's understanding of the important role played by capital markets in financial development and economic growth.
- The study will also investigate the benefits that will accrue to Lesotho by establishing its own stock market in order to complement financial services that are provided by banking institutions for Lesotho's investors.
- The study will then propose policy reforms that are inevitable for the proper functioning of the national stock market and to realise value add from such development.

1.4 Research Questions

The research is in particular intended to address the following questions:

- What benefits accrue from the stock market that Lesotho can gain?
- Based on the current level of development, which model of operation for a stock market can be suitable for Lesotho?
- What are the potential challenges that could have a negative impact on the performance of the stock market and how can these challenges be addressed?

1.5 Justification/Rationale

As mentioned in the background, Lesotho has been facing a huge challenge of inadequate capital markets platforms; segments of capital markets exist merely in the name of collective investment schemes. These are entirely driven by foreign subsidiaries, namely StanLib and African Alliance. The banking institutions have also failed to influence the local savers because products or services that they provide do not seem to be suitable for the local environment; most of them are of foreign origin. This has subsequently led to its citizens to either cross the border looking for investments in South Africa while some channelled their savings through pyramid and Ponzi schemes which were mushrooming within the country in order to stimulate their investment appetite.

With the banking institutions dominating the financial intermediaries sector, it is pertinent to complement financial services provided by banks with those that the stock market can bring, in an effort to facilitate capital allocation. It is expected that the positive relationship between banking sector development and stock market development that has been observed in other countries can be realised in Lesotho as well. It is crucial therefore, to also indicate the importance of stable political environment, improved living conditions for citizens as well as historical experiences and the economic context in the quest to achieve effective and efficient capital markets development.

A wide variety of literature has been studied on the relationship between financial system development and economic development, in particular, focusing on the important role that capital markets play. This has revealed that in developed countries where a host of financial services exist, financial systems are efficient. However, the situation is different in developing countries where the level of development is low due to lack of investment opportunities, high poverty levels and lack of financial knowledge. In Lesotho, the situation is no different from that of other developing countries. Hence, there has been an overflow of investors crossing the border seeking investment instruments that would better suit their preferences from other countries, and even plunging their hard earned savings into Ponzi schemes in pursuit of better returns as well.

This study will therefore, attempt to establish if the absence of longer term investment vehicles influenced savers to direct their domestic savings to South Africa or Ponzi schemes that results in flow of capital that does not benefit economic development in the country. The study will further provide useful information to policy-makers on how best the stock market can contribute to the economic growth of the country, taking into consideration of the size and the infrastructural set up of the country. Challenges that can impede proper functioning of the stock market will be presented and the possible ways for addressing these challenges will be explored. The study will also set the tone at which regulation and supervision of the stock market should be aligned to regulation of other institutions that operate in the financial sector while also analysing the suitable model of stock exchange to be established in Lesotho based on the situational analysis to be made in this research paper.

1.6 Organisation of the study

The rest of the paper is structured as follows: Chapter 2 focuses on related literature on the relationship between financial development and economic growth, the role of the financial markets in an economy particularly on economic growth. It further explores the development of stock markets in Africa, in particular, in Lesotho. Chapter 3 will provide details of the methodology used in the study and a brief analysis of different approaches for establishment of stock markets, while Chapter 4 will present an analysis of the responses received which then answers the research questions in the study. The analysis will be confined to findings pertaining to the advantages and disadvantages of each approach or model. It will conclude by identifying the approach that may be suitable for Lesotho in its efforts to develop a stock market. Recommendations will be covered in chapter 5 and will be guided by the conclusions drawn from the study.

CHAPTER 2.0 LITERATURE REVIEW

This section presents the theoretical aspects relating to stock market development and its contribution to economic growth. The subject on economic development has been underpinned by the theoretical interest of several authors including Demirguic-Kunt and Levine (1996), Levine and Zervos (1993, 1995, 1998). It is noted that the benefits derived from stock market development have largely been ignored in the past. However, recent evidence has shown that stock markets can boost economic growth. The analysis will henceforth, focus on the following themes:

Firstly, the relationship between financial development and economic growth;
Secondly, the role of the financial markets in an economy; and
Lastly, development of stock markets in Africa, with particular emphasis on Lesotho.

The study will further present an overview of benefits realised by countries that established stock markets derived from the existing literature, and attempt to highlight those that Lesotho can understudy.

2.1 Financial Development and Economic Growth

2.1.1 The Role of Financial Systems

A financial system comprises institutions, instruments and markets that support a country's economy. A well planned financial system facilitates economic growth through proper allocation of funds by institutions (financial intermediaries) in support of firms that face external financing constraints. Financial systems facilitate the exchange of goods and services, mobilise savings and allocate resources. It has been determined that the financial system in general performs four basic functions essential to economic development and growth, namely, mobilising savings, allocating resources to productive uses, facilitating transactions and risk management, and exerting corporate control.

In countries where these functions interplay, it is expected that such countries will have higher economic growth rates marked by higher levels of productivity. Financial systems are augmented by stable macroeconomic factors that include political stability, information disclosure, well-functioning intermediaries that minimise information and transaction costs, and stable inflation and interest rates environment.

2.1.2 The Evolution of Financial Development

Huang (2006) described financial development as increasing the efficiency in allocating financial resources and monitoring capital projects, by encouraging competition and increasing the importance of the financial system. In the study of the effects of financial liberalization on financial development in emerging markets, he further indicated that financial systems in developed countries are dominated by stock markets whereas those in emerging markets are found to be less developed and inefficient, and to some extent, corporate governance standards are generally low. There was robust evidence that indicated that the link between financial openness and financial development in stock markets exists. This was found utilising financial development indicators that include banking system, stock market and bond market measures.

Rajan and Zingales (2003) also found that trade openness benefits financial development positively. The major focus was placed on the rules of demand and supply which ultimately have influenced a country's openness to trade and hence, abolishing controls that may hinder movement of capital flows. The study further emphasized the importance of government support for financial development, which may be in the form of standards on property rights, accounting and disclosure standards that encourage transparency, legal systems that enforce contracts, and a regulatory infrastructure that protects consumers, promotes competition, and controls unreasonable risk-taking.

Financial development therefore, is largely influenced by the structure, size and the efficiency of a financial system. Financial developments are defined by Roubini and Bilodeau (2008) as "the factors, policies, and institutions that lead to effective financial intermediation and markets, and deep and broad access to capital and financial services". This definition takes into consideration the inputs and outputs that support a financial system. In broad terms, financial development influences the ease with which firms are able to access external finance for their prospective projects. Looking at a sample of transition economies, Pistor, Raiser, and Gelfer (2000) indicated that in addition to the quality of legal frameworks the effectiveness of legal institutions are crucial for financial development.

Levine (2003) indicates that financial development takes place when financial instruments, markets, and intermediaries streamline informational asymmetries, enforcement, and transaction costs. Previous research initiatives conducted have found that in countries where financial development is at an advanced stage, financial services are extensively available, enabling risk diversification. Rajan and Zingales (2003) support this view by emphasizing the ease with which firms would access finance and anticipate high returns. Financial development influences the long-run economic growth of a country when firms and consumers have access to financial services that ultimately improve their well-being. The importance of efficient financial systems in financial development is therefore underscored, as greater financial development leads to greater mobilization of savings which are ultimately allocated to investment projects with positive prospects. Hence, financial markets and financial intermediaries facilitate availability of financial services to support financial development.

Several authors have undertaken research on the relationship between financial development and economic growth. Subsequent to such research, a consensus was reached that well-functioning financial intermediaries have played a significant role in economic growth (King, Levine, 1993(a,b); Levine and Zervos, 1998; Levine, Loyasa and Beck, 2000 (a, b)). King and Levine (1993a) determined that financial services accelerate economic growth through initiatives aimed at enhancing capital accumulation and efficient deployment of such capital by economies. It is pertinent to note that economic growth can be achieved when major drivers of the financial system are efficiently supporting financial development. These drivers comprise financial intermediaries and markets.

Roubini and Bilodeau (2008) highlighted a number of factors that may be considered when measuring the extent of financial development in a country. These pillars or determinants include but not limited to:

Factors, policies, and institutions: These are enablers for the development of financial intermediaries, markets, instruments and services. They are usually grouped into institutional, business and macroeconomic environments. The institutional environment comprises the overall laws, regulations and supervision of the financial sector, as well as the quality of contract enforcement and corporate governance standards.

The Institutional Environment

Research focusing on the role of institutions in financial development has been considerable, with much emphasis on the effects of the legal and regulatory environment on the functioning of financial markets. It has been argued that a legal and regulatory system involving protection of property rights, contract enforcement and good accounting practices is essential for financial development. La Porta et al., (1997, 1998) have argued that the origins of a country's legal environment have a significant influence on development of financial structures and corporate governance institutions. They indicate that laws that focus on the treatment of creditors and shareholders, the efficiency of contract enforcement and the country's bank and stock market development have a positive impact on financial structures. They further indicated that legal environments control the size and degree of a country's capital markets; a trustworthy legal environment supported by robust legal framework and smooth criminal and civil justice system will tend to provide confidence to prospective investors, especially foreign investors.

Empirical evidence from Beck and Levine (2003) also revealed that the law and finance theory substantiates the point that historical differences in legal practice have a greater influence on development of laws that support private contractual arrangements, and the enactment and enforcement of investor protection laws. Legal institutions resulting from these structures therefore, determine the willingness of savers to invest in firms, the effectiveness of corporate governance, and the degree of financial market development.

Haber (2002) demonstrated in a study of the politics and political institutions in Mexico and the United States that such institutions play a major role in a country's financial development. Outcomes of the decisions made by politicians in a country and the power to determine the size of institutions is a result of prevailing laws and regulations; and hence, the extent of the need for public finance. This view, however, does not support the legal origins view.

Empirical evidence by Chin and Ito (2005) also found that financial openness can have a positive impact on equity markets if legal systems and institutions are at a reasonable level and are well developed. They also indicated that to increase the benefits of financial openness in emerging countries, law and order should be quite high. Huang (2006) also points that geographical position of institutions may affect financial development through its demand and supply sides, by influencing the quality of institutions.

The Business Environment

The business environment largely depends on the effective performance of financial institutions which ultimately feeds into a high degree of financial development. Important factors to be considered according to the World Bank indicators for purposes of assessing effective performance of financial institutions include the availability of human capital, the level of training for staff working in the financial sector, the availability and quality of training institutions and research facilities; the state of physical capital (physical and technological infrastructure) and other aspects such as taxation levels and the costs of doing business (costs of starting and closing a business, registration of property, licensing, imports and export costs).

Macroeconomic Environment

The macroeconomic environment as indicated by Montiel (2003) entails macroeconomic policies. These policies include income per capita and quality of institutional environment; fast growing income per capita leads to credit-worthy firms and consequently, improvement in the institutional environment that enables financial intermediation. With an increasing per capita income, it is expected that premiums associated with external credit will decrease, thereby prompting more external credit to a variety of firms and, thus leading to an increase in financial intermediation. Furthermore, favourable economic conditions were also identified as important factors for financial development as mentioned in studies such as those made by Azariadis and Smith, (1996); Boyd, Levine and Smith (2001) and Khan, Senhadji and Smith (2006).

Financial intermediation and markets: Factors such as variety, size, depth, and efficiency of the financial intermediaries and markets that provide financial services become important for contributing to economic growth. Basically, financial intermediation is the core activity of the savings-investment process. These theories have been supported by empirical evidence in studies conducted by such authors as King and Levine (1993), in which a range of indicators for financial development and economic growth were studied.

Financial intermediation is facilitated by intermediaries such as banks, insurance companies, non-bank financial institutions and pension funds. These institutions solicit funds from a variety of small savers, pool them together and lend to firms that need funds to undertake projects that have positive returns. The size of the banking system in an economy has influence over the amount of resources that can be channelled from savers to investors. In the same manner, financial markets, instruments and institutions provide opportunities for investors to specialize in particular markets or services; they also acquire and disseminate information, and mobilize savings in a more efficient way to promote investment, and diversify risks.

Capital availability and access: the outputs of financial intermediation are represented by the size and depth of the financial sector and the availability of, and access to, financial services. A large financial system is ideally expected to efficiently manage allocation of capital and improve access to finance and hence, promote risk diversification.

2.2 The Role of Financial Markets and Financial Development

2.2.1 Importance of Financial Markets and Institutions

Economic theory provides that a strong positive relationship exists between financial market development and economic growth. It further provides that financial systems play an important role of intermediation between lenders and borrowers. Financial markets therefore, become important channels for investors by providing saving mechanisms that enable borrowers to find the required finance. Agarwal and Mohtadi (2004) found evidence from a study of 21 emerging markets that there exist a positive relationship between stock market development and economic growth, thereby, enhancing investor behaviour. The risk- return opportunities are assessed for projects that are to be undertaken. In this way, financial markets encourage investment in the production of goods and services, which consequently, enhance economic growth of domestic savings and more efficient financial intermediation.

A well-developed financial system, comprising well-developed financial markets and institutions, offers a wide selection of financial products to intermediaries that provide borrowers and lenders with a close match for their financing needs. Banks and other financial institutions collect savings deposits from a variety of individuals and combine them to create a pool of funds available for large enterprises to borrow. They assess managers and projects that are most likely to yield highest returns and monitor the use of those borrowed funds to ensure that they are directed towards financing of projects they were intended for. Individuals, businesses, and governments that need financing can easily discover financial institutions or financial markets that may provide the required funding. This allows investors to compare the cost of financing to their expected return on investment, thus making the investment choice that is suitable.

It thus seems obvious that the more efficient the financial system in mobilising savings, the more resources are channelled to productive activities at minimal costs leading to rapid economic growth rate. The importance of institutional quality has also been emphasized by Lombardo and Pagano (2000), who demonstrated a positive interrelationship between total stock market returns and the respect for law, the lack of government corruption, efficiency of the judicial system, quality of accounting standards, and a low risk of contract repudiation and nationalization. Furthermore, Mayer and Sussman (2001) underscored the fact that regulations on information disclosure, accounting standards, and permissible practices of banks affect financial development.

The link between financial intermediation and economic growth was supported by research studies conducted by scholars such as Greenwood and Jovanovic (1990), Bencivenga and Smith (1991), and Obstfeld (1994). These papers featured the fact that financial intermediation promotes growth as a larger fraction of investment is directed to activities that are expected to yield high returns. Even though the debate on the direction of causality between financial intermediation and economic development is still on-going; evidence suggests that effective financial markets have a positive effect on future economic growth (Gorton and Winton, 2002; King and Levine, 1993; Levine, 2004; Levine, Loyasa and Beck, 2000). Financial markets also provide liquidity, and promote risk diversification among savers. It is noted by several authors that large financial markets with lots of trading activity provide more liquidity for market participants than thinner markets with few available securities and participants and thus limited trading opportunities (Demirgüç-Kunt and Levine, 1996). The existence of robust financial markets and institutions also facilitates the international flow of funds between countries.

2.2.2 Financial Markets Development and Economic Growth

Much of the literature on the relationship between financial markets and real output lacked supporting evidence until the 1970s when studies by Goldsmith (1969), Shaw (1973) and MacKinnon (1973) found that development of financial markets was significantly correlated with the level of per capita income. Arestis, Demetriades and Luintel (2001), indicated that the growing importance of stock markets influenced research into the relationship between financial development and economic growth, with particular emphasis on stock market development. Rousseau and Wachtel (2000) and Beck and Levine (2003) show that stock market development is strongly correlated with economic growth rates of real GDP per capita. In addition to these studies, El-Wassal (2005), in his investigation of the relationship between stock market growth and economic growth involving 40 emerging markets found evidence supporting economic growth, financial liberalisation and foreign portfolio investments as leading factors in emerging stock market growth. More importantly, they found that stock market liquidity and banking development both predict the future growth rate of economy when they both enter the growth regression.

Research studies undertaken assert that efficient allocation of capital is achieved either through bank-based systems or market-based systems. However, the debate on which system is more efficient is still on-going. According to theory, well-developed stock markets should increase savings and efficiently channel such savings into productive investments. Stock markets are therefore, expected to contribute to the mobilisation of domestic savings by providing a selection of financial instruments available to savers to diversify their investment portfolios. Dailami and Aktin (1990), argue that stock markets provide an important source of investment capital at relatively low cost. Most institutional investors take advantage of country investment for the better allocation of assets focusing on geographical distributions.

The arguments for stock market development were supported by various empirical studies, such as Levine and Zervos (1993), Atje and Jovanovic (1993), Levine and Zervos (1998). Although these studies emphasise the importance of stock market development in the growth process, they do not simultaneously examine banking sector development, stock market development, and economic growth in a combined structure. Naceur, Ghazouani and Omran (2007) indicated that a financial system is responsible for proper allocation of resources in an economy. Therefore, stock markets have also been very important in recent years as a major channel for foreign capital flows to emerging economies.

Furthermore, some authors argue that larger, well-organized stock markets can boost economic growth (Levine and Zervos, 1995). Stock market development has been the subject of intensive theoretical and empirical studies (see Demirguc-Kunt and Levine (1995), Levine and Zervos (1993, 1995, 1998)). Cooray (2010) further found supporting empirical evidence that stock markets can influence economic growth. He found that economic growth can be positively influenced by increased physical capital and the required infrastructure.

According to Adjasi and Biekpe (2006), the presence of stock markets promotes efficient resource allocation and growth as it mitigates the problem of asymmetric information. It has been found that the existence of well-organised secondary markets for securities markets makes equities attractive because it increases liquidity and hence, allows easy portfolio diversification. Well-developed and active stock markets transform the pattern of demand for money, and well-functioning stock markets create liquidity, and hence spur economic growth. This is supported by the fact that the primary benefit of a stock market is liquid trading and price determining mechanism for a diverse range of financial instruments. This allows risk spreading by capital raisers and investors and matching of the maturity preferences of capital raisers (generally long-term) and investors (short-term). This in turn stimulates investment and lowers the cost of capital, contributing in the long term to economic growth.

However, Stiglitz (1989) warned that even though developed countries have distinct advantages in issuing stocks; for developing countries, the liquidity view should be treated with caution as sometimes firms that issue shares may include those that believe the market has overvalued their shares and see an opportunity to take advantage of the market ‘s ignorance.

More generally, economic theory suggests that stock markets encourage long-run growth by promoting specialization, acquiring and disseminating information, and mobilizing savings in a more efficient way to promote investment. Research also shows that as countries become wealthier and advanced, stock markets become more active and efficient relative to banks. Financial markets foster specialization in entrepreneurship, entrepreneurial development, and the adoption of new technologies. They do this by making funds available to potential entrepreneurs for activities which - in developed economies - must typically be undertaken on a larger scale than any small number of individuals can readily afford (Greenwood and Smith, 1997).

Boyd and Prescott (1986) and Stiglitz (1985) argued that banking sector development can play an important role in promoting economic growth, as banks are better than stock markets when it comes to resource allocation. They went further to show that the role that banks play of monitoring the use of funds borrowed by firms is of central importance in corporate finance. Arestis, Demetriades and Luintel (2001) asserted that while both banks and stock markets play an important role in the growth process, the banking sector development impact on economic growth in the long run is much higher than that of the stock market development effect.

A well-developed financial system generally achieves efficient allocation through either bank-based systems or market-based financial systems. Theory indicates that bank finance growth has been more effective and efficient than market-based systems, particularly in underdeveloped economies where non-bank financial intermediaries are generally less sophisticated. Evidence showed that compared to other forms of financial intermediation, well-established banks are able to form strong ties with the private sector and this enables them to acquire information about firms more efficiently and to persuade firms to pay their debts in a timely manner. King and Levine (1993) used different measures of bank development for several countries and found that banking sector development can spur economic growth in the long run.

Notwithstanding, the finance growth promoted by banks has been criticised in that banks provide finance to well-established, safe borrowers whereas; stock markets can finance risky, productive and innovative investment projects. In developing countries banks tend to avoid lending to new innovative and productive borrowers because of the high risk of default associated with new borrowers, or they will charge a risk premium on the lending rate to mitigate this risk. This discourages less risky investments from taking place although they could be viable and more productive, hence, negative impact on economic growth in the long run.

Debt finance is likely to be unavailable in many countries, particularly in developing countries, where bank loans may be limited to a selected group of companies and individual investors. In tandem with the latter statement, Kablan (2009) argues that banks in sub-Saharan Africa would normally lend to clients with a good capacity for payment, side-lining start-ups and small, micro and medium enterprises (SMMEs) which still require funding. Even though the literature has emphasised the role of the banking sector as the only organised capital market in most developing countries, it has neglected the potential role of stock markets for efficient capital allocation and risk sharing in a liberalised financial market (Caporale, Howells and Soliman, 2004). There has also been research that argues that stock markets can be counter-productive. The theoretical literature offers conflicting predictions about the role of stock markets and banks in promoting economic growth. The literature on financial liberalisation has emphasised abolishing interest rate ceilings and encourages free competition among banks as the way forward to achieve economic growth. However, it has largely overlooked the possibility that endogenous constraints in the credit market, such as inadequate information, could be a significant obstacle to efficient credit (Caporale, Howells and Soliman, 2004).

According to Singh (1996), even though there has been a notable progress in the development of stock markets in emerging markets, this does not mean that even the most advanced emerging stock markets are mature. Evidence has shown that in most stock markets, trading occurs in only a few stocks which account for a significant amount of the total market capitalization. Yartey (2008) also indicated that beyond these actively traded shares, markets are facing serious information and disclosure deficiencies on other stocks. There are serious weaknesses in the transparency of transactions on the less developed stock markets.

Nevertheless, benefits derived from stock market development for developed economies have been outstanding. Developing countries can also gain from this development and must gauge contribution to economic growth based on the size and activity in those markets and on the general financial structure prevailing in these countries. The well-functioning of financial markets should be supported by clearly defined property rights and accounting procedures that conform to best practices. Well-developed stock markets enable share ownership to individuals with relatively liquid means of sharing risk when investing in promising projects. The result is that capital is not prematurely withdrawn from firms to meet short-term liquidity needs. Moreover, stock markets play a key role in allocating capital to the corporate sector, which will have a real effect on the economy on aggregate.

2.3 Stock Market Development in Africa

Economic theory asserts that a well-developed financial system is supported by efficient and effective financial markets comprising institutions and instruments that are able to mobilize savings, allocate resources and diversify risks. Although some studies did not support development of stock markets in African countries, regarding them as “costly developments”, recent evidence suggests that stock markets have a potential to boost economic growth (Singh, 1999). Furthermore, Ngongang (2015) also demonstrated from data observed on 21 Sub-Saharan African countries that a positive relationship exists between financial development and economic growth. Research shows that benefits brought about by stock market development have been largely ignored in the past; hence, why research in this area has become popular. Nowbutsing and Odit (2009) found evidence that stock market development positively affects economic growth in their study of the Mauritian stock exchange for years 1989-2006.

Development of stock markets has surged in recent years and African countries saw this development as another tool for accelerating financial development and economic growth. However, unlike in the developed countries, financial systems in most African economies are still underdeveloped. Their impact on financial development is not significant, both to their own economies and international investors (Kenny and Moss, 1998).

Establishment of stock markets is therefore, envisaged to boost financial and economic development. In 2012, there were around twenty-nine (29) stock exchanges in Africa representing thirty-eight (38) nations’ capital markets (see table 2). Two out of the total number of 29 stock exchanges, represented regional stock exchanges, namely, the Bourse Régionale des Valeurs Mobilières, or BRVM, located in Abidjan, Cote d'Ivoire; and the Bourse Régionale des Valeurs Mobilières d'Afrique Centrale, or BVMAC, located in Libreville, Gabon. The BRVM serves countries of Benin, Burkina Faso, Guinea Bissau, Côte d'Ivoire, Mali, Niger, Senegal and Togo; the BVMAC serves the Central African Republic, Chad, Congo, Equatorial Guinea and Gabon(ASEA,2012).

Historical evidence suggests that there is a connection between a country's stage of development and the structure of its financial system. Banks have played a leading role in providing finance (debt finance) for infrastructure at the preliminary stages of development and thereby, encouraging growth. Garcia and Liu (1999) found evidence supporting the view that banks and stock markets are complementary in the development of a country. Using pooled data from fifteen (15) industrial and developing countries, they found that essential predictors of market capitalization include stock market liquidity and the level of real income whereas macroeconomic stability did not have any explanatory power.

The theoretical debate on financial structure brings into perspective four distinct views: the bank-based, the market-based, the financial services and the law and finance (Mahonye and Ojah, 2014). Proponents of bank-based system argue that banks can mobilise capital, identify and select projects with positive cash flows, monitor the use of funds and manage the risk. By virtue of the services they offer, long-run relationships with firms are maintained and information about firms is not disclosed prematurely to the public markets (Levine, 1997). Based on this view, Rajan and Zingales (1999) also assert that banks are able to influence big firms to repay the loans.

Proponents of market-based systems on the other hand, indicate that this model of financing provides for risk-sharing because investors hold a diversified portfolio of stocks in different sectors (Diamond, 1984). Information about listed firms is therefore, reflected in the share prices. The law and finance theory is supported by La Porta et al (1997, 1998) arguing that the legal infrastructure has greater influence on the institutions and standards governing legal rights and enforcement of contracts. Dermirguc-Kunt and Maksimovic (1996) proved that firms operating in counties which have achieved some level of effectiveness in their legal systems tend to grow much faster because of availability of external finance. The financial services view suggests that banks and stock markets complement each other on promoting economic growth. Hence, quality and a wide selection of services influence productive investment.

Catalan, Impavido and Musalem (2000) in their study of the relationship between the development of contractual savings which comprise assets of pension funds and life insurance companies, found that are more powerful in developing capital markets because of their long-term nature. They also found evidence that countries with more developed contractual savings sectors tend to have more developed markets.

The bank-based financial structure has been criticised for neglecting non-banking financial institutions (NBFI) that have a comparative advantage in mobilizing long-term capital for investment (Ziorklui, Nyagetera and Rutasitara, 2001). Critics argue that the structure of commercial banks, that of short-term assets and liabilities, is not capable of meeting long-term capital needs of the private sector. In the study of the effects of financial resources on regional economic growth in China, Zhang (2014) noted the importance of improving credit resources from the banking institutions in an effort to provide sufficient funding for economic development. Secondly, higher yields on short-term government Treasury bills provide greater incentives for commercial banks to hold a larger proportion of their asset portfolios in short-term government treasury bills. This action has led to the crowding out of private enterprises, especially small and medium-sized enterprises (SMEs) from the credit market.

Brugger and Rajapatirana (1995) highlighted the challenges faced by small businesses and the banking institutions wherein a familiarity relationship between these parties has not been established. They reflected problems that banks face when they attempt to price loans for small businesses without critical information relating to projects undertaken. This challenge therefore, leads to reluctance of banks to advance credits in this sector for fear of riskiness of projects or they tend to impose high interest rates in return for perceived risk.

However, in a well-developed regulatory infrastructure there is an easy flow of information from businesses to banks, and vice versa. In this way, competition is easily promoted and hence, private sector credit is able to grow to acceptable levels that can influence economic growth. The emphasis as Oluitan (2012) indicated is the need to position banks in ways that will direct improvement of private sector credit to encourage economic growth. Government regulation in terms of reserve requirements and the new risk-based capital requirements constrain the ability of commercial banks to provide long-term capital to the private sector. Commercial banks face real challenges of assessing the risks of borrowers properly in an informational deficient environment and would be averse against extending credit for business activities that are considered very risky (Ziorklui, Nyagetera and Rutasitara, 2001). Furthermore, as Andrianaivo and Yartey (2010) highlighted, financial intermediation in African countries is hindered by slow execution of court proceedings, the absence of credit assessment information and insufficient protection for property rights.

Notwithstanding conclusions brought about by the theories on financial structure, Africa has been plagued with high poverty levels and unstable political unrest post-independence. These have to some extent contributed to the slow pace of financial development in these countries. In most developing countries, most firms have to rely heavily on bank lending for sources of funds due to the fact that securities markets only provide a small fraction of funds that firms require; size of issues on bonds and equities is marginal. As a result, the slow pace of growth hinders financial development of a country. Jefferis (1995) asserted that because of their small size and illiquidity, most stock markets in Africa will remain largely insignificant as a source of investment funding. He concluded by citing the case of the Botswana Stock Exchange which had serious limitations to finance the manufacturing sector and diversifying the economy.

Studies on developing countries, in particular, Sub-Saharan Africa, indicated that capital accumulation through the stock market may be more costly and may lower the return on savings or investments, as a result of limited financial markets, instruments, and financial institutions, as well as poorly defined legal systems (Kenny and Moss, 1998; Hearn and Piesse, 2009). The impact of limited information or lack of financial transparency is understood when information is not readily available to market participants. Furthermore, in these small markets, it is difficult for investors to hold a well-diversified portfolio because only a limited range of financial assets or savings and investment products is available. Marone (2003) noted that in small economies the savings rate is usually low and it is found that households sometimes allocate their resources to real or tangible assets that may not diminish in value even when monetary fluctuations are prevailing.

African stock exchanges, with exception of the Johannesburg Stock Exchange (JSE) have revealed common characteristics which constitute barriers to the growth and efficient operation of the stock markets; namely, a small number of listed indigenous companies, low liquidity levels, inadequate market infrastructural support, total trading activity which is normally dominated by trading in just few stocks, high poverty levels prevalent in the continent, lack of public awareness of benefits of investing in shares by those with financial ability to do so as well as reluctance amongst indigenous companies to be less dependent on bank finance (Irving, 2005).

In the study of the Lusaka Stock Exchange, Marone (2003) suggested that for a stock market to achieve its role effectively, economic, political, regulatory and social environments should be conducive enough to enable its growth. Indicators for stock market development as stipulated by Yartey and Adjasi (2007) include macroeconomic stability comprising stable rates of inflation, high income levels, savings and investments; banking services; good quality institutions comprising law and order, democratic accountability, bureaucratic quality which broaden the confidence level in equity investment; and shareholder protection. A further observation was that, as a country achieves higher levels of income, its savings mobilisation will also increase and hence, the expectation for the stock market to effectively allocate resources to productive investment. This view was supported by recent studies on financial structure (Demirguc-Kunt and Levine, 1999; Cherif and Gazdar, 2010).

Evidence supporting the benefits derived from stock market development indicates that where stock markets are used as an innovation, they are able to overcome the structural and environmental impediments that stifle investment. It is important to note that evidence for African countries on the positive impact of financial development on economic growth is still limited; however, results from some studies supported that view (see Ndikumana, 2000; Allen and Ndikumana, 2000). Kenny and Moss (1998) made reference to the development of the electricity sector in Cote d'Ivoire during 1990; shares were distributed among small investors with the controlling interest of the leased power grid left in the hands of a consortium of French utility companies. In this country, benefits derived included the decrease of the price of electricity, reduced systems failures and outage times.

The Ghana stock Exchange was also awarded as the best stock market with performance of 144 percent end-of–year return by Morgan Stanley Capital International Global Index (Mensah et al., 2012). This was also an indication that even though African stock markets are small, some can still achieve better performance according to world standards. Ndikumana (2001) suggested that further positive progress on improving macroeconomic and financial sector reform includes the Ugandan government which posited credibility in policy decision-making, thereby promoting a conducive environment for private investment and growth.

2.4 The Evolution of Stock Market Development in Lesotho

The proliferation of stock markets in most African countries resulted from a program of financial liberalisation recommended by World Bank and IMF. In Lesotho, the major structural reform was undertaken in the late 1980s, and became effective in 1995. These reforms were focused on privatisation of large state-owned enterprises (SOEs), in a way to improve their economic efficiency. The Privatisation Act of 1995 stipulated that the privatisation program was aimed at, amongst others, reducing the budgetary burden on Government with a view to releasing Government funds for other essential services expenditures. The aim of the reforms was influenced largely by change of ownership, which was meant to improve economic performance (Vickers and Yarrow, 1998; Laffont and Tirole, 1991; Cook and Fabella, 2001).

Initially, thirty-six (36) SOEs were earmarked for privatisation; however, only twelve transactions were undertaken. Some of the challenges that the privatisation program encountered included lack of interest by foreign investors in the SOEs and inadequate mechanism for public participation in the privatization program. Perotti and Oijen (2001) found that there was a high growth in stock market development in countries which undertook privatization prior to the actual start of privatisation sales. In Lesotho, however, the stock market was not in existence at the time of privatization, and the move was intended to stimulate interest for the private sector towards developing a stock market. The introduction of the Lesotho Unit Trust in 2001, which later became StanLib Lesotho, was a result of the Government of Lesotho's privatization and private sector development programme aimed at facilitating the participation of Basotho in the shares previously owned by the Government in parastatals.

The Government of Lesotho expressed a desire to have a stock exchange in Lesotho in 2012, during the delivery of the 2011/12 budget speech by the Minister of Finance and Development Planning. However, processes paving the way for the development of the financial markets had started earlier with a number of steps including a situational analysis, intended to make a thorough assessment of the prospects of having a stock market in Lesotho as well as assisting in the determination of the appropriate model to be adopted.

The first step commenced in 2001 where the Government of Lesotho embarked on the initiatives to introduce Government Securities market in an effort to respond to a call for the development of capital markets in Lesotho. This step involved money market development and improvement. Second step was the introduction of the bond market in 2010, aimed at extending the yield curve as well encouraging long term investors. Notwithstanding the measurable success in in both the treasury bills and bond markets there seemed to be a gap in so far as the investment platforms are concerned and this was occasioned by the absence of the stock exchange. It is on the basis of the foregoing circumstances that the Central Bank of Lesotho Commissioned a study intended to explore the prospects of establishing a stock exchange in Lesotho.

Lesotho is part of the Sub-Saharan Africa region, with a population of around two million people and is entirely surrounded by the Republic of South Africa. The banking system in Lesotho is largely dominated by South African bank subsidiaries. Theory posits that the success of a stock market in a country largely depends on the functioning of institutions that facilitate development finance. From the literature reviewed (Jefferis and Smith, 2005; Irving, 2005; Smith, Jefferis and Ryoo, 2002), it is clear that even though African stock markets have grown in number and size, in general they remain thin, illiquid and technologically challenged, and ultimately becoming inefficient as far as information is concerned; with the exception of the JSE.

In consideration of these challenges, Ntim (2013) investigated possibilities of improving informational efficiency if these markets were to harmonise and integrate their operations. The idea harmonisation and integration is also supported by Claessens, Klingebiel and Schmukler (2002) and Irving (2005) who indicated benefits such as resolving issues of illiquidity, size and a source of capital flows in Africa. Fish and Biekpe (2002) suggest that regional integration will create expansion in trading volumes through economies of scale. In line with this argument, Abumustafa (2007) highlighted that better communication and technological infrastructure will reduce operational costs and improve the flow of information in the market.

Similar to other sub-Saharan Africa countries, Lesotho is expected to face similar challenges such as those pointed by Hearn and Piesse (2009) who articulated barriers to the development of small stock markets with special focus on the Kingdom of Swaziland and the Republic of Mozambique. It is likely that the establishment and growth of Lesotho's proposed stock market would be challenged by its geographic location within South Africa which is already advanced in this area. However, it may also benefit to a large extent if companies can dual-list in JSE and Lesotho.

Based on the analysis made in the previous steps, different models of stock markets were considered ranging from Over-the-Counter Markets (OTC) to fully fledged stock exchange providing services for stock brokers and traders of stock. The last option considered was that of Namibia where JSE platform is used by Namibian Stock Exchange in order to tap from the JSE expertise.

CHAPTER 3.0 – METHODOLOGY

3.1 Introduction

This chapter discusses the main data collection methods undertaken for this study. The objective of this study emanates from the fact that with the growing stock markets in Arica, some economies have enjoyed benefits derived from their operations. In an effort to achieve a similar purpose, Lesotho is also establishing its own stock market; therefore, gains and benefits are likely to be derived with the aim to accelerate growth and hence, economic development in the country.

The research methodology used in the study was to a large extent influenced by a number of studies that have been undertaken on African stock markets with particular emphasis on market efficiency and economic growth. Therefore, a qualitative approach was considered appropriate. This was a mixed methodology comprising desk-top research, a survey and structured interviews. Desk-based research focused on the systematic review of the literature in order to secure evidence from the theoretical perspective. Structured interviews and survey were used to provide initial understanding of the thinking behind the development of the stock market.

3.2 Data Collection Methods

3.2.1 Desk-based research

Firstly, desk-based research was undertaken and this followed a systematic review of literature in order to ascertain empirical evidence on the experience of other countries on stock market contribution to their economies. This method was suitable for this study because a lot of research has been made on stock market development and economic growth, and this would provide insight into the focus on developing countries in Sub-Saharan Africa and the benefits gained. Special challenges that small countries in sub-Saharan Africa encounter in developing stock markets were also studied through review of literature.

3.2.2 Survey

Following the literature review, a survey whose main technique involved a questionnaire distributed to potential participants in the stock market was undertaken to gather information on issues highlighted under the literature review. The questionnaire was distributed to individuals that work in finance and investment fields in order to establish or gauge expectations, ranging from practitioners to academics.

Due to the small size of the country and the fact that economic activity and knowledge on issues relating to stock markets is concentrated in Maseru urban area, the survey was focused in this area for gathering information. Their views and opinions were regarded as important for the operation of the stock market going forward. Particular consideration was made on the fact that the concept of stock market developments is not yet widely known in Lesotho; so those companies which had representation during the launch of the Maseru Securities Market (MSM) in January 2016 were better placed to respond to the questionnaire. The population frame was determined regardless of whether or not these companies have the ability to meet the listing requirements for the stock market.

The questionnaire allowed for collection of information by gender, age group and the field of finance. The web-based "questionpro" platform was used as an instrument for carrying the survey. Around 17 out of 69 participants responded to the questionnaire, implying a response rate of about 25 per cent.

3.2.3 Interviews

Interviews with relevant stakeholders, in particular officers of the Central Bank of Lesotho - employees in the Financial Markets Department, who were the facilitators of the stock market establishment, were conducted. Particular emphasis was made on advantages and disadvantages that stock market operations have on the economy of Lesotho, specifically focusing on challenges on the ground, including but not limited to the following:

- number of companies with a potential to list on the stock market,
- conversion of family businesses into public companies whose financial statements should be publicly disclosed,

- lack of knowledge by the general public whose participation would be crucial in buying and selling of shares, etc.

3.3 Assessment of the Legislative Framework and Listing Requirements

Throughout the interview process, challenges arising from the legal framework and the minimum requirements for listing in the Main Board of the proposed facility were raised by practitioners. These can be summarised into infrastructural challenges and Operational independence. The legal framework; namely, the Central Bank (Capital Markets) Regulations 2014, pursuant to section 5, establishes the Central Bank of Lesotho (CBL) or Commissioner of Financial Institutions as the Registrar of Capital Markets. In this way, the regulations empower the Central Bank of Lesotho as the Securities Market Regulator. Lopez-de-Silanes (2004) emphasized the importance of enforcement of contracts and dispute resolutions in the markets. It is therefore, noted that the regulations highlight the corporate governance structures that are entrusted to boost investor confidence as far as regulatory issues are concerned.

However, the market participants do not support the idea of the CBL being a regulator in this case. This issue has come up in most interviews with concerns related to potential conflict of interest as the CBL will play as both a referee and a player in the sense that it is the one spearheading the establishment of the stock market whilst on the other hand it is conferred with the power to be the licensing authority. The dual mandate is in contrast with best practices for establishing stock markets within the SADC region. There is a proposal that in order to achieve utmost operational independence, the stock market should be supervised and regulated by another standalone body or authority to ensure sustainability.

The regulatory environment has also been raised by respondents as an issue of concern; in particular, from banks operating in the country. The perception is that since the Central Bank is the regulator for banks and will also supervise the stock market, this may bring potential conflict of interest on issues of regulatory requirements which are more stringent for banks than for any other institutions.

Furthermore, another challenge that faces most companies operating in Lesotho is that they are not public companies and/or public companies conforming to the set standards specified in the listing requirements to satisfy transparency and accountability requirements. In addition to this, respondents raised the issue of publication for financial statements which is not a practice for most companies in Lesotho. The financial sector consists mostly of private firms whose likelihood to participate in the stock market may be limited.

Other respondents indicated that they had not yet considered listing in the stock market because of their small size and in most cases, they have only started business.

3.4. Analysis of stock market models

The study revealed that stock markets take different forms in different jurisdictions and this is dictated by peculiar circumstances in each country. The study briefly analysed models/approaches used to establish stock markets. Three options for the establishment of a stock market in Lesotho were identified through desk research carried out:

a) The first one is an Over-the-counter (OTC) facility, which is a small platform that is less restrictive in terms of rules and regulations than a fully-fledged exchange, where even small enterprises may be able to float their equities. Over-the-counter (OTC) financial transactions represent all the financial activities that do not take place on an organized market. OTC transactions imply a transaction between financial actors that agree privately on volume and price. No public report is usually made on those transactions. They mostly involve large financial institutions such as investment banks and other institutional investors.

Globally, OTC markets are tactically positioning themselves as transactions in these markets are reported to have overtaken exchange markets in terms of volumes traded daily, mainly due to the increase in electronic trading and the rise in alternative investing. Most exchanges started out as an OTC before being fully fledged stock exchanges. The advantage with this model is that it is not costly to set up, allows both large and small scale issuers the opportunity to raise funds from the market. The possible disadvantage is that issuers may take advantage of the less stringent requirements and regulations of this arrangement and as a result put public funds invested in the entities in jeopardy.

b) The second option is to establish a fully-fledged stock exchange, which provides services for stock brokers and traders of stocks, bonds and any other securities. The advantage of this set up is that it is self-regulatory and requires oversight from either a regulatory authority or can be regulated by the Central Bank. It can be very costly to establish especially if the initiative is not led by the business community. It requires large administrative and regulatory frameworks.

c) The third option that was identified is a similar model to the one Namibia adopted. Namibia Stock Exchange is closely associated with the Johannesburg Stock Exchange (JSE), harnessing the expertise and experience of the JSE. The Lesotho Stock Exchange would list its shares on the JSE using the JSE trading platforms. This would attract some costs and warrants a critical consideration due to linking with a well-established giant and use of sophisticated systems regardless of the size of the economy.

However, more benefit would ensue from knowledge sharing and transfer of expertise from the JSE. The advantage of this approach is that it will also be in line with the current efforts to integrate and harmonize the operations of the SADC stock exchanges.

CHAPTER 4.0 – PRESENTATION AND ANALYSIS

This chapter provides a presentation and analysis of data collected from potential market participants in the Lesotho Stock market and views of other experts in the finance space. As highlighted in chapter 1, methods utilised for data collection included desk research, structured interviews with relevant stakeholders and a questionnaire for potential participants in the stock market**.**

4.1 Presentation of Results and Analysis

The study was designed to establish if there are any benefits to be derived from a national stock market. It also examines whether or not the presence of banking institutions could have had any influence on the fear of replication for platforms that can be accessed from South Africa and whether the necessary infrastructure is unavailable for the operation of a stock market. In order to gather information for this study, both primary data and systematic review of literature was utilised to ascertain evidence on the perceptions about the national stock market.

4.2 Summary of Responses from the Survey

This part summarises some of the responses from the survey and interviews. Following the review of literature throughout the study of stock market development, with a focus on developing economies, in particular, small economies in Sub-Saharan Africa, and a questionnaire was developed. The following responses are based on the main questions from the survey. Presentation of data is subdivided into main responses from the survey and interviews.

4.2.1 Responses on questions 1 to 4 are summarised in the Table 1

Category	Percentage	Narration
Company Representative	22.22	
Individual	77.78	
Male	77.78	
Female	22.22	
Field of work	66.67	Banking
	11.11	Financial Advisor
	5.56	Stock Broker
	16.67	Other
Age Group	5.56	25-30
	61.11	31-40
	33.33	41-50

4.2.2 Responses on availability of investment instruments

Evidence from developed countries has been determined to support the fact that financial development of a country is driven by successful functioning of financial institutions and ample financial instruments that allow holders the liquidity they need when necessary and the exit strategies. Research has shown that in countries where financial instruments are plenty, the level of development is at an advanced stage.

The empirical study by Beck and Levine (2004) on the relationship between stock market, bank development and economic growth, support the fact that well-functioning financial systems have the ability to achieve minimal information and transactions costs and consequently optimal financial resource allocation and economic growth. However, in most African countries, it has been found that financial intermediaries are held back in providing financial services because of high transactions costs and lack of appropriate collateral and basic requirements for financing. This remains a challenge in most countries in Africa; in Lesotho as well, availability of financial instruments is limited and as a result, savers have become vulnerable to a number of mushrooming pyramid or Ponzi schemes emerging from a number of countries.

Respondents of this survey were asked to provide their opinions on whether they are aware of investment instruments available in Lesotho, and whether or not there are enough instruments to satisfy the needs of the investing community. All those who responded were aware of the financial instruments and out of these, 94.44 per cent indicated that investment instruments are not adequate.

4.2.3 Responses on whether availability of investment instruments could deter people from investing in illegal (pyramid/ponzi) schemes

A perception was made in the study that due to lack of investment platforms, people have become vulnerable to illegal schemes such as pyramid and Ponzi schemes in an effort to tap into attractive returns on their funds. The purpose of posing the above question was to determine the extent to which people tend to invest in these illegal schemes for better returns or because investment platforms or instruments are not enough for the investing community. The majority (61.11 per cent) of the responses were on the affirmative, implying that sufficient investment instruments may attract investors to direct their hard-earned savings.

4.2.4 Responses on why people invest outside Lesotho

In Lesotho, the banking sector dominates the financial sector in all respects, maturity size and development. The majority of banking institutions are subsidiaries of the South African banks (three of the four banks). This sector has grown over time and as in other countries. However, private sector credit remains small because of generally infrastructural issues including, economic policies that are not explicit in terms of growing the Lesotho economy, reluctance to extend credit to people in the rural areas for lack of proper collateral, banking products that are developed from the South African banking perspective and which may not be suitable for Lesotho, etc.

The purpose of raising this question was therefore, to measure the range of responses which may represent initiatives to be addressed in the future to restrain the flow of funds going outside the country. This is one of the initiatives that policymakers need to focus on so as to achieve economic growth from local funds; it is considered that in a country where intermediation is functional, growth of households result; hence, growth and development for an economy.

An area of concern for investors is that Lesotho is characterised by low rates of return on investments. What the financial intermediaries offer is very low compared to returns earned across the border on similar products. Other reasons for investing outside Lesotho included tax exemptions on certain investments as well as convenience.

4.2.5 Responses to additional investment instruments

Lack of investments instruments has been observed over time. This has been reflected by the rise and boom of pyramid and Ponzi schemes across the country. To some extent, this has implied poverty-stricken community which strives to earn quick and huge returns over a short period of time. Furthermore, the rate of unemployment in Lesotho has hugely grown and this has been reflected by this behaviour in some way.

On the other hand, mushrooming of these illegal schemes reflected plenty of investible funds which cannot be directed to formal sources of investing because they are either not known or they are not in place. This is another area that policy makers need to address in the development of policies for encouraging longer term savings and further enhance financial education programmes. In this area, the observation is that some of the responses included instruments that are already in place but some segments of the society do not know anything about them. These include unit trusts and Treasury bills and bonds.

From the responses received, it is imperative to mention that equities and derivatives, corporate bonds and listed property have been raised as instruments that need to be added to a basket of investments.

4.2.6 Responses on the role of the stock market

The role of the stock market has been described by several authors, with its origins derived from studies by Shaw (1973) and McKinnon (1973) in which a relationship between capital markets development and long-term economic growth was determined. Singh (1992) put forth the fact that in many developing economies, development of stock markets was apparent resulting from privatisation, move towards liberalisation and reduction of state ownership in firms. He concluded that developing countries should nurture bank-based financial systems more than encouraging stock market development.

In theory, a stock market is expected to encourage savings as households are provided with an additional instrument that may enable risk diversification and satisfy liquidity needs. The proper functioning of financial markets is facilitated by availability of clearing and settlement systems, stable macroeconomic environment, creditor rights protection and legal systems for enforcement of contracts (Litan, Pomerleano and Sundararajan, 2003; Andrianaivo and Yartey, 2010). The success of the stock market therefore, will depend on financial stability and soundness of the institutions or firms and this information should be easily accessible on a timely basis. Furthermore, management or reduction of political risk on banking sector and stock market development has been identified as important for development of African financial markets.

Based on information studied from this literature, it was crucial to understand what the Lesotho financial sector perceives as the role of the stock market and whether it can be achieved. A general observation was that most respondents understood this role. It will therefore, be essential or policy makers to initiate efforts that ensure stability of the markets.

4.2.7 Responses on whether or not the stock market will attract new investors and increase competition in the financial sector

Some studies have confirmed growth of African markets as a means of earning better returns and achieving risk diversification for international investors. However, Nellor (2008) indicated that market depth and infrastructure remain challenges facing African countries; it is vital therefore, that policy makers need to strengthen supervisory capacity to manage these financial activities and capital flows.

The majority of respondents believed that the establishment of the stock market can attract new investors in Lesotho. Around 66.67 per cent supported this fact, while 27.78 per cent responses were on the negative; 5.56 per cent did not have an idea on this issue. The legislative framework in Lesotho permits participation of foreign investors in the stock market. Policy makers should therefore, exercise caution with respect to capital flows which may threaten the stability of the markets if it is excessive.

As far as competition for financial instruments is concerned, 83.33 per cent concurred with the fact that the stock market is likely to introduce competition, while 16.67 per cent were on the negative.

4.2.8 Responses on whether the legal framework for the stock market is sufficient to attract foreign participation

Enabling legislation is necessary for the stock market to achieve its objective. Legislative frameworks are an essential part in determining participation of both local and foreign participants to ensure protection of property rights. Litan, Pomerleano and Sundararajan (2003) posited that the demand for securities can be enhanced through contractual savings held with institutions such as pension funds as long as transparency and governance structures are well established, thereby providing security for foreign investors. This has been emphasized by Haber (2002) indicating the importance of political institutions in determining the size and target market. Supporting legislation for pension funds may also influence the savings behaviour in a country if investors are confident that their rights are adequately protected. Bain (1981) made reference to the British occupation pension schemes whose tax arrangements had a great power on the savings culture and consequently economic and political stability.

It is very important for policy makers to ensure that laws and regulations allow smooth operation of the stock market. The majority of respondents (55.55 per cent) believe that the legislative framework is not sufficient at this stage to attract foreign participation, while 27.78 per cent responded that it is adequate.

4.2.9 Responses on what can be done to ensure that the stock market will benefit the Basotho

In this area, the idea was to have a general suggestion from the respondents to ensure that the stock market does not end up as a “white elephant” but rather come up with initiatives that can be made for it to be a success for the nation. A range of suggestions were made including the following; Government must be willing to release some of its shares in some companies, awareness on the benefits that can be derived from the stock market must be made for the Basotho to understand, tax and transactions fees must be kept at a minimum and ensure that an independent authority outside the Central Bank regulates the stock market.

Control over taxes or subsidies are a prerogative of government in all respects as a way of encouraging financial institutions to provide finance in certain sectors of the economy (Bain, 1981). Nellor (2008) made an example of the success of the Indonesia where the government introduced tax breaks as one of the indicators of attracting investment while also maintain its competitiveness.

These suggestions provide a broad overview of what policy makers need to think about implementing in the long term. Furthermore, as noted throughout the literature, and supported by studies of Acaravci, Ozturk and Acaravci (2009), it remains an important fact that Sub-Saharan African countries should expand and improve their credit systems through appropriate regulatory and policy reforms in order to support higher economic growth.

4.2.10 Responses on how the banking sector can complement the operation of the stock market

Literature has highlighted that financial development in an economy depends on the proper functioning of financial institutions and markets. Litan, Pomerleano and Sundararajan (2003) emphasized that growth and stability can be achieved through efficient mobilisation of capital and proper pricing of risks involved. The stock market and banking institutions have the ability to enhance financial intermediation; they can work as complements rather than as substitutes. The whole idea for the development of a stock market in Lesotho emanated from the fact that the banking industry in Lesotho is dominated by the subsidiaries of South African banks, and this has influenced product development and intermediation efforts to a certain extent, which have proved not to be suitable for the local market. The stock market therefore, is intended to encourage long term investment and contribute to economic development of households and hence, economic growth.

Respondents were requested to make suggestions that can promote complementary services between the banking institutions and the stock market. The expectation from the respondents is that banks should play a supportive role in encouraging financial inclusion through low transaction costs while also acting as settlement agents. This is another policy issue that needs to be incorporated in the development policies to encourage formal financial services to be provided to all levels of the society. Furthermore, Andrianaivo and Yartey, (2010) found evidence that supports the notion for governments to formulate policies that promote domestic savings in an effort to stimulate stock market development.

4.2.11 Responses with regard to whether the establishment of a national stock market was a necessity in Lesotho depending on the size of the private sector

In most countries where banking institutions are significantly dominating the market with excess liquidity, they tend to neglect identification of credit-worthy borrowers and consequently, monetary policy fails to encourage lending conditions and the broader monetary aggregates. As elaborated by Mlachila, Park and Yabara (2013), this situation prevails in Lesotho as well, where credit to deposit ratio is very low and the economic activity is small in size. However, initiatives such as the development of a stock market have in some economies provided another platform where shares exchange hands and as a result, countries achieve financial development and economic growth. Furthermore, studies such as those conducted by Kim and Singal (2000) provided evidence that stock markets tend to become more efficient when domestic markets have been liberalised and foreign investors participate freely. The evidence also indicated that market openings have favourable effects on the emerging economies.

In response to this question, most respondents confirmed that this development is critical for Lesotho, irrespective of the size of the private sector.

4.2.12 Responses with regard to any possible threats that may be incidental to the establishment of the stock market

While it is agreed that well-functioning stock markets provide a source of funding for firms, it is also expected that sound macroeconomic environment will have a greater influence on the stability of the equity markets (Litan, Pomerleano and Sundararajan, 2003). Ojah, Gwatidzo and Kaniki (2010) further suggested that governments of the East African community may pursue investment or growth policies that focus on financial markets deepening while also enhancing legal infrastructures in order to have a positive influence on the firms' decisions to invest. It is noted that most local markets allow foreign participation in an effort to widen and diversify the investor base for financial instruments. While foreign participation may support development of the markets, foreign investors may also perpetrate the flow of funds out of the country and hence, contribute to volatility of markets. In small economies in which shares are held by a few institutional investors or elites, the threat can be lack of liquidity.

In response to this question, threats in the sequence of volatility of markets that may be caused by a financial crises, possibility of wealthy investors dominating the market and holding on to more attractive investments, insufficient laws governing the market and conduct, were highlighted. These responses reflected on issues that policy makers can focus on to ensure smooth operation and a supportive environment for the stock market.

4.3 Summary of Interview with the Lead Coordinators at the Central Bank of Lesotho (CBL).

This study was undertaken at the time when the CBL was also making strides to develop capital markets in Lesotho. The interviews were conducted after the launch of the national stock market; namely, the Maseru Securities Market (MSM); the launch event was held on 22 January 2016. Therefore, the interviews could be regarded as a fact-finding effort on new developments after the launch of the MSM.

4.3.1 New listings in the MSM

In response to whether there have been any companies which have shown interest to list on the MSM, the answer was not yet. However, a number of companies of different sizes have made enquires about the MSM; the launch could be seen as a sensitisation program for the market because most companies did not quite understand the whole idea of a stock market.

4.3.2. Targeted companies for listing

In response to companies that were ideal targets for listing on the MSM prior to the launch, the answer included companies in which the Government of Lesotho (GoL) has shares including but not limited to Lesotho National Development Corporation (LNDC), Maluti Mountain Brewery (MMB). Notwithstanding, other private (family-owned) companies including Matekane Group of Companies (MGC), Nthane Brothers and Moruo Development were also identified as targets. However, challenges for these companies include financial education/literacy as they would want to retain shares within the family.

Education is a very important component in the success of stock markets in Africa. Yartey and Adjasi (2007) have indicated the importance of strengthening education in the future success of African stock markets as a policy action. Education about the role of the stock market has a likelihood of increasing investor base and the issues around the liquidity of the stock market. They further emphasize that insecurities about firms losing their control in family businesses can be easily managed if they are knowledgeable about their role in the stock market. Yartey (2005) provided evidence from a study of the Ghanaian experience in which firms were unwilling to list on the stock exchange for fear of losing control. However, if all levels of society understand the role of the stock market, countries are better able to benefit.

4.3.3 Support Initiatives by the Government of Lesotho

Another question posed was in relation to support initiatives from the GoL considering the level of poverty in-country and no savings culture. The answer was elaborate to reflect efforts such as engagement of the World Bank Technical Assistance to assess GoL parastatals including those mentioned previously for feasibility of releasing shares to the public. In view of the second component, the reaction of the community to uptake illegal investments in pyramid schemes was misinterpreted as too much liquidity in the hands of people who require better returns even though such funds are misdirected. In terms of a savings culture, there is need to educate the community on formal financial services and instruments; in the long-term proper investments can be achieved.

4.3.4 Assessment of Listing Requirements

In view of the assessment of the listing requirements for the MSM, the comment was that the Lesotho Institute of Accountants will be a pillar of regulation with regard to publication of financial statements that conform to International Accounting and Reporting standards. Otherwise, listing requirements have been relaxed to enable even smaller companies to participate. It is worth noting how important regulation and supervision is where accountability, transparency and enforcement are concerned. Friedman and Grose (2006) alluded to a simple and supportive disclosure framework that enables identification of beneficial owners of transactions.

4.3.5 Challenges in the MSM

The other questions were in relation to immediate challenges foreseen in the MSM, support of the pension funds and banking institutions. In view of these, banks are expected to participate in the MSM as sponsors, settlement agents and investments advisors. However, their participation in these areas will depend on whether the activities are regarded as permissible to be undertaken by banks under the Financial Institutions Act 2012, being the legislation that regulates the banking sector.

As far as pension funds are concerned, proposals have been put forth in the Draft Pensions Bill that is going through legislative structures for approval and enactment to impose local asset holding requirements. The contractual savings institutions are an important component in the development of capital markets and economic growth; it is therefore, important to encourage reforms that will ensure an enabling regulatory framework to allow growth of these institutions. In support of these reforms, Catalan, Impavido and Musalem (2000) emphasized that a strategy comprising a stable macroeconomic environment, sound banking system, a reliable financial sector regulation and supervision and an appropriate tax system will be essential.

In view of the challenges, an observation is that there is a general lack of knowledge within the government structures such that this translates into a situation that can be perceived as lack of political will.

CHAPTER 5.0 – CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

The purpose of this study was to investigate possible gains from and threats incidental to the establishment of the Lesotho stock market. Major focus was to evaluate whether the stock market can stimulate economic growth in Lesotho, the potential challenges to be encountered and ways of addressing such challenges in order to benefit from the development of a stock market as in other small economies in Sub-Saharan Africa. The study further intended to determine a suitable model of for a stock market based on the available models analysed considering the size and economic activity of Lesotho.

5.2 Policy Issues and Recommendations arising from the study

From the literature reviewed as well as results from the survey and interviews, a number of policy issues need to be considered in the success of the stock market. Such policies include but not limited to the following:

- Strengthening the regulatory and legislative framework that will remove barriers perceived; these include areas such as tax breaks, standalone regulatory authority in order to achieve operational independence. Development of laws and reforms pertaining to contractual savings are also a necessity.

- Enhance education in –country at all levels of society so that the role of the stock market should be clearly understood, and hence, increase investor base. Education for better understanding of the available financial instruments is also a necessity;

- Strengthen cooperation between other regulatory bodies such as the Lesotho Institute of Accountants for monitoring disclosure requirements of public companies in Lesotho;

- Encouraging development of other financial instruments suitable for the local market by financial intermediaries. Promote financial inclusion by encouraging financial institutions to extent credit even to the rural poor by developing enabling laws that allow collateral substitutes, and to introduce low transactions costs;

- Stabilising the macroeconomic environment to balance inflationary pressures and interest rates offered on domestic savings; and

- The government should work towards reducing the unemployment rate and poverty levels in order to minimise vulnerability of investors to pyramid schemes.

5.3 The Stock Market Model for Lesotho

In line with the different models that can be adopted on the establishment of a stock market, desk research was undertaken and three alternatives were considered as follows:

a) Over-the-counter (OTC) facility – The advantage for this set up is that it is not costly and allows both large and small scale issuers the opportunity to raise funds from the market. This option was considered inappropriate for Lesotho because a lot of effort had gone into development of legislation intended to facilitate operations of the stock market hence publication of Central Bank (Capital Markets) Regulations, 2014.However, it could only be rolled out for specified period to facilitate the commencement of trading as well ascertaining the level of participation and prospects for the success of the stock market. Furthermore, the modern electronic infrastructure for facilitating payments and settlements had already been procured and utilised for money market operations. The CBL had already procured a more advanced and modern securities trading and custodianship system that is currently used in the trading of Government Treasury securities.

b) The second option was to establish a fully-fledged stock exchange. However, based on the costs involved in this setting it would not be justified largely due to the fact that the private sector is not leading this initiative. The Government of Lesotho could not afford the huge costs involved in the establishment of the fully fledged facility whose sustainability is not ascertained. It would also be difficult for the institution to be self-regulatory since knowledge on the operations of the stock market is still biased towards the Central Bank and not the market participants as provided for by the best practices.

c) The third option that was identified is a similar model to the one Namibia adopted. Namibia Stock Exchange is closely associated with the Johannesburg Stock Exchange (JSE), harnessing the expertise and experience of the JSE. This model was considered appropriate for the Lesotho Stock Exchange as it would list its shares on the JSE using the JSE trading platforms. It is expected that some costs would be incurred for linking with the JSE but not at a magnitude that warrants a fully-fledged stock market. This approach would enable CBL to tap from the skills and expertise of the JSE as a well-established and experienced institution. The advantage of this approach is that it will also be in line with the current efforts to integrate and harmonize the operations of the SADC stock exchanges.

In the final analysis, factors such as the population size, economic activity, cost implications as well as the support of the private sector and the government of Lesotho were taken into consideration. Therefore, a phased approach which is less restrictive in terms of regulatory framework administered under the CBL Act, 2000 read with the Capital Markets Regulations was believed to be suitable. The first phase involved introduction and operationalization of the OTC market with a view to establish prospective participants and trading activity whilst the second phase would involve a shared infrastructure model similar to the model adopted by Namibia, using a link to the JSE.

5.4 Conclusion

A number of conclusions can be drawn from the results of the study. Firstly, stock market development is one of the critical channels of the growth process in an economy.

Secondly, sequencing of reforms is essential in the development of capital markets, for instance, developing the contractual savings institutions frameworks play an important role in promoting capital markets development.

Third, governments' initiatives such as opening of markets and introduction of tax breaks and subsidies, and strengthening of education, may benefit the economies if they are geared towards achieving overall economic development and growth.

Fourth, Lesotho can also benefit from the establishment of the stock market while also not ignoring the strengthening of institutional infrastructures. However, the development of the stock market faces a number of challenges that call for structural reforms to assist the stock market in achieving its critical role. Many lessons could be drawn from empirical studies especially from African countries.

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Annex 1: Interview Questions for Lead Coordinators at the Central Bank of Lesotho

1. After the launch of the MSM which was a success, how is the uptake by the private sector, any interested companies to List? And how many?

2. Based on the assessment of the size of the private sector prior to launching, were there any companies that we were targeting from the private sector besides companies in which Government has some shareholding that may satisfy the Listing requirements?

3. A lot of work was done to sensitise potential participants in the MSM, how was the response from a few elites that hold huge sums of money in this country? The likes of MGC, Nthane Bros, Moruo Development, etc

4. Lesotho is one of those countries that are poverty-stricken and no savings culture. Do we foresee a change of policy from the government in order to support initiatives such as MSM?

5. Do we foresee Basotho investing for the longer term? What has been the response from the financial education initiatives?

6. What is your assessment of the Listing Requirements; depending on the size and type of companies operating in Lesotho? E.g. public companies which publish financial statements and whose minimum shares are 1000000.

7. Sponsors. Which companies are we targeting in this area? Are they available in Lesotho currently to serve on this role?

8. In order for Basotho to benefit from this initiative, what should be done in order for banking institutions to complement rather than compete with the stock market?

9. Have pension funds supported this initiative, and in what way?

10. What are the immediate challenges that we foresee after the establishment of the MSM if any?

Annex 2: QUESTIONNAIRE: Development of a national stock market in Lesotho: A response to structural challenges.

BACKGROUND INFORMATION

1. Are you an individual or representing a company?
2. What is your gender?
3. What was your age in years at your last birthday?
4. In which field of finance do you work? Bank, Insurance, pension, financial advisor, stock broker, other

FINANCE AND INVESTMENTS

5. Please provide your view on the following:
- Are you aware of the investment instruments available in Lesotho?
- In your opinion, are existing investment instruments or vehicles enough in Lesotho?
- Do you think availability of investment instruments can deter people from investing in illegal schemes (such as pyramid/ponzi schemes)?

6. Which of the following financial instruments do you hold? In Lesotho? In South Africa? In other countries?
   - Treasury/Bills /Bonds
   - Mutual Funds/Unit Trusts
   - Call deposits
   - Fixed Deposits
   - Other

7. Please state reasons for investing outside Lesotho.

8. Which other financial instruments can be introduced to add to those that are available in Lesotho?

9. What do you think is the role of the stock market?

10. Please provide your view on the following:
- Do you think a stock market will attract new investors in Lesotho?
- Do you think most South African companies operating in Lesotho will participate in the stock market in Lesotho?
- Do you think development of the national stock market will boost economic growth?

- Do you think the stock market will encourage competition in the financial sector for financial instruments?
- Do you think the legal infrastructure for the stock market is sufficient to attract foreign participants?

11. Please make suggestion that can be made for the national stock market to be of benefit to the Basotho people.
12. Please make comments/Suggestions that can be made to the banking sector in order to complement the operation of the stock market.
13. In view of the size of the financial sector in Lesotho, do you think the establishment of a stock market is necessary?
14. In your opinion, are there any possible threats incidental to the establishment of the stock market? Please comment on how they can be addressed if there any.

Thank you for your participation.

Table 2: List of Stock Exchanges in Africa

Economy	Exchange	Location	Founded	
Algeria	Algiers Stock Exchange	Algiers	1997	5
Botswana	Botswana Stock Exchange	Gaborone	1989	44
Cameroon	Douala Stock Exchange	Douala	2001	2
Cape Verde	Bolsa de Valores de Cabo Verde	Mindelo	2005	
Côte d'Ivoire	Bourse Régionale des Valeurs Mobilières*	Abidjan	1998	39
Egypt	Egyptian Exchange*	Cairo, Alexandria	1883	833
Ghana	Ghana Stock Exchange*	Accra	1990	34
Kenya	Nairobi Securities Exchange*	Nairobi	1954	64
Lybia	Libyan Stock Market*	Tripoli	*2007*	7
Malawi	Malawi Stock Exchange*	Blantyre	1995	14
Mauritius	Stock Exchange of Mauritius	Port Louis	1988	88
Morocco	Casablanca Stock Exchange*	Casablanca	1929	81
Mozambique	Bolsa de Valores de Mozambique*	Maputo	1999	
Namibia	Namibia Stock Exchange*	Windhoek	1992	
Nigeria	Abuja Securities and Commodities Exchange	Abuja	1998	
Nigeria	Nigerian Stock Exchange*	Lagos	1960	223
Rwanda	Rwanda Stock Exchange	Kigali	2008	5
Seychelles	Seychelles Securities	Victoria	2012	4

	Exchange (Trop-X)*			
Somalia	Somalia Stock Exchange	Mogadishu	2012	
South Africa	JSE Limited*	Johannesburg	1887	402 (as of May 30, 2014)
Sudan	Khartoum Stock Exchange*	Khartoum	1994	54
Swaziland	Swaziland Stock Exchange*	Mbabane	1990	10
Tanzania	Dar es Salaam Stock Exchange*	Dar es Salaam	1998	17
Tunisia	Bourse de Tunis*	Tunis	1969	56
Uganda	Uganda Securities Exchange*	Kampala	1997	17
Zambia	Agricultural Commodities Exchange of Zambia	Lusaka	2007	
Zambia	Lusaka Stock Exchange*	Lusaka	1994	16
Zimbabwe	Zimbabwe Stock Exchange*	Harare	1948	64

(*): members of Afican Securities Exchanges Association, ASEA
Source: https://en.wikipedia.org/wiki/List_of_African_stock_exchanges