THE ROLE OF FINANCIAL MARKETS IN ECONOMIC GROWTH

Dr. MOHAMED JALLOH
DIRECTOR GENERAL /CHIEF EXECUTIVE OFFICER
SIERRA LEONE STOCK EXCHANGE
C/O BANK OF SIERRA LEONE

WAIFEM REGIONAL COURSE ON OPERATIONS AND REGULATION
OF CAPITAL MARKET, ACCRA, GHANA.

1. **INTRODUCTION**

Financial markets play an important role in the mobilization of financial resources for long term investment through financial intermediation. The existence of money markets facilitate trading in short-term debt instruments to meet short-term needs of large users of funds such as governments, banks and similar institutions. Government treasury bills and similar securities, as well as company commercial bills, are examples of instruments traded in the money market. A wide range of financial institutions, including merchant banks, commercial banks, the central bank and other dealers operate in the money market. Public as well as private sector operators make use of various financial instruments to raise and invest short term funds which, if need be, can be quickly liquidated to satisfy short-term needs. Unlike the money market, the capital market mobilizes long-term debt and equity finance for investments in long-term assets. Capital markets also help to strengthen corporate financial structure and improve the general solvency of the financial system.

The securities segment of the capital market complement traditional lending institutions by providing risk capital (equity) and loan capital (debt). By means of these instruments, the market is able to mobilize long-term savings and provide capital to investors to finance long-term investments thereby broadening ownership of productive assets. Dealers in the securities segment of the capital market include banking institutions, stockbrokers, investment and merchant bankers and venture capitalists who intermediate between the market and the public.

Well functioning financial markets are very crucial for the promotion of global financial integration. An efficiently functioning domestic financial market can better position a country’s competitiveness in the markets for global capital
(Senbet and Otchere 2005). Accessing global markets for capital through a well-functioning financial system lessens a country’s reliance on foreign aid and other forms of external borrowing. It has been pointed out by a number of financial analysts that financial globalisation allows for the sharing of local security risks. Given the benefits associated with having well-functioning financial systems, a number of African countries have endeavored to put in place various measures aimed at developing the financial sector. Financial sector reforms have therefore been widely used as policy measures to encourage the development of domestic financial systems as well as the dismantling of barriers to international capital flows. African financial markets have been increasingly integrated with the other world capital markets. The encouraging drive towards globalizing capital flows in Africa has led to the growing relevance of emerging capital markets in the continent.

Over the past two decades, the continent of Africa has experienced a relatively fast development of equity markets. Between 1980 and 1999, the number of active Stock Exchanges in Africa more than double by increasing from 8 to 17 (Ndikumana 2001). To take full advantage of financial globalization, African countries are now moving towards regionalization of their financial markets. The first regional Stock Exchange – Bourse Régionale des Valeurs Mobiliéres (BVRM) - was formed in 1998 by Francophone West African countries and based in Abidjan. This regional Stock Exchange was establish to serves equity markets in Benin, Burkina Faso, Cote d’Ivoire, Guinea-Bissau, Mali, Niger, Senegal and Togo. Currently, Anglophone West African countries are also contemplating forming a regional stock exchange under the umbrella of the ECOWAS. In a similar fashion, Kenya, Uganda and Tanzania are also contemplating on having a
regional stock exchange for Eastern Africa. The Southern African Development Committee (SADC) has also proposed the idea of a regional stock exchange.

2. THE ROLE OF FINANCIAL MARKETS IN RESOURCE MOBILIZATION

At any point in time, we have people that have money that they don’t want to spend but rather save for future uses. This set of people choose to save because they have more than what they needed to spend for the time being. On the other hand, there are people that want to spend money to undertake some economic activities but don’t have the required amount of financial resources. Though some do have some money, it may not be enough to fully finance the intended activity. For instance, an individual may want to start a small private business but lacks enough money to finance the business. In that case he/she may need additional financial resources to fully finance his/her business. The Government for instance would like to construct of a well equipped modern Hospital or construct a well paved high way linking Sierra Leone to neighbouring countries like Guinea and Liberia but may not have enough economic resources to finance the projects. As a result, the Government may want to quickly access additional financial resources through borrowing from the general public. In another example, a university student may want to pay his/her college fees but may not have adequate funds to do so and may look for an opportunity to borrow. A company may also want to build a new factory to increase its production owing to the increasing demand for its products but may not have additional funds to finance the building of the factory. Thus the management of the company may want to access additional funds by taking a loan from some where. In all these cases, it will be practically difficult to easily identify someone or a set of people that can easily afford to lend the
Government, the student, the businessman and the company the amount of money they respectively needed to execute their intended expenditures. As a result, most economies around the world therefore rely principally upon the market system to carry out the complex task of allocating scarce resources.

By definition, a market is a place or a mechanism through which buyers and sellers exchange goods and services using a generally accepted medium of Exchange (i.e. Money). Thus, just like any other market, the Financial Market is a specialized market that is responsible for channelling financial resources from the surplus units ( savers ) to the deficit units ( those who needed additional funds) to carry out some form of economic activities. The Financial Market therefore constitute of all financial institutions that receive financial resources from the surplus units of the economy in the form of savings and transfer them to the deficits units through lending activities. This role of transferring financial resources from the surplus units to the deficit units is what is referred to as financial intermediation. Thus, a Financial Market comprises of all institutions that play the role of financial intermediation. These set of institutions are therefore referred to as financial intermediaries. The businessman who needed some additional money to start his business, the Government that needed more funds to undertake developmental projects, the student that needed a loan to pay his/her college fees, and the company that needed more finances to expand its operation will all find the financial Market a useful avenue to access additional funding.

3. DIVISION OF THE FINANCIAL MARKET
The Financial market is divided into two main divisions, namely (i) the Money Market, and (ii) the Capital Market. The Money Market is quite different from the Capital Market in the sense that, unlike the Capital Market, one cannot raise long-
term capital from the Money Market. The existence of money markets facilitate trading in short-term debt instruments to meet short-term needs of large users of funds such as governments, banks and similar institutions. Government treasury bills and similar securities, as well as company commercial bills, are examples of instruments traded in the money market. A wide range of financial institutions, including merchant banks, commercial banks, the central bank and other dealers operate in the money market. Public as well as private sector operators make use of various financial instruments to raise and invest short term funds which, if need be, can be quickly liquidated to satisfy short-term needs.

Unlike the Money market, the Capital market is that constituent of the Financial Market that facilitates the mobilization of long-term investment capital for the financing of business enterprises as well as Government long term investment projects. In other words, the term Capital Market refers to a specialized financial institution that provides a channel for the borrowing and lending of long-term funds (i.e. over one year). It is a well organized financial institution that facilitates the transfer of financial resources from those that have surplus funds (savers) to those that needed the use of these funds (i.e. Government and private sector businesses) to undertake long-term investment. Thus the Capital Market offers an opportunity for both private business people and Government to mobilize huge amounts of financial resources from the general public through the sale of financial securities.

The Capital Market is divided into two areas; the **Primary Market** and the **Secondary Market**. The Primary Market deals with the trading of new securities. When a company issues securities for the first time (i.e. IPO), they are traded in the Primary Market through the help of issuing houses, Dealing /Brokerage Firms,
Investment Bankers and or Underwriters. The acronym IPO stands for **Initial Public Offering**, which means the first time a company is offering securities to the general public for subscription. The amount of money raised in the Primary market goes directly to the Issuing Company/Firm to finance its operations. Once the securities (shares) of a company are in the hands the general public, they can be traded in the Secondary Market to enhance liquidity amongst holders of such financial securities. Thus, the Secondary Market facilitates the buying and selling of securities that are already in the hands of the general public (investors). Here, the term investor is used to refer to an individual or an institution that buys the securities (Shares) of a Company with the intent of making some financial returns. **The Stock Exchange** therefore is an organized financial platform that deals in transactions involving the buying and selling of financial securities in the Secondary Market. In short, the Stock Exchange does the work of a Secondary Market by facilitating a formal trading arrangement for financial securities.

4. **THE KEY PLAYERS IN THE CAPITAL MARKET**

The key actors in a well organized Stock Exchange include the Dealers/Stockbrokerage Firms, Company Registrars, Issuing Houses, Mutual Fund Managers, Investment Bankers, the Stock Exchange, the Security and Exchange Commission (which regulates the activities of the Exchange), the Central Security Clearing and Settlement (CSCS) system, the Investing Public, Accountants (Auditors) and Solicitors.

a) **Stock Brokers**: A stockbroker is a licensed member of a Stock Exchange that buys and sells financial securities for their clients/customers. That is, a Stockbroker is an agent that simply buys or sells securities on the behalf of an investor. This simply means that a Stockbroker executes trade on the instruction of his/her
customer. Because he/she is trading on the behalf of someone (the investor), he/she gets his/her compensation by levying some form of tax (i.e. a commission) from the proceeds of the trade. On the other hand, a dealer buys and sells financial securities on his/her own account. In other words, a dealer enters the market as a buyer or seller of securities using his/her own financial resources. Thus, his/her compensation depends on the outcome of the trade. If he/she can buy at a lower price and sells at a higher price, then he/she will make a capital gain. If the reverse holds, then he/she is liable to make a capital loss which he/she has to bear up alone. In some cases, an individual/institution can act in the capacity of a Stockbroker as well as a dealer in securities. In this case, the institution or individual is referred to as a Dealer-Broker. In a Dealer-Broker setting, the individual can buy or sell securities for him/her self or for some other person with the hope of making a commission.

b) **Registrars:** Registrars are a group of operators in the capital market that are charged with the responsibility of keeping records on the ownership of a company's securities. They ensure that details on the transfer of ownership of securities from one investor to another are well recorded to avoid confusion on claims arising from benefits associated with holding such securities. During the allotment stage of an oversubscribed issue of securities, Registrars prepare a range of analysis on how the securities should be allotted. They also prepare the list of investors that qualify to receive dividend from the Company's annual dividend disbursement to shareholders.

c) **Issuing Houses:** An Issuing House is normally a licensed corporate body that acts as an agent for an issuer of securities in the primary market. Marketing of the securities issued by an issuer is very crucial in the Capital market. Issuing Houses
perform this function by helping the issuer in packaging and marketing the offer of securities to the general public. They can normally underwrite the offer of securities by providing the issuer with the required financial resources and eventually sell the securities to the general public. That is, instead of the issuer having to wait until the securities are sold, an Issuing House can buy the securities at a discount thereby making the needed funds immediately available to the issuer. Sometimes, instead of underwriting the offer, an Issuing House can simply use its best effort in selling the securities to the general public. In this situation, an Issuing House will not undertake any responsible for securities that are not bought.

d) **Mutual Fund Managers:** Mutual Funds or Unit Trust Funds are non-bank financial institutions that mobilize financial resources from the general public for investment in the capital market. As a result of his/her expertise in portfolio management, a Mutual Fund Manager reduces the risk of investors by diversifying investment from the pool of funds into various securities. Thus by pooling resources from many individual investors and investing in various securities in the capital market, a Mutual Fund Manager reduces idiosyncratic risk through portfolio diversification.

e) **The Stock Exchange:** A Stock Exchange is licensed non-bank financial institution that provides a platform for transactions involving the buying and selling of financial securities in the Secondary Market. It is a place where debts and equity securities of varying types are traded to facilitate capital mobilization. In short, the Stock Exchange does the work of a Secondary Market by facilitating a formal trading arrangement for financial securities. Some of the Stock Exchanges in Africa include the following: Botswana Stock Exchange (BSE) in Botswana; Cairo and Alexandria Stock Exchange (ESE) in Egypt; Casablanca Stock
Exchange (CSE) in Morocco; Ghana Stock Exchange (GSE) in Ghana; Lusaka Stock Exchange (LUSE) in Zambia; Khartoum Stock Exchange (KSE) in Sudan; Malawi Stock Exchange (MASE) in Malawi; Maputo Stock Exchange (MPSE) in Mozambique; Mauritius Stock Exchange (MSE) in Mauritius; Nairobi Stock Exchange (NSE) in Kenya; Namibia Stock Exchange (NASE) in Namibia; Nigerian Stock Exchange (NISE) in Nigeria; Swaziland Stock Exchange (SSE) in Swaziland; Sierra Leone Stock Exchange (SLSE) in Sierra Leone, Tanzania Stock Exchange (TASE) in Tanzania; Tunis Stock Exchange (TSE) in Tunisia; Uganda Stock Exchange (USE) in Uganda; and Zimbabwe Stock Exchange (ZSE) in Zimbabwe.

f) **The Security and Exchange Commission (SEC):** Government plays a central role in the capital market by creating the basic institutions that regulate and supervise principal market participants. The Security and Exchange Commission (SEC) is the apex regulatory body of the Capital Market. In many countries with well-established Capital Markets, there is always the need for the establishment of a body charged with the responsibility of regulating corporate and individual capital market operators. In Sierra Leone, the Supervision Department of the Bank of Sierra Leone is currently playing the role of SEC in an effort to establish a regulatory framework for the Sierra Leone Capital Market until a Security and Exchange Commission is established.

g) **The Central Security Clearing and Settlement (CSCS):** The Central Security Clearing and Settlement (CSCS) system is a subsidiary corporate body of a well-established Stock Exchange that performs the role of clearing and settlement of transactions involving the buying and selling of securities. This function is done by maintaining a record of all traded securities on behalf of shareholders. It
facilitates the delivery (i.e. transfer of shares from sellers to buyers) and settlement (Payment) of securities transacted in a well organized Stock Exchange.

h) **Investing Public:** An investor is an individual or an institution that buys financial securities with the sole purpose of making some financial returns from the investment. Investors cannot buy securities directly from the Stock Exchange except through a licensed stock broker. When an investor is desirous of buying securities from the Capital Market, he/she approaches a Stock Broker who will execute his/her mandate in the market.

i) **Accountants (Auditors) and Solicitors:** Accountants and Solicitors are also very important players in the Capital Market. The full disclosure requirements for listed Companies in the Capital market necessitated the regular publication of financial statements of listed companies. Prior to the publication of such financial statements, certified accountants (Auditors) are required to authenticate the extent to which such financial statements can reliably inform the true picture of the Company’s financial position. This is meant to provide an accurate guide for investors’ decision making.

Listed Companies also needed the services of Solicitors to interpret the legal implications of some of the rules and regulations guiding their participation in the capital market. These rules and regulations may either be those of the Securities and Exchange Commission (SEC) or those of the Stock Exchange. In either case, a legally minded person is required by Listed Companies for the interpretation of the laws regulating their activities in the capital market.
5. THE ROLE OF FINANCIAL MARKETS IN ECONOMIC GROWTH.

Financial Markets play an important role in promoting economic growth. It is commonly argued in the economic literature that a well functioning financial sector creates strong incentives for investment and also fosters trade and business linkages thereby facilitating improved resource use and technological diffusion. By mobilizing savings for productive investment and facilitating capital inflows, financial markets stimulates investment in both physical and human resources. The financial sector also channels savings to more productive uses by collecting and analyzing information about investment opportunities. It has also been argued that the financial system can enhance efficiency in the corporate sector by monitoring management and exerting corporate controls.

Public as well as private sector operators make use of various financial instruments to raise and invest short term funds which, if need be, can be quickly liquidated to satisfy short-term needs. The Central Government, for instance, can borrow money from the general public to finance long-term investment projects by issuing treasury notes or bonds. The proceeds from the bonds issue can be used to build public hospitals, construct roads, provide public transports, build airports, construct dams, or build other social infrastructures. This entails national wealth creation for economic growth. The Government of Sierra Leone can mobilize a huge amount of financial resources from the Capital Market to finance long term development projects.

In many countries, local government authorities issue municipal bonds to finance long-term projects like the construction of public markets, recreational centres,
roads, develop efficient transport system, build Schools, hospitals and provide many other services from which they can generate a regular source of income. The Freetown City Council as well as those in the provinces can issue municipal bonds to develop social infrastructures.

Corporate bonds can be issued by public companies to finance long-term development projects like the construction of new plants, expansion of existing plants, construction of new buildings, introduction of new technology, purchase of new equipments etc. Corporations can also issue equities (Common Stocks and preferred stocks) to raise additional financial resources for long term investment. The proceeds from equities could be use to purchase new equipment, construct new factories, expand operations etc. All these activities, the purchase of new equipments, expansion of existing plants, construction of new buildings etc, entail wealth creation from the Capital Market by corporations.

Investors make money in the Capital Market through buying and selling of financial securities. When investors buy debt instruments like government bonds, municipal bonds or corporate bonds, they receive an interest payment from the issuer of the debt security plus the principal amount at the end of the loan period. The amount of interest payable to an investor holding a debt security depends on the interest rate agreed by the loan contract. The higher the interest rate on a debt security, the higher the expected interest payment. For example, an investor that purchase Le800,000 worth of five-years government bonds with an interest rate of 9% per annum will receive Le1,230,899.16 at the end of the five year period. The extra Le430,899.16 is the interest payable to the investor for holding the government bonds valuing Le800,000 for five years. Suppose the interest is now raised to 12% per annum. Then the investor holding Le800,000 worth of
government bonds will now receive Le1, 409,873.35 at the end of the five year period. Thus the investor has generated Le 609,873.35 for holding the bonds valuing Le800,000 for five years. Thus, investors create wealth in the capital market by investing in debt securities

Suppose an individual invests in equities (i.e. common and preference shares). The investor in this case becomes a shareholder or part owner of the company that issues the shares. As a shareholder, the investor is entitled to receive a share of the Company’s annual profit which is distributed in the form of dividend. The amount of dividend received by an investor depends on the number of shares he/she holds as well as the dividend policy of the company. Sometimes the company may decide not to pay dividend in cash but rather by issuing additional shares to the existing shareholders. An investor may also decide to sell his/her shares to make a capital gain. For instance, if the investor bought 2000 shares of a particular company at a price of Le400.00 per share and then later sell his/her shares at Le1000.00 per share, he/she will make a capital gain of Le1, 200,000.00 by selling the entire 2000 share that he/she holds. The receipt of dividend, bonus shares and capital gains from selling shares all amount to wealth creation by the investor.

6. CONCLUSION
The Financial Market plays an important role in promoting economic growth. By mobilizing savings for productive investment and facilitating capital inflows, it stimulates investment in both physical and human capital. The Financial Market also channels savings to more productive uses by collecting and analyzing information about investment opportunities. Thus, by creating an efficient mechanism for transactions in long term financial instruments, it provides a wide
range of wealth creating opportunities for the Government, Corporations, Private individuals, and other financial institutions.