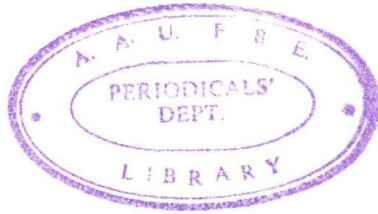


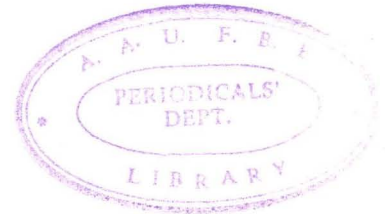
MBA 136



ADDIS ABABA UNIVERSITY

FACULTY OF BUSINESS AND ECONOMICS

MBA PROGRAM



POSSIBILITIES OF DEVELOPING CAPITAL MARKET IN ETHIOPIA

IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE MASTER DEGREE IN BUSINESS ADMINISTRATION



YIDENEKACHEW TESSERA BEZABIH

136

July 2006
Addis Ababa

MBA
YID

ADDIS ABABA UNIVERSITY
FACULTY OF BUSINESS AND ECONOMICS
MBA PROGRAM

**POSSIBILITIES OF DEVELOPING CAPITAL MARKET IN
ETHIOPIA**

YIDENEKACHEW TESSERA BEZABHI
ID. NO. GSR/7203/97

APPROVED BY

SIGNATURE

CHAIR MAN OF MBA PROGRAM

ADVISOR

INTERNAL EXAMINER

EXTERNAL EXAMINER

Declaration

I, Yidnekachew Tesera, declare that this study titled "Possibilities of Developing Capital Market in Ethiopia" is the result of my own effort and study. I have carried out the research by myself except for the guidance and advice of my research advisor. This study paper has not been submitted for any degree/diploma in this or any other university. It is offered here in AAU in partial fulfillment of the requirement for the degree of Masters of Business Administration.



Yidnekachew Tesera Bezabih

Certificate

I certify that Yidnekachew Tesera has carried out his research work on the topic titled "Possibilities of Developing Capital Market in Ethiopia" under my Supervision. This work is original and it is suitable for the submission for the award of the degree of masters in Business Administration.



Dr. Uluagnathan
Research Advisor
Faculty of Business and Economics
Dept. of Accounting & Finance
Addis Ababa University

Acknowledgement

First and for most I would like to express my heart felt gratitude to my advisor Dr. Uluagnathan, for his sincere support, and encouragement during the preparation of this paper. I am also highly grateful for the unreserved assistance extended to me from my friends: Ato Alemayehu Sebru, Zelalem Tessera, Tamrat Mengesha, and Habtamu Beyecha.

My thanks should also goes to the documentation center clerk of the NBE, the experts in the Ethiopian Privatization Agency, the experts in the Ethiopian Investment Office, and the Business Information Section of the AA Chamber of Commerce for their co-operation by providing me the necessary documents.

Finally, I would like to extend my grateful thanks to my wife Woinshet Girma for helping me in writing and for her encouragement, and my love and good wish for my first baby Lisa who happens to come to this world while this paper is in progress.

Abstract

One of the phenomenal events of the 21st century is the globalized feature of both the factor and product market all over the world. This, does not only created opportunity for the developing countries for a relatively easier access for the products and services of developed countries, but also helped the developed one's to enjoy the benefit of diversification and exploit the potential cheap labor power, un exploited natural resource, and high purchasing power bloated by large population size. Moreover, the globalization trend also made it possible for a relatively easy transfer of technology and above all the transfer of finance.

Shortage of finance is a major constraint in realization of economic development for developing countries. They usually rely on foreign borrowing to finance their larger and long term projects. However; this source is the most unreliable and remote. Thus, it is desperate move fro developing countries like Ethiopia to search for the alternative means to reap the premiums made available in the global market. The World Bank and IMF recommend to countries to exercise liberalization and deregulations of the economy to be able to participate and benefit from the global market. Among the most important intermediations recommended for integration in the global market and mobilize and channel both foreign and local resources to wards the most productive sector is the development of capital market.

Recognizing the role played by security market in mobilizing and allocating resources more than a dozen of African countries developed a stock market. Ethiopia is not among this group. This paper focuses on evaluating the need and identifying the availability of the pre-requisites for stock market development and concludes by recommending the possibility of emerging stock market in Ethiopia.

Acronyms

CBE.....Commercial Bank of Ethiopia
IFC..... International Finance Corporation
IMF..... International Monetary Fund
NBE..... National Bank of Ethiopia
SSA..... Sub Saharan African Countries

Table of content

Page

Chapter One Introduction	1
1.1 Background.....	1
1.2 Statement of the problem.....	3
1.3 Significance of the paper.....	4
1.4 Research Question.....	4
1.5 Methodology.....	6
1.6 Scope of the paper.....	7
1.7 Limitation.....	7
1.8 Organization.....	7
Chapter Two Literature Review.....	8
2.1 Financial Assets.....	8
2.1.1. Properties of financial assets.....	8
2.1.2. Classification of financial markets.....	11
2.2. Functions of Capital Market.....	14
2.3. Capital Market Institutions.....	15
2.3.1 Investment banking.....	15
2.3.2 Dealers.....	16
2.3.3 Brokers.....	16
2.3.4 Clearing Banks.....	17
2.3.5 Exchanges.....	17
2.4 History of Stock Exchange.....	18
2.4.1 Stock exchange.....	18
2.4.2 Over the counter market.....	19
2.5 The Role of Financial Intermediaries.....	19
2.6 Measures of Stock Market Development.....	19
2.7 Indicators of Capital Market Development.....	21
2.8 The Role of Financial Sector in the Economy.....	22
2.9 Stock Market Development and economic growth.....	23
2.10 Determinant of Stock Market Development.....	24

2.10.1	The Institutional Approach.....	25
2.10.2	The Macro Economic Approach.....	25
Chapter Three	Analysis on Capital market Formation in Ethiopia.....	29
3.1	History.....	29
3.1.1	Operation of the Share Dealing group.....	30
3.2	The present capital Market status in Ethiopia.....	32
3.2.1	Treasury- Bill Market.....	33
3.2.2	Bond Market.....	35
3.2.3	Inter Bank Money Market.....	35
3.3	The Need for Capital Market Development in Ethiopia.....	36
3.3.1	To Enhance Public Saving.....	37
3.3.2	To Improve the Efficiency & the Role of Banks.....	41
3.3.3	To Facilitate Private Sector Investment.....	45
3.3.4	To Facilitate the Privatization Process.....	47
3.3.5	Maximizing Foreign Capital Inflows.....	50
3.4	Viability of Developing Capital Market in Ethiopia.....	51
3.5	Comparative Analysis with experience of some African Countries.....	55
3.5.1.	Size and Liquidity.....	56
3.5.2.	Incentives to Attract Inflow of Investment.....	60
3.5.3.	The Banking Sector's Role.....	61
3.5.4.	Macro economic & Political Factors.....	64
3.5.5.	The Legal Framework.....	65
3.6.	Measures to be taken in developing capital Market in Ethiopia.....	65
3.6.1.	Developing Public Confidence.....	68
3.6.2.	Financial Intermediary Development.....	69
3.6.3.	Promoting Financial Market Development through Regionalization.....	70
3.6.4.	Human Resource and Infrastructures Development.....	71
3.6.5.	Promoting Capital Market development Through Privatization.....	71
3.6.6.	Globalizing the Capital Markets.....	72
3.6.7.	Designing Efficient Regulatory Systems.....	72
Chapter Four	Summery Conclusion & Recommendations.....	74

4.1. Summery & conclusion.....	74
4.2. Recommendations.....	77
Reference.....	82

List of Tables

	Page
Table 1 Treasury Bills Auction Result (2000/01-2003-04).....	34
Table 2 Inter-bank Money Market Transactions Up to June 2004.....	36
Table 3 Interest rate structure of commercial banks.....	38
Table 4 Capital and branch Network of the banking system.....	39
Table 5 Expenditures on GDP and Gross Domestic Savings (As percent of GDP).....	41
Table 6 Trend of licensed and operational investment project.....	47
Table 7 Sectoral Contribution to GDP and GDP Growth.....	54
Table 8 Resource Mobilizing & Disbursing Activities of Commercial Banks and DBE.....	63

CHAPTER ONE

INTRODUCTION

1.1. Background

The achievement of sustainable economic growth demands, among other things, considerable resources for investment and the efficient utilization of those resources. The resources may be generated internally or externally. However, without an efficient financial system, the improvement in resource mobilization and its efficient allocation towards economically viable investment can be only partial. Strengthening this idea, Bimal Jalan, in his book titled Finance and Development, 1999, explained the change in perception about the role of financial system in development. According to him, as opposed to the earlier belief that the real economy is to lead and shape the financial system, today, it is the real economy which is supposed to be the prisoner of the weak financial system. i.e.; proper development of financial system is no longer regarded as "ancillary" or an adjunct to the development of the economy, but as a precondition for growth. Moreover, to bring about economic growth countries should not only have favorable economic policies, but also need to develop actual institutional capacities in order to overcome the obstacles to the generation and flow of invisible resources.

As discussed in the Ethiopian economy (1994 E.C). The mobilization of economic resources from variable economic agents is one of the main common problems of developing countries. In most cases there is significant gap between the actual monetary saving and the targeted investment requirements of these countries. This investment gap is increasing from time to time and hence leading many to resort to external borrowing.

Ethiopia is not an exception to this general picture of developing countries. The problem of resource mobilization is at least as serious as that of most other developing countries. The level of saving is far below the domestic investment requirement, as per the data in the report of the NBE, 2003/04 the average gross domestic saving rate for the years between 1991 up to 2002/03 is only 4.4. In the year 2003/04 the gross domestic saving rate is only 2.8%. When this low saving rate is compared with actual investment the gap has widened to reach 19.8% of the GDP. So the system has compelled to resort to external borrowing to finance large development projects.

Thus; to bridge this growing gap between domestic saving and investment, strong mechanism for efficient mobilization of resources should be put in place so as to channel resources towards the investment levels required to sustainable economic growth. However; this requires a stable and sound policy environment and the existence of effective institutions for channeling the resources. This is most likely to be realized through the developing and strengthening the financial sector. One of the financial intermediation, which could be highly effective, given the right institutional design and macroeconomic environment is the capital market.

Essentially a market is place which introduces a buyer to a seller. According to Ross, Westerfield and Jordan a stock market, like any market, is just a way of bringing buyers and sellers together. In financial markets it is debt and equity securities that are bought and sold.

International Financial Institutions suggest stock market exchanges, as a major component of liberalization and structural adjustment program in financial sector of developing countries in order to bring economic development and efficient allocation of resources. This fact has been supported by a number of studies including researches made: by Ross Levine Dec. 1997. Vol.5, No. 5; by Hamid Methodi and Sumit Agrawal, 1998, and also an empirical studies made by Levine and Zervos (1996) all showed a strong correlation between stock market development and long term economic growth. Similarly Green Wood and Smith (1996) showed that a large stock market can lower the cost of mobilization savings and there by facilitate investments in the most productive technologies. They also provided data on the trend in stock market activities in the world in the recent past. According to this data during the period between 1985, and 1995 world stock market capitalization rose from 4.7 trillion to 15.2 trillion, and emerging market capitalization jumped from less than 4% to almost 13% of total world capitalization. In addition Korayezyle (1996) showed that emerging markets have become more integrated with world capital market; consequently, portfolio equity flows to emerging market jumped from 150 million in 1984 to over 39 billion in 1995.

Hence, if a country is successful in building the institutions necessary for facilitating efficient resource mobilization, allocation and in inspiring investor's confidence in an exchange, investible funds could be mobilized from both demotic and external sources for better economic development.

1.2. Statement Of The Problem

According to the international Finance Corporation (IFC, 1997), Sub Sahara Africa attracted only \$11.8 billion in private capital in 1996; this is less than \$1 for every \$20 invested in developing countries. This region however received about 50% of \$20 billion annual aid to developing countries, and still live in extreme poverty; however, many Africa countries, including Ethiopia are in the process of overhauling their economic and political systems and trying to open up to the untapped market in the world.

As discussed earlier many research findings shows that to bring about economic growth, among other things one important thing is the development of domestic capital market. Thus if Ethiopia wants to become self reliant, and develop its economy, it will have to develop its stock market. However, stock market development is not an easy task, especially for countries like Ethiopia. Many of the infrastructures required for stock market development represents a major shift in culture. This is because most developing countries have little or no experience with modern market driven economy mechanism as a whole, much less with even more complex securities markets.

Nevertheless, some developing countries, eager to maximize the benefits of stock markets, some times disregarding the costs and the requirements push a head with policies, and environment that may not produce the desired effect. To benefit from stock market development, it requires identifying and putting in place the factors that are identified as a pre conditions and determinants for the stock market development. These include: developing macro economic situations which are conducive to the supply of good quality securities and sufficient demand for them, and infrastructures capable of supporting efficient operation of securities markets.

Like other developing countries, Ethiopia is trying to develop stock market. Increased attention is being given recently by business sectors especially by members of the Addis Ababa Chamber of Commerce, and academicians of different business and economics Faculties, such as AAU, Mekele University, and to some extent by the policy makers; on developing favorable policies and basic infrastructures. However; the issue is a subject of argument. There are groups who argue in favor of developing the market now with the available infrastructures; where as others are skeptical over the timing and efficiency in the

establishment of the market currently. Thus; evaluating the need for SMD, identifying for the macroeconomic factors and the necessary infrastructures, checking their availability in Ethiopia, evaluating their efficient functionality, and pointing out what is slacking requires continuous research.

1.3. Significance of the Paper

As prior research findings mentioned in the introduction part indicates stock market developments positively contributes to the economic growth; however, developing stock market requires well established political, economic, and social environment. Otherwise its implementation, as some research finding indicates, would not bring the required result instead hampers growth.

Thus this paper tries to review the ideal situation for stock market development, the situations with in which countries, like Ethiopia, managed to develop their stock market, and evaluate the objective reality prevailing in Ethiopia to identify the problems and strengths and recommend as to whether Ethiopia can develop stock market or not and or the need for further research.

1.4. Research Question

Is there a need for stock market development in Ethiopia?

Is Ethiopia in a position to develop its own stock market?

Hypothesis

There is a relative current need in Ethiopia for stock market development.

Ethiopia can develop local stock market if at least the basic required infrastructures and macro economic policies are put in place.

Measures

The present felt need for stock market development is measured by:

- Observing the number of share companies operating currently in the country.

- Evaluating the number and size of public enterprises that Ethiopia wanted to privatize and measuring the success of the privatization attempt so far without stock market.
- Evaluating the availability and access of credit to long term investment in the country.
- The size of non performing loan of banks.
- The utilization pattern of idle cash of the available institutional investors. and
- The percentage of licensed investment projects that fail to operate.

As shown in the hypothesis the required infrastructures and the macro economic factors are the independent variables, while the possibility of stock market development is the dependent variable. The way the constructs are operationalized and made measurable is explained below.

Basic Infrastructures and macroeconomic factors are measured as follows

The basic infrastructures are measured by institutional infrastructures, regulatory infrastructures, and legal infrastructures. Institutional infrastructures are measured by:

- The a availability& function of investment banks
- The availability or possibility of having enough number of brokers, floor trader and dealers
- The a availability & functionality of clearing banks
- The availability or possibility of establishing institutional investors

Regulatory Infrastructure, which includes

Regulatory Infrastructures, which Includes government & private bodies with a power & responsibility to supervise the market are measures by:

- The availability or possibility developing of stock exchange commission private regulatory associations
- The availability and functioning of Accounting standard boards and Auditing professional organizations

- The availability and workability of rules, regulations, procedures and requirement of the above organizations

Legal infrastructures measured by

- The protection of the Property rights of investors and creditors
- The legal conditions of contractual relationships
- Forms of incorporations
- Rights & responsibilities of market participants

Macro economics factors are measured by

- Economic system
- Inflation rate
- Per capita income
- Public awareness of the operation of stock markets
- Interest rates
- Tax policies
- Educational policy

1.5. Methodology

This study is descriptive in nature; it uses more of secondary data and to some extent primary data. As explained by Olson Jr. (1996) the two important determinants of stock market development are institutional infrastructures and macro economic factors.

To be able to substantiate the possibility of starting a stock market in Ethiopia, the basic institutional infrastructures and macro economic factors are reviewed and analyzed so as to measure their role in stock market development. The knowledge about the effect of each factor is then used to predict the viability of developing stock market in Ethiopia. Besides, the study also thoroughly examines the experiences of other countries related with some of the most important determinates of stock market development. Since the results of different countries are compared the data is consistently defined across countries. More over; care will be taken to use standard data produced by organizations like International Finance Corporation, World Bank, and issues of the IMF.

In the study selected countries are examined. A fair combination is made to make the study more complete as follows: some countries with emerging stock market are taken from Sub Saharan Africa, few countries with emerging markets from other regions, and also countries with developed stock markets for comparison. The selection of sample is based on simple random sampling technique, and the classes of samples are based on their uniformity in their level of socio economic development, the sub Sahara Africa market is meant to be used as base to make inferences to the viability of development of stock market in Ethiopia.

1.6. Scope of the paper

This study is mainly developed to substantiate the need and viability stock market development in Ethiopia. To this end a brief review of the emergency and functioning of the stock markets of other counties are made. However; the major focus area of the paper is a related to making a thorough analysis of the past trends, present status, and future prospects of stock market development in Ethiopia.

1.7. Limitation

Although the emergency of stock exchange in Ethiopia dates back to 1950's, it is discontinued following the adoption of a command type economic system by the defunct Derg regimes. Consequently; the study is based on the experience of other countries, and publications of international organizations. Besides, the National Bank of Ethiopia, which is supposed to be the ultimate responsible body for the development of stock market in the country, has almost ignored the issue and as a result the researcher got difficulty in obtaining data.

1.8. Organization

The study is organized into four chapters. The first chapter deals with introduction where the statement of the problem, significance, research question, hypothesis, methodology, scopes, limitation and organization of the paper are included. The second chapter is devoted to literature review on the concept and functioning of stock market. Chapter three is devoted to the history, the current need, the prospects and challenges of developing stock market in Ethiopia, and the analysis of the experiences of other countries along with the discussion of their implications to Ethiopia, and finally chapter four presents summery, conclusions and recommendation.

CHAPTER TWO

LITERATURE REVIEW

2.1. Financial Assets

The types of market in an economy can be broadly categorized as a product market, which is a market for manufactured products and services, and a market for factors of production, which is a market for labor and capital. Among the things traded in the factor market includes financial assets.

According to the definition given by Frank Fabozzi and Franco Modigliani " financial assets are intangible assets (as opposed to tangible assets), that represents legal claims to some future benefits.¹" They also explained that the typical future benefit for financial assets, financial instruments, or securities is the claim to future cash. Thus, the value of these assets is the present value of the cash flow expected. This principle of valuation of financial assets works for all financial assets regardless of their specific nature. That is it applies equally to stocks, bonds, loans, and real estate.

Financial assets have two major economic roles:

- They transfer funds from those who have surplus to those who are deficit.
- Redistribute the unavoidable risk associated with the cash flow generated among those seeking and those providing the fund.

2.1.1. Properties of Financial Assets

As opposed to tangible assets financial assets have certain important properties that made them preferable means for investors. These properties are summarized as follows:

- **Moneyness:** This is one of the desirable properties of financial assets for investors. It refers to the quality of financial assets to be close to money i.e. they can be transformed in to money at a little cost, without delay, and risk.
- **Divisibility and denomination:** This refers to the minimum size at which financial assets can be traded or liquidated for money. The smaller the size the more divisible is the asset. For example, a financial asset like a bank deposit is infinitely divisible.

¹ Frank fabozzi, Franco modigliani, Capital markets: Institutions and Instruments,

- Reversibility or round trip cost: this refers to the property of a financial asset related to its costliness of investing in it and divesting. Some financial assets, such as bank deposits are highly reversible, because the depositor can deposit or make a withdrawal with out any delay and cost. However there are also financial assets that are relatively less reversible. For example financial assets that are traded in an organized security markets involve costs such as transaction costs information costs, and etc.
- Term to maturity: This refers to length of time involved between the issuance and the settlement of a financial asset. Investment in some financial assets can be liquidated by the investor (creditor) at any time like the case in demand deposit. On the other hand, there are also many financial assets whose maturity ranges from one day to 100 years, and for some maturity is not at all a question i.e. they are perpetuities.
- Liquidity: This is among the most important properties of financial assets. Different authors gave different definitions for liquidity. Stated in a simple language liquidity refers to the ease with which financial asset are traded or exchanged, or it shows the degree to which sellers stand to lose if they want to sell immediately as against engaging in a costly and time consuming search.
- Convertibility: This refers to the inherent nature of a financial asset to be converted into another financial asset. The timing, the cost, and condition for conversion are clearly indicated in each financial asset at the time of its issuance.
- Currency: A financial asset should be denominated interims of a currency, so that investors can choose one keeping in mind the currency that they are expecting at maturity. Some financial assets are denominated by more than one currency (dual currency) in order to minimize foreign exchange rate risk
- Cash flow and return predictability: Return predictability is one of the basic properties of financial assets. It is a major determinant of their value. The return that an investor is expecting to receive by investing in a financial asset depends on the cash flow that is expected to be received in the form of interest, dividend, expected selling price of the asset, and principal repayment.
- Complexity: Some financial assets are complex. They are made up of two or more simpler assets, and in most cases they involve choices granted to the issuer or the

investor, which they can exercise to alter the cash flow during and at the termination of the contract.

- Tax status: both the tax rate and the tax status of different financial assets differ from one another. The income from some financial assets is tax exempted, and the cost of raising fund using some of the financial assets is tax deductible.

The market where the different financial assets are traded is simply given different names in different books by different authors. Frank fabozzi, and Franco modigliani identified these market as a financial market and then tried to classify it in different ways taking different criteria. Popiel, 1990, considers the market for trading financial assets as a capital market. For him a capital market is made up of the securities and non securities market. According to his discussion the securities market is made up of a market for debt (bonds, debentures, etc), equity (shares or stocks), and treasuries. The non securities market, on the other hand encompasses the activities of the banking sector.

The international Encyclopedia of social science defines securities market as organizations of security holders and brokers whose operations reduce the cost of transferring ownership of government and corporate bonds and stocks and increases the liquidity of these assets." ²

Like Popiel, Dr. Mohamood Osman Imam, in his research titled "capital market development in Bangladesh: problems and Prospects", defined capital market as a market for long-term funds. According to his discussion capital markets, facilitate an efficient transfer of resources from savers to investors and becomes conduits for channeling investment funds from investors to borrowers. The capital market is required to meet at least two basic requirements: (a) it should support industrialization through savings mobilizations, investment fund allocation and maturity transformation and (b) it must be safe and efficient in discharging the aforesaid function. It has two segments, namely, securities segments and non-securities segments.

Securities Segments - The securities segment is concerned with the process a firm distributes its securities to the public in the primary market and the securities are then traded in the secondary markets. Financial intermediaries, such as merchant banks, asset Management

² International Encyclopedia of social science, Vol. 14, the Macmillan Company & The free Press, New York, 1968, p. 136

Company, underwriters, broker-members etc. are involved in the process. Securities segments of capital market have two important roles to play: information production and monitoring. The prospective allocative role of stock price arises because the markets have information that manager does not have. Current stock prices are indicative of the potential investment decision making to profitable industrial sectors to which resources must be allocated. If the stock price goes down manager is less likely to invest while he/she is more likely to invest if the price goes up. It shows how stock prices influence the equity fund allocation decisions.

Non-securities Segments - are those markets in which loan / equity loan are provided by the banks and financial institutions such as banks. We need to recognize that conditions in the bank-based system are unpalatable in the sense of huge non-performing loans, high degree of classified and default loans, capital inadequacy of banks and the like.

2.1.2. Classification of Financial Markets

A thorough discussion on the classification of financial markets is given by Fabozzi and Modigliani. They have given different classifications using different criteria as briefed below.

One way to classify financial market is by type of financial claim. The financial claim arising from investment in financial assets can be fixed amount (which arise from debt instruments) or a residual amount (which arise from equity instruments). The markets in which debt instruments are traded are called debt market, and the markets in which equity instruments are traded are called stock markets. A stock market is a market for the trading of company stock, and derivatives of same; both those securities listed on a stock exchange as well as those only traded privately.

It is also possible to classify financial market based on the time to maturity of the claims. In this regard, a financial market for a long term financial assets is referred as capital market, and a financial market for a short term financial assets is referred as money market. One year is usually taken as a cut off point for distinguishing a financial asset as a short term or long term asset. That is a financial asset with maturity of one year or less is considered as short term and is considered as a part of the money market. The term money market is defined by

Robert D. Auerbach as a group of markets where low default risk, very liquid, large denomination, short-term debt are traded.³

On the other hand financial assets with a maturity of more than a year are considered as a part of capital market. Strengthening this similar definition for capital market is given by Brigham and Houston. They defined capital market as a market for long term debt and corporate stock. They are markets where financial instruments of longer terms to maturity are traded or they are markets that provide funds for a long term use."⁴

A third way to classify financial markets is by whether the financial claims are a newly issued or not. The market for the newly issued financial asset is known as primary market, and a market, where already issued financial assets are re traded or exchanged is referred as secondary market.

Primary Market

A primary market is a market for financial claims that are newly issued. In this the original borrower and an investor or an intermediary are involved. The issuance of securities in primary market should go through certain legal requirements. For example, in USA, the issuances of securities in a primary market are regulated by SEC. According to securities act of 1933, registration statement must be filed with SEC by issuer before issuance.

Normally, the registration statement should contain the following important information.

- The nature of the business of the issuer
- Key provisions or features about the security
- The nature of their investment risk associated with the security
- The background of their management, and
- A certified financial statements

Both the issuer and the under writer will take legal responsibility for any misleading information intentionally included in the prospectus or the supplementary documents provided to SEC.

³ Robert D. Auerbach, "Money, Banking, and financial markets" second edition, Macmillan Publishing Comp. New York , 1985

⁴ Brigham, Eugene F. and Houston, Joel F., Fundamentals of Financial Management, the Dryden Press, Philadelphia 1998, p.111

Secondary Market

Secondary Market is a market where already issued financial assets are traded. The most important distinction between primary market and secondary market is that in the secondary market, the issuer of the financial asset does not receive funds from the buyer, instead already issued securities changes hands in the secondary market and funds flow from the buyer of the asset to the seller.

Major functions of secondary markets include:

Secondary markets offer several advantages both for the issuers and investors as briefed below:

- The secondary market reveals the consensus price that their asset commands in the open market
- Provides a chance to the buyer sell the securities any time when they want to change their position; investors will be happy to buy more securities than they will be otherwise.
- Offers liquidity for their shares.
- Information on the value of shares and bonds they bought, and
- Reduce the search and transaction cost for buyers and sellers of financial assets.

As far as the trading locations of secondary market are concerned, they can be traded in organized and some what regulated markets in a specific geographical location. They are also located traded in the so called over the counter market (OTC).

Financial markets can also be classified by its organizational structure as auction market, over the counter market, and intermediate market.

The whole discussion in this paper deals with the market where the different types of financial assets are traded. As discussed above the name given to this market can be capital market, or securities market, or financial market. Regardless of the name the purpose, the operation, and the participants are the same. Therefore either of these names can be used in the discussion.

2.2. Functions of Capital Market

As it has been indicated through repeated research findings improving the financial sector plays a significant role in the economic growth. Among the important financial aspects requiring intermediation is the emerging and developing of capital market. The concept behind capital market consists of both securities and non securities market. The securities market is made up of the equities and debt market the non-securities market refer to the banking sector. As the focus of this paper is the securities market, the following brief discussion is made on the main contributions of securities market.

- Provide financial resources that can be channeled to finance long term moments.
- Reduces financial risk by making diversifying possible.
- ◉ Improves the efficiency of investment by allocating finance to more efficient investors, especially when the market itself allocates financial resources.
- ◉ Improves the level of saving. The availability shares & debt securities with competing returns motivate the public to save and make investment.
- ◉ Since the development of securities market complete with banks both on the supply & demand side forces banks to improve their efficiency.
- ◉ Improves the earning capacity of institutional savers this is achieved through the alternative investment options provided by the securities market.
 - Foreign exchange gains resulting from the flow of funds from overseas portfolio investments provided the market is open to investors.
- ◉ Provides the opportunity for a broader public ownership of companies and for a wider distribution of corporate profit.
- ◉ Enable companies to benefit from a balanced capital structure.
- ◉ Makes the process of privatization relatively easy.
- ◉ Improves the standard of financial reporting and the quality of information made available to creditors.
- ◉ Provide better opportunities for small emerging companies to raise funds in the securities market.
- Provide effective tool for monetary and fiscal policy. An economy with monetary and fiscal policies through manipulating interest rates and money supply by buying & selling securities.

2.3. Capital Market Institutions

In order to perform their purpose efficiently capital markets must be equipped with adequate and well functioning institutions are required. These institutions facilitate the exchange of securities in financial markets by matching buyers and sellers and improve liquidity in the secondary market. The capital market institutions do not provide the services of financial intermediaries, but simply make it easier for buyers and sellers of securities. Capital market institutions include: investment banking, brokers, dealers, clearing banks, and organized exchanges. All together these institutions facilitate the trading of securities by reducing the cost of searching, transaction cost, and serve as an information source that enable the capital market to function smoothly.

2.3.1. Investment Banking

Investment banking firms assist both investors and borrowers. They help borrowers in order to obtain the money that they want, and also help investors, who wish to invest their surplus money, by acting as brokers and dealers in buying and selling of securities. Thus it can be said that investment banking firms perform both a critical role in both primary and secondary markets.

The activities of investment banking involve some or all of the following: public offering (underwriting) of securities, private placement of securities securitization of assets, merger and acquisitions, merchant banking etc⁵

The underwriting of securities is the traditional role associated with the activities of investment banking. While underwriting of securities, investment banking firms accomplish one or more of the following: they advise the issuer on terms and timing of the offering, and buying securities from the issuer in their account, and distributing the issue to the public. In doing so the underwriting firms the investment banker publicly announces the upcoming new issue in financial publication and else where. They earn income (spread) by underwriting a firm's new stock or bond issue at a higher price. In exchange for this spread the underwriter assumes the risk of not being able to sell the securities to the investor.⁶

⁵ Frank fabozzi, Franco modigliani, Capital markets: Institutions and Instruments,

⁶ Miler Roger Le ray," Modern Money and banking " McGraw Hill, Inc., USA, 1993, P.101

When an investment banking firm buys securities, which is commonly called underwriting by accepting the risk of selling the securities to investors, the arrangement is called firm commitment. On the other hand, when the firm agrees to use only its expertise to sell the securities without buying the assets, the arrangement is known as best effort underwriting. When an investment banking firm commits its own fund by either taking an equity interest or creditor position in companies, the activity is referred to as merchant banking.

2.3.2. Dealers

A dealer or a market maker is an entity which is willing to buy a financial for its own account (add to an inventory of the security) or sell for its own account (reduce the inventory of security).

Dealers are individuals or firms that act as market makers by quoting bids and offers on securities. Dealers trade between ultimate buyers and sellers-hold inventories of securities and sell them for higher price than what they have paid, earning the spread between the bid price and asked price.⁷

The role of the dealer in securities market has been analyzed by George Stigler and Harold Demstet, according to their analysis dealers are known as suppliers of immediacy. This refers to the ability to trade promptly to the market.⁸

2.3.3. Brokers

Most investors specially, those unsophisticated ones, may not be skilled in the art of the deal or completely informed about every facet of trading in security. Thus they need some one to receive and keep track of their order for buying and selling, to find other parties wishing to sell or buy, to negotiate for good prices, to serve as a focal point for trading, and to execute the orders.

A broker is an entity that acts on behalf of an investor who wishes to execute orders.⁹ As a broker is acting on behalf of the investor, its activity does not require taking a position on the assets (buying and holding). Rather, the broker receives, transmits, and executes investor's

⁷ Kohn, Mier, Money, "Banking and Financial Markets" The Dryden Press, Chicago, 1991, P. 152

⁸ George Stigler, " Public Regulation of Security Market" Journal Of Business, April, 1964, P. 117 - 134

⁹ Frank fabozzi, Franco modigliani, Capital markets: Institutions and Instruments,

order with other investors. For doing this the broker receives a commission. This commission is considered as the transaction cost of the capital market.

Brokers not only provide search service at a cheaper price than an investors own cost of direct search, they also arrange transactions closer to the best available than is possible in a direct search. Their extensive contact provides them with a pool of information, which individual transaction could not economically duplicate. By charging a commission less than the cost of direct search, they give investors an incentive to make use of that information.¹⁰

2.3.4. Clearing Banks

If trading is at the heart of a capital market, then clearance and settlement are the veins and arteries. Each executed trade is completed only after shares are exchanged for payment. As a consequence, the way in which the clearance and settlement process is organized has a great impact on the efficiency, fairness and stability of the system as a whole.¹¹

Traders involving dealers and brokers are executed by a number of clearing banks that specialize in providing this service. A clearing bank will keep the dealer's inventories in book entry account. The bank will also hold demand deposit to be used in executing trades, and to finance the dealer's trading it will make loans as necessary.¹²

2.3.5. Exchanges

Securities may be traded in an organized stock exchange or through over the counter markets.

Stock exchanges

Stock exchanges are not financial intermediaries, because they do not acquire funds from savers to invest in borrowers but they make it easier in matching surplus units with the deficit one.

According to the information posted in the legal encyclopedia about what a stock market is and about its history the following is summarized: stock exchange, which is an entity (a corporation or mutual organization) in the business of bringing buyers and sellers of stocks

¹⁰ Garbed, Kenneth, "Securities Market ", McGraw-Hill Inc, New York, 1982, P. 423-424

¹¹ Pardy, Robert, "Regulatory and Institutional Impact on Security Markets Computerization", The World Bank, 1992, P. 27

¹² Kohn, Meir, "Money, Banking, and Financial Markets" The Dryden Press, Chicago, 1991, p. 157

together. For example, 'the stock market' in the United States includes the trading of stocks listed on the NYSE, NASDAQ, and Amex, and also on the OTCBB and Pink Sheets.

2.4. History of Stock Exchange

In 12th century France the courratier de change were concerned with managing and regulating the debts of agricultural communities on behalf of the banks. Because these men also traded with debts, they could be called the first brokers.

In late 13th century Bruges commodity traders gathered inside the house of a man called Van der Bourse, and in 1309 they institutionalized this until then informal meeting and became the "Bruges Bourse". The idea quickly spread around Flanders and neighboring counties and "Bourses" soon opened in Ghent and Amsterdam.

In the middle of the 13th century Venetian bankers began to trade in government securities. In 1351 the Venetian government outlawed spreading rumors intended to lower the price of government funds. Bankers in Pisa, Verona, Genoa and Florence also began trading in government securities during the 14th century. This was only possible because these were independent city states not ruled by a duke but a council of influential citizens.

The Dutch later started joint stock companies, which let shareholders invest in business ventures and get a share of their profits - or losses. In 1602, the Dutch East India Company issued the first shares on the Amsterdam Stock Exchange. It was the first company to issue stocks and bonds.

2.4.1. Stock Exchange

A stock exchange is essentially a marketplace for stocks and bonds, with stockbrokers earning small commissions on each transaction they make. Stocks that are handled by one or more stock exchanges are called listed stocks. For a corporation's stock to be listed on an exchange, the company must meet certain exchange requirements. Each exchange has its own criteria and standards, but in general a company must show that it has sufficient capital and is in sound financial condition. Once a company is listed, trading in its stock will be suspended if the company's financial condition deteriorates to the point that it no longer meets the exchange's minimum requirements.¹³

¹³ [http:// www. answer. com/library/legal/Encyclopedia](http://www.answer.com/library/legal/Encyclopedia)

2.4.2. Over-The-Counter Markets

All transactions not made in the stock exchanges take place in over-the-counter (OTC) trading. An OTC transaction is not an auction on the stock exchange floor but a negotiation between a seller and a buyer. Most sales of bonds occur in OTC trading as do most new issues of securities. In the 1980s discount OTC brokerage firms appeared, offering lower commissions on stock transactions for investors who were willing to do more research on their own. By the 1990s these firms had proliferated.

Dealers in OTC trading are not confined just to large cities, as are stock exchanges, but can be found in many locations throughout the United States. In 1971 these firms were linked to an electronic communications system and became NASDAQ, the National Association of Securities Dealers Automated Quotations. By the 1990s NASDAQ had become the second largest U.S. stock market.

2.5. The role of financial Intermediaries

Financial intermediaries obtain funds by issuing financial claims against themselves to market participants, then investing those funds. The major roles played by financial intermediaries include one or more of the following:

- Providing maturity intermediation
- Risk reduction via diversification
- Reducing the cost of contracting and information processing, and
- providing payment mechanisms¹⁴

2.6. Measures of Stock Market Development

In the study conducted by Sumit Agarwal the following are used as measure for stock market development:

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

¹⁴ Frank fabozzi, Franco modigliani, " Capital markets: Institutions and Instruments", pp.22 -26

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

Turnover Ratio (TR): This ratio equals the value of total shares traded divided by market capitalization. Though it is not a direct measure of theoretical definitions of liquidity, high turnover is often used as an indicator of low transaction costs. The turnover ratio complements the market capitalization ratio. A large but inactive market will have a large market capitalization ratio but a small turnover ratio. Turnover also complements the total value traded ratio. While the total -value-traded ratio captures trading relative to the size of the economy, turnover measures trading relative to the size of the stock market. A small liquid market will have a high turnover ratio but a small total value traded ratio.

Growth: This measure is constructed from the World Development Indicators data set.

Foreign Direct Investment (FDI): Flow of foreign direct investment to and from the country is used as a control variable since we believe that FDI is an important determinant of economic growth.

Investment (INV): This measure is also used as a control variable since we believe that Investment is an important determinant of economic growth.

Primary School Enrollment (PE): Primary school enrollment is used as a control variable since we believe that human capital is an important determinant of economic growth. Foreign Direct Investment and Primary School Enrollment are from the World Development Indicators data set.

According to the study conducted by Sumit Agarwal on Stock Market Development and Economic Growth: one, among the three stock market variables, both MCR and STR variables are significant. Recall that MCR is the total market capitalization as a percentage of GDP and so should be highly correlated to investment. The results also show that Value of Shares Traded as a percentage of GDP is also significant. This implies that as the investment

is directly correlated to STR. It is also pertinent to recall that TR is the least suitable indicator of liquidity in the stock market and hence this variable is uncorrelated to investment. There is also direct correlation between investment and growth. ¹⁵

Although, the study failed to show a direct correlation between stock market variables and growth, the results do imply that stock market variables indirectly are correlated to growth. There are some other interesting observations; foreign direct investment is highly correlated with domestic investment and growth and GDP variables are also highly correlated.

2.7. Indicators of Capital market development

The standard quantitative indicators of stock market development are partly simple and partly difficult to measure.

The simple indicators of market development include-increased breadth as measured by new listings, increased size as measured by market capitalization and new issues, and increased liquidity as measured by value traded.

Indicators more difficult to determine, but which may be even more important, are the "soft," qualitative matters of improved market efficiency in terms of transaction costs; clearing, custody and settlement procedures; corporate governance and disclosure standards; accounting and auditing standards; and standards of company and economic research. Progress here is very sensitive to individual market conditions and thus difficult to generalize. But the apparent trend on the part of emerging market companies, brokerage firms, stock exchanges, and regulators is toward increased accommodation to the legitimate demands of domestic and international investors.

Other indicators of market development are the increasing range of financial products and services available in emerging markets and from international sources. Examples include a growing list of financial futures and options in the emerging markets themselves, stock options and index futures trading at international exchanges, and an active international over-the-counter index swaps market.

¹⁵Sumit Agarwal, ARC-STM Dev't and Economic Growth. doc 2006

2.8. The Role of the Financial Sector in an Economy

The main reason why an efficient financial system is essential to an economy is that there are substantial information and transactions costs. Asymmetric information creates adverse selection and moral hazard, and high transactions costs impose inefficiencies. By specializing in collecting information, evaluating projects, sharing risks, and providing liquidity, allocations across investments. Consequently, financial intermediation increases capital productivity, and promotes economic growth. They have identified three main channels through which financial intermediaries and markets may affect economic growth.

First, a developing financial sector makes room for increasing saving rates. By using economies of scale and expertise, financial intermediaries and markets are able to provide savers with a relatively higher yield, and therefore stimulate savings. A lot of literature has shown the role played by financial intermediaries and markets in increasing savings. For example, McKinnon (1973) and Shaw (1973) emphasize the role played by financial liberalization in increasing savings and, hence, investment. They claim that financial deepening improves not only productivity of capital but also the saving rate and, therefore, investment and growth.

Second, by reducing information and transactions costs, the financial intermediaries and markets perform the essential economic function of increasing the funneling of funds from lenders to borrowers. For example, Gurley and Shaw (1955, 1960 and 1967) stress the importance of financial intermediation in channeling savings to investment.

Third, the financial sector improves the allocation of resources. A recent line of research argues forcefully that financial development enhances growth by promoting an efficient allocation of investment through various mechanisms:

- fund pooling, that is, making large investment projects possible and lending cheaper;
- risk diversification, that is, reducing productivity and default risks by holding diversified portfolios;
- liquidity management, that is, providing liquidity to investment projects;
- (4) screening, that is, gathering and evaluating information on projects to channel funds to the most profitable ones;
- (5) monitoring, that is, disciplining borrowers'

performance to make sure they fulfill their commitments. A well functioning financial system improves resource allocation through these mechanisms.

2.9. Stock Market Development and Economic Growth

Various researches have been conducted to determine the contribution of stock market development on economic growth. The review of literature on such studies shows that most of the findings support the positive role of stock market development on economic growth. However few research findings argue to the contrary. The forgoing discussion presents a brief review of some of such findings.

Most existing literature focuses on the contributions of the financial intermediaries to economic growth; this is because that indirect finance through the financial intermediaries is many times more important than direct finance through the financial markets, especially in developing countries. Numerous empirical tests have shown that financial variables have important impacts on economic growth. However, most of the evidence uses bank-based measures of financial development such as the ratio of liquid liability of financial intermediaries to GDP and domestic credit to the private sector divided by GDP. Not until recently has the emphasis increasingly shifted to stock market indicators, due to the increasing role of financial markets in economies. For example, Atje and Jovanovic (1993) test the hypothesis that the stock markets have a positive impact on growth performance. They find significant correlations between economic growth and the value of stock market trading divided by GDP for 40 countries over the period 1980-88. Similarly, Levine and Zervos (1996, 1998) and Singh (1997), show that stock market development is positively and robustly associated with long-run economic growth. In addition, using cross-country data for 47 countries from 1976-93, Levine and Zervos (1998) find that stock market liquidity is positively and significantly correlated with current and future rates of economic growth, even after controlling for economic and political factors. They also find that measures of both stock market liquidity and banking development significantly predict future rates of growth. They, therefore, conclude that stock markets provide important but different financial services from banks. Furthermore, using data from 44 industrial and developing countries from 1976 to 1993, Demirguc-Kunt and Levine (1996a) investigate the relationships between stock market development and financial intermediary development. They find that countries with better-developed stock markets also have better-developed financial intermediaries.

Thus, they conclude that stock market development goes hand-in-hand with financial intermediary development. Existing models suggest that stock market development is a multifaceted concept, involving issues of market size, liquidity, volatility, concentration, integration with world capital markets, and institutional development.

Using data on 44 developed and emerging markets from 1986 to 1993, Demirguc-Kunt and Levine (1996a) find that large stock markets are more liquid, less volatile, and more internationally integrated than smaller markets. Furthermore, institutionally developed markets with strong information disclosure laws, international accounting standards, and unrestricted capital flows are larger and more liquid markets. Theory also points out a rich array of channels through which the stock markets — market size, liquidity, integration with world capital markets, and volatility — may be linked to economic growth. For example, Pagano (1993) shows the increased risk-sharing benefits from larger stock market size through market externalities, while Levine (1991) and Bencivenga, Smith, and Starr (1996) show that stock markets may affect economic activity through the creation of liquidity. Similarly, Devereux and Smith (1994) and Obstfeld (1994) show that risk diversification through internationally integrated stock markets is another vehicle through which the stock markets can affect economic growth. Besides stock market size, liquidity, and integration with world capital markets, theorists have examined stock return volatility. For example, DeLong et.al. (1989) argue that excess volatility in the stock market can hinder investment, and therefore growth.

2.10. Determinants of stock market development

The research made by Valeriano F. Garcia and Lin Liu on Macroeconomic Determinants of Stock Market Development further describes the different variables that determine the stock market development as briefed below:¹⁶

There are two approaches to assess stock market capitalization, one is institutional and the other is macroeconomic.

¹⁶ VALERIANO F. GARCIA and LIN LIU, Macroeconomic Determinants of Stock Market Development, *Journal of Applied Economics*, Vol. II, No. 1 (May 1999), 29-59

2.10.1. The Institutional Approach

The institutional approach looks at institutional factors such as property rights, clearance and settlement issues, transparency and the inside information problems, taxation issues, and accounting standards.

2.10.2. The Macroeconomic Approach

The macroeconomic approach looks at factors such as real income growth, savings and investment, financial development, and inflation. As it is known, both institutional and macroeconomic factors are important in stock market development. Pagano (1993) shows that regulatory and institutional factors may influence the functioning of stock markets. For example, mandatory disclosure of reliable information about firms may enhance investor participation, and regulations that instill investor's confidence in brokers should encourage investment and trading in the stock markets. However, the institutional factors are directly reflected in macroeconomic factors. It has been shown that some institutional measures such as legal rule are highly correlated with stock market liquidity, and stock market liquidity is one of the macroeconomic determinants. For example, Demirguc-Kunt and Levine (1996b) find that countries with well-developed regulatory and institutional systems tend to have large, liquid stock markets.

Real Income and Income Growth Rate

Real income and income growth rate: Real income has been found to be highly correlated with the stock market size. Higher volume of intermediation through stock markets causes higher real income growth.

High income growth in-turn promotes development in the stock market. As income increases, its cyclical component should impact the size of the stock market and its price index. In addition, because higher income usually goes hand in hand with better defined property rights, better education, and a better general environment for business, we expect it to have a positive effect on the stock market size.

Savings and investment:

Savings and investment: Like financial intermediaries, stock markets intermediate savings to investment projects. Usually the larger the savings, the higher the amount of capital flows

through stock markets. Thus, it is expected that savings and investment to be important determinants of stock market capitalization.

Financial intermediary development

Savings and investment:: Since both the banking sector and stock markets intermediate savings towards investment projects, they can be either complements or substitutes. From the “demand for funds” point of view, the Modigliani-Miller theorem (1958) states that in a perfect market with symmetric information, the market value of all the securities issued by a firm is independent of the firm’s source of finance and consequently firms could go either to the banking sector or to the stock markets to finance their capital. However, asymmetric and imperfect information dominates in the real world. Some countries also distort the financing choices through taxes, subsidies and regulations. Thus, debt or equity financing does matter. From the “supply of funds” point of view, in the short run the relationship might be negative because of arbitrage between interest rates and stock market returns, but in the medium and longer term investors would probably want to diversify their financial assets and spread their savings between the banking sector and stock markets. The substitutes or complements issue could be country specific due to special incentives to obtain debt or equity financing. This complements or substitutes issue has been addressed by many researchers. For example, Boyd and Smith (1996) suggest that stock markets and banks may act as complements rather than as substitute sources of capital. Demircug-Kunt and Levine (1996a) find that across countries the level of stock market development is positively correlated with development of financial intermediaries.

Thus, they conclude that stock markets and financial institutions are generally complements and they grow simultaneously. In contrast, Garcia (1986) finds that many developing countries have had many episodes of intermittent monetary policies with immediate consequences on banking credit. By changing credit in an exogenous way the central bank may create a negative correlation between banking credit and other sources of finance.

Stock Market Liquidity

Stock market liquidity: Liquidity is usually defined as the ease and speed at which agents can buy and sell securities. It is one of the most important functions the stock markets provide (Miller, 1991). Many high-return projects require a long-run commitment of capital, which bears higher default and liquidity risks. Investors are generally reluctant to take these risks.

Thus, without liquid stock markets less investment may occur to the high-return projects. In contrast, liquid stock markets allow investors to alter their portfolios quickly and cheaply, it makes investment less risky and facilitates longer-term, more profitable investments (Levine (1991) and Bencivenga, Smith and Starr (1996)). Consequently, the more liquid the stock market, for example, see King and Levine (1993a, b, c), and Levine and Zervos (1998), the larger amount of savings are channeled through stock markets. Therefore, it is expected that a more liquid market leads to higher market capitalization.

Stock market liquidity is measured in two ways. First, the ratio of total value traded to GDP is computed. This ratio measures the value of equity transactions relative to the size of the economy. Second, the ratio of the total value traded divided by market capitalization is computed. This ratio, frequently called the turnover ratio, measures the value of equity transactions relative to the size of the equity market. These two liquidity indicators do not directly measure how easily investors can buy and sell securities at posted prices. However, they do measure the degree of trading in comparison to the size of both the economy and the market. Therefore they positively reflect stock market liquidity on an economy wide and market wide basis. Moreover, these two measures complement each other. For example, the same study made by Valeriano F. Garcia and Lin Liu, shows that in Indonesia the ratio of value traded to GDP is 1.8%, but the turnover ratio is 219%, which means that Indonesia has a small but active market. In contrast, Taiwan has the value traded to GDP ratio 151%, but turnover ratio 24%, which means that Taiwan has a big but relatively inactive market.

In contrast, some economists regard liquidity as retarding growth by reducing uncertainty and consequently precautionary savings and by lowering investors' search incentives because it would be easier for them to get out fast. Also liquidity would reduce shareholders incentives to control managers due to their short-run commitment to the corporation.

Macroeconomic Stability

Macroeconomic stability: General macroeconomic stability may well be an important factor for the development of the stock market. We expect that the higher the volatility of the underlying economic situation the less incentive firms and savers would have to participate in the market. With the high instability found in many developing countries, particularly during the seventies and eighties, stock markets became more opaque. Prices become signals with large standard deviations which make it very difficult to assert whether price changes were

temporary or permanent, and markets become more uncertain and prone to attract mostly "gamblers". Furthermore, the profitability of corporations can experience sharp movements due to unexpected changes in economic policies such as monetary policy, fiscal policy, exchange rate policy and trade policy. Hence, we expect that stock markets in countries with volatile macroeconomic conditions would also have volatile price indexes and market capitalization. Theoretically both stock market volatility and macroeconomic volatility are hypothesized to have negative effects on stock market capitalization.

To evaluate the effects of macroeconomic stability on market capitalization three proxies are used. These are: inflation rate, inflation change, and the standard deviation of inflation rate.

First, the inflation rate is used to measure macroeconomic stability. In addition to current inflation rate, the study also considered expectation and examined the effect of last year's inflation rate.

Second, the difference of inflation rates is used to measure macroeconomic stability. The change of this year's inflation rate from last year is calculated. Then Inflation change is used to measure macroeconomic stability. It is believed that high, stable inflation may not represent much instability, but inflation rates that bounce around a lot probably do represent macroeconomic instability.

Third, the standard deviation of twelve-month inflation rate is calculated. Both current and last year's standard deviation values are examined.

CHAPTER THREE
ANALYSIS ON CAPITAL MARKET FORMATION IN ETHIOPIA

3.1. History

Ethiopia has never practiced share trading in a fully developed stock market. However rudimentary practice of share trading in Ethiopia goes back to 1956, when companies began issuing shares for public subscription.¹⁷

The first share company offering its share in the market was the Addis Ababa Abattoirs S. C.¹⁸ This stimulated both the purchase interest of the public and other companies to issue their shares. As a result, in the year that followed a number of other companies issued varying amounts of shares to the public. These companies include, among others, the Bottling Company of Ethiopia (1957), Indo-Ethiopian Textile(1958), HVA-Ethiopia(1959), etc.¹⁹ Similar practices continued without proper institutional arrangements until May 1960.²⁰

As far as the market capitalization is concerned, the total investment in major publicly traded shares during the period 1959 - 1963 was close to 61 million. However; of this amount about 41 million (67%) was invested in foreign companies, the most significant of which was in HVA of Netherlands.²¹

The State Bank of Ethiopia is said to have started the first institutional arrangement for share trading through the establishment of share exchange department in May 1960, in order to encourage share trading.²² The share exchange department which is also known as share dealing group(SDU) is involved in buying shares from existing active companies to issue their shares and offer them for sale to the public.

¹⁷ National Bank of Ethiopia, Study Report on the Establishment of a stock exchange in Ethiopia, July, 1999, Addis Ababa.

¹⁸ Feleke Mamo, Towards Promoting Capital Market in Ethiopia: Opportunities and Challenges, Mekele University, September, 2000, pp 103.

¹⁹ National Bank of Ethiopia, Study Report on the Establishment of a stock exchange in Ethiopia, July, 1999, Addis Ababa, pp. 14

²⁰ Ibid, PP 14 -15

²¹ Ibid pp. 15

²² National Bank of Ethiopia, Study Report on the Establishment of a stock exchange in Ethiopia, July, 1999, Addis Ababa pp. 15

During the early years of share trading practice in Ethiopia, The Addis Ababa Bank and the Investment Bank of Ethiopia also took part in strengthening the market by providing over the counter facilities to members of the public.

Latter it its successor, the National Bank of Ethiopia (NBE) took over the activities and created a more integrated and organized market in co-operation with other financial institutions and few private company leaders in 1965.²³

According to study made by Feleke Mamo at the beginning there are only five companies officially offering their shares in the market, through time the market expanded and the number of companies offering their shares increased to 21.²⁴ The founding members of the then share dealing group were: NBE itself, the CBE, the Ethiopian Investment Bank, the Addis Ababa Bank, the Saba Utility Share Company, and Mr. Alfred Abel (an individual investor).

The share dealing group established by the National Bank of Ethiopia, served as a legal institution. It had its own rules and regulations that consisted of 12 articles. The establishment of the share dealing group and its positive role in facilitating the share trading played a vital role in mobilizing funds to various investment areas thereby contributing much to the economic development of the country. It mobilized long term savings to finance long term investments.²⁵

3.1.1. Operation of the Share Trading Group

The share trading activities of the group had been accomplished in two major arrangements: through the share dealing group meeting; and at the offices of the group members. It is also indicated that three types of transactions namely spot, forward and option were conducted at the meeting of the group.²⁶

²³ Ibid, pp. 16

²⁴ Feleke Mamo, Towards Promoting Capital Market in Ethiopia: Opportunities and Challenges, Mekele University, September, 2000, pp 104

²⁵ National Bank of Ethiopia, Study Report on the Establishment of a stock exchange in Ethiopia, July, 1999, Addis Ababa pp. 22

²⁶ Ibid, pp 22

The practice of share registration, and transferring activities are further expanded and resulted to the establishment of a separate body, named Commercial Nominees P.L.C.

During the Imperial era (up to 1974), the government issued several proclamation to encourage private domestic and foreign investments. Among the incentive provided include: tax holiday, tariff protection, remittance of profit, repatriation of invested capital, tax exemption on imported capital goods, and concessions in the form of land leases or land grants.²⁷ According to the study made by J. D. Von Pische (1968), former lecturer of AAU, the business of stock market was moderately successful in its pioneering effort.²⁸

The development of the securities market comes to an end with the coming to power of the defunct DERG regime in 1974. During the DERG regime (1974 - 1991) the Ethiopian financial system in general went through a system of financial repression.

After the fall of the military regime in 1991, Ethiopia adopted new economic policy that calls for greater private participation in the economy, as it is believed that the private sector is the moving force of the economy.

The government transformed the economy from the centrally planned to a market oriented system. The government adopted structural adjustment program that satisfy the International Monetary Fund (IMF)/the World Bank requirement. The change mainly involves liberalization of factor and commodity market, as well as the privatization and commercialization of state owned enterprises.

Subsequent to the issuance of the new economic policy in November 1991, several new codes, policies, and regulations such as the investment code, labor code, tax policies, foreign trade policies, and financial policies, which improve the climate for private business, have been issued. The new investment code is aimed at stimulating both domestic and foreign private sector investment.

²⁷ Aserat Tessema (professor), "prospects and Challenges for Developing a Stock Market in Ethiopia: an analytical review"

²⁸ Taken from the citation in Aserat Tessema, "prospects and Challenges for Developing a Stock Market in Ethiopia: an analytical review"

Since 1991 many changes have been introduced by the government, among the most important one includes the measure taken to devalue the Ethiopian currency, birr, to the level that has reflected its approximate value in 1992, and the subsequent commencing of foreign exchange auctioning in 1993, and the liberalization of foreign trade policies.

However the financial sector reform which is so important for the liberalization of the private sector potential is not moving at an appropriate pace, and is not large enough to bring about much impact.²⁹ Although the government allowed the opening of private banks, the sector is allowed only to Ethiopian citizens.

The country by now has 8 commercial banks namely commercial bank of Ethiopia, Construction and Business Bank, Dashen Bank S. C, Awash International Bank S. C, Bank of Abyssinia S. C., Wogagen Bank S. C, United Bank S. C, Hibret Bank S. C, Nib International Bank S. C. (six of which are private banks), and Development Bank Ethiopia. There are nine insurance companies including the Ethiopian Insurance Corporation, and 23 micro finance institutions.³⁰

3.2. The Present Capital Market status in Ethiopia

When discussing the current capital market situation of Ethiopia, it becomes evident that there is an already functioning but unorganized market both for equity and debt market. This is evidenced by a number of financial transactions made by investors and the government it self.

⊕ As far as the first time issuance of shares is concerned, there are significant numbers of companies that are organized as a share companies satisfying the requirements needed in the commercial code of Ethiopia to be able to issue shares. Some of these companies are being formed by share holders of more than hundred, often involving owners that are not relatives and friends. The share holders of such big firms come to gather for the purpose of investment. Thus, one can say that there is some form mechanism (market) where by the shares of such companies is being traded.³¹

²⁹ Asrat Tessema, prospects and challenges for developing Securities Market in Ethiopia, An analytical review, Black well Publishing Ltd, 2003

³⁰ NBE, Birritu, No. 88, A bilingual quarterly Bulletin, Feb, 2003 - April 2003.

³¹ Addis Ababa Chamber Of Commerce, Proposal for the Formation of Share Market in Ethiopia, 1999, pp.10

3.2.1. Treasury Bill Market

When considering the activity of the government in the financial market, it is possible to find a more structured market for financial assets. The Treasury bill is the only primary securities market actively functioning in Ethiopia. The market for long term securities is not widely practiced in Ethiopia.

During the fiscal year 2003/2004, the total face value of T-bills supplied to the market was birr 51,645.00 million, reflecting a significant annual growth rate of 74.1%. The growth was observed in all the three types of bills. The annual growth observed is 222.6%, 33.8%, and 6.1% for the 28, 91, and 182-day T-bills respectively. The total demand for T-bills reached Birr 61,143 million in 2003/04, increasing by 58.9% over the preceding year. The demand for the 28, 91, and 182-day T-bills went up by 165.4%, 34.7%, and 7 percent respectively in the same period.³² The report also shows that almost all (92.8%) T-bills supplied by the NBE are bought by banks. The explanation given for this in the report is the excessive reserve that banks have. The participation of other financial and non financial private companies is limited. (See table 1 below)

³² National Bank of Ethiopia, Annual Report, 2003/4, Addis Ababa, pp.43.

Table 1 Treasury Bills Auction Result (2000/01-2003-04)

	2001/02	2002/03	2003/04	Percentage Change	
	A	B	C	C/A	C/B
Number of Bidders	346	293	193	-15.3	-
Amount Demanded (Mn.Br.)	26,089.1	38,478.6	61,143.2	134.4	58.9
28-day	10,340.5	8,958.0	23,778.0	130.0	165.4
91-day	9,650.3	20,869.7	28,105.5	191.2	34.7
182-day	6,098.3	8,650.9	9,259.7	51.8	7.0
Amount Supplied (n.Br.)	16,625.02	29,668.0	51,645.0	210.6	74.1
28-day	6,200.0	7,100.0	22,905.0	269.4	222.6
91-day	6,450.0	17,218.0	23,044.0	257.3	33.8
182-day	3,975.0	5,350.0	5,696.0	43.3	6.5
Amount Sold (Mn.Br.)	16,481.2	29,668.0	51,632.0	213.3	74.0
Banks	12,084.4	26,874.6	47,921.8	296.6	78.3
Non-banks	4396.8	2,793.4	3,710.2	-15.6	32.8
Average weight price for Br 100					
For Successful Bids (birr.)					
28-day	99.92	99.99	99.97	0.1	0.0
91-day	99.55	99.64	99.98	0.3	0.3
182-day	98.48	98.89	99.61	1.1	0.7
Average weighted Yield on					
Successful Bids (br.)					
28-day	1.08	0.197	0.391	-63.8	98.5
91-day	1.81	1.440	0.425	-76.5	-70.5
128-day	3.1	2.246	0.785	-74.7	-65.0
Outstanding Bills at the end of the period (Mn.Br.)	4,478.2	9,100.0	12,485.0	178.8	37.2
Banks	3,425.5	8,094.3	11,418.0	233.3	41.1
Non-banks	1,052.7	1,005.7	1,067.0	1.4	6.1

Source: NBE

3.2.2. Bond Market

Although long term securities are not widely traded, NBE data shows that a two year government bond was issued on November, 2000, the bond matured and replaced by a 91-day T-bill on November, 2002. The practice of bond issuing continued in 2002/3 - 2003/4. Bonds worth 910.6 million were issued to the Commercial Bank of Ethiopia and the Development Bank of Ethiopia out side the auction for the purpose of transferring bad debts of former public enterprises and other co-financed project loan to the central government.³³

3.2.3. Inter-Bank Money Market

Pertaining to this, only 12 transaction involving birr 166.7 million were traded in the market since the introduction of the inter-bank money market in the country (September 1998). During the period the average inter bank rate stood 7.8%. It is also stated that only one transaction involving birr 25 million was affected during 2003/04 between the CBE and Nib International Bank. Persistent excess liquidity in the banking system and the lack of collateral for the private banks has mainly contributed for the poor performance of the inter bank money market.³⁴ (See table 2 given below)

With regard to the existence of the secondary market operation in Ethiopia, the report of the NBE states that secondary market does not exist at all.³⁵ However the study made by the Addis Ababa Chamber of Commerce states that though not as visible as the primary market, the secondary market operation is being practiced in the country by the way of minimal exchange of shares among investors.³⁶

³³ Ibid, pp. 46

³⁴ Ibid, pp. 46

³⁵ Ibid, pp. 43

³⁶ Addis Ababa Chamber Of Commerce, Proposal for the Formation of Share Market in Ethiopia, 1999, pp.10

Table 2 Inter-bank Money Market Transactions Up to June 2004

No	Borrower	Lender	Amount	Interest	Date of Transaction	Maturity Period
			Borrowed (in Mn.Br.)	Rate (%)		
1	Nib int. bank	Awash Int. Bank	7	11	16/11/00	Overnight
2	Wegagen Bank	Commercial bank of Eth	10	8	3/01/015	5 years
3	Nib Int. Bank	Commercial bank of Eth	10	8	31/03/01	3 years
4	Wegagen Bank	Commercial bank of Eth	10	8	22/03/01	1 year
5	Nib Int. Bank	Commercial bank of Eth	3.6	8	31/06/01	6 months
6	Nib Int. Bank	Commercial bank of Eth	3.7	8	30/11/01	6 months
7	Nib Int. Bank	Commercial bank of Eth	0.8	8	31/01/03	6 months
8	Nib int. bank	Bank of Abyssinia	29.0	7	28/02/03	3.5 months
9	Nib int. bank	Bank of Abyssinia	19.0	7	31/03/03	3.5 months
10	Nib int. bank	Bank of Abyssinia	20.3	7	28/02/03	3.5 months
11	Nib int. bank	Bank of Abyssinia	29.0	7	31/03/03	3.5 months
12	Nib int. bank	Commercial bank of Eth	25.0	7.5	07/07/03	5.2 months
	Total /Average		166.7	7.9		

Source NBE

3.3. The Need for Capital Market Development in Ethiopia

At a broader level, we regard that the functions of capital markets in an economy could be categorized into one of allocation of capital and governance. It should be recognized that the broad functions of capital markets extend beyond mobilization of domestic financial resources to risk pooling and sharing among market participants as well as facilitation of international capital inflows. Equally important, though, are the governance functions of capital markets, they manifest themselves in the form of information processing and aggregation, monitoring, and facilitation of efficiency-based takeovers of companies.

The depth of the capital market infrastructure has to be judged on the basis of the efficiency with which these various functions of capital markets are carried out. For instance, the mere erection of stock exchanges is inconsequential, if the environment is hostile against

opportunities for risk-sharing and liquidity provision and transformation.³⁷ Moreover, the mere existence of banks in a country is of little value, if their existence is merely to purchase government securities at the expense of commercial lending. In fact, the demise of commercial lending prevents banks from serving as informed agents or intermediaries on behalf of the society, and hence building vital information capital for efficient allocation of resources. The need for stock market in Ethiopia may be justified on the ground of macroeconomic conditions, particularly on the saving and investment situations and the structure of financial institutions involved in the mobilization and allocation of financial resources. Pertaining to this, Yishak Mengesha on his study argued that securities market may be treated as an additional means through which financial resources can be mobilized so as to augment the overall saving rate in the country.³⁸

The forthcoming discussion focuses on the justifications of the need for developing stock market in Ethiopia.

3.3.1. To Enhance Public Saving

It has been proved that one of the major roles of the development of capital market is to mobilize the desperate savings of the public towards more productive sector of the economy. However, to maximize this role of capital market, a country shall have a well developed culture and option of savings. Saving among other things depends on income and also on a number of other socio economic factors, such as accessibility to banking and other alternative means of asset holding which includes securities market. In this regard securities market can play significant role by increasing the national saving through providing alternative means of saving in stocks and bonds. Since stock and bonds are more risky investments their return will normally be higher and thus attractive than bank saving.

As the data described in the annual report of the NBE shows: through out 2003/04 the minimum saving deposit rate remained at 3% per annum with the exception of one private bank that pays 3.15%. The interest rate on time deposit; however, ranged between 3.4% and 3.84%. Only three banks pay interest of on average .93% on demand deposit. The report further explains that both time and saving deposits were negative in real terms taking into

³⁷ Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

³⁸ Yishak Mengesha, Towards Promoting Capital Market in Ethiopia: Opportunities and Challenges, Mekele University, September, 2000, pp. 4

account the 9% percent average inflation rate recorded at the close of 2003/04.³⁹ Thus, considering the attractiveness of the current annual yield of saving in Ethiopia one can easily judge that it is dissatisfactory. (Table 3 the interest rate trend of the country)

Table 3 Interest rate structure of commercial banks

	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04
1. Deposit Rate						
Saving deposit	6.00	6.00	6.00	3.01	3.01	3.01
Time deposit						
Up to 1 year	6.27	6.28	6.36	3.30	3.35	3.40
1-2 years	6.36	6.54	6.67	3.51	3.62	3.64
Over 2 years	6.43	6.69	6.80	3.57	3.82	3.84
Average	6.35	6.50	6.61	3.46	3.60	3.62
Demand Deposit	-	-	-	0.83	0.93	0.93
2. Lending rate						
Minimum	10.5	10.5	10.5	7.5	7.0	7.0
Maximum	13.0	13.5	15.0	14.0	14.0	14.0
Average	11.75	12.0	12.75	10.75	10.5	10.5
3. Yields o t-bills	4.88	1.11	0.61	0.95	0.62	0.59
4. Real rate of interest						
Deposit 1/	1.2	-0.2	11.2	10.2	-12.1	-1.9
Deposit 2/	7.3	3.6	4.1	2.1	2.5	-1.6
Lending 1/	5.7	4.3	18.0	17.5	-4.9	1.5

Besides the low yield, the saving of Ethiopia also suffers from sever inaccessibility of banking and other facilities needed for increasing saving rate. As the data in the annual report of NBE shows, there are only 9 banks, and 23 microfinance institutions that are under the supervision of the NBE. However, their service is barely sufficient for increasing the saving rate for two main reasons: primarily, most of them are located in big cities, not in the rural areas where majority of the population lives, and secondly, because the number of branches of banks is only 359 at the close of 2003/04 they are small for the current population size of the country. It is indicated that the bank branch to population ratio is 1: 198,050 during the year 2003/04. The report shows that Ethiopia is one of the under banked country even at Sub Saharan African countries standard.⁴⁰ (See table 4 below)

³⁹ National Bank of Ethiopia , Annual Report, 2003/4, Addis Ababa, pp. 27-28

⁴⁰ Ibid, pp.27-28

Table 4 Capital and branch Network of the banking system

Bank	Branch Network					
	2002/03	2003/04				
	Total	%Share	Regions	Addis Ababa	Total	% share
1. Public Banks						
Commercial bank of Ethiopia	172	50.7	136	36	172	47.9
Construction & Business bank	20	5.9	15	6	21	5.8
Development bank of Ethiopia	32	9.4	32	1	33	9.2
2. Total public banks	224	66.1	183	43	226	63.0
3. Private banks						
Awash international bank	26	7.7	14	17	31	8.6
Dashen Bank	28	8.3	15	16	31	8.6
Abyssinia bank	14	4.1	10	9	19	5.3
Wegagen Bank	23	6.8	17	8	25	7.0
United bank	13	3.8	3	11	14	3.9
Nib international bank	11	3.2	1	12	13	3.6
4. total private banks	115	33.9	60	73	133	37.0
5. total Banks	339	100.0	243	116	359	100.0

In relation to the issue of saving the cross country analysis made on Sub Sahara Africa by Ikhide (1996) which also included Ethiopia identified that bank branch to population ratio turned out to be the important variable in determining the gross domestic saving.⁴¹

Thus, as the data in the report of the NBE shows the bank branch population ratio of Ethiopia need to be improved for increasing the saving rate, besides increasing other financial institutions like financial markets that contribute to increase the available facilities of saving are believed to motivate public savings even in low income countries like Ethiopia. Pertaining to this, a study made by Valeriano F. Garcia and Lin Liu states that a lot of literature has shown the role played by financial intermediaries and markets in increasing savings. For example, McKinnon (1973) and Shaw (1973) emphasize the role played by financial liberalization in increasing savings and, hence, investment. They claim that financial

⁴¹ Ikhide, Commercial Bank Offices and the Mobilization of Private savings-in Selected Sub Saharan Countries, 1996, The Journal of Development Studies, Vol. 33 No. 1 PP.117-132.

deepening improves not only productivity of capital but also the saving rate and, therefore, investment and growth.⁴²

A study made by Ingaham, 1992, and Mofunaaya, 1992, states that given the appropriate strategies including better rates of return and access to financial services, the potential savings of low income earners can be mobilized and channeled to more productive investment activities.⁴³

When compared to the Imperial Era, the saving rate of the Ethiopia drastically deteriorated during the DERG regime. As the data stated shows, the saving rate declined from 11% to 4% during the era of DERG.⁴⁴ The trend in saving rate in recent year is not improving. The average gross domestic saving between 1991/92 to 2002/03 is 4.4%, however the gross domestic saving rate were only 2.3% and 2.8% in the year 2002/03, and 2003/04 respectively.⁴⁵ (See table 5 given on the next page)

The present saving rate of Ethiopia, according to the world development report, 1997, is far below the rate of gross domestic saving of developing countries, which on average stands on 30%. The same source shows that when India and China are excluded, the rate will decline to 10%, the rate for Sub Saharan African Countries is given to be 16%.⁴⁶ This shows that Ethiopia still is far below the average given for Sub Saharan Countries. Therefore; the country has to develop its capacity to rise saving through different mechanism one of which is developing capital market.

⁴² Macroeconomic Determinants Of Stock Market Development, *Journal of Applied Economics*, Vol. II, No. 1 (May 1999), 29-59

⁴³ Ingaham, Barbara), House hold Savings and credit, a Long View of Policy, 1992, pp. 1-2/97

⁴⁴ eshetu Chole and Mekonene Maniyazewal, The Macro Economic Performance of the Ethiopian Economy, In The First Annual Conference on Ethiopian Economy, 1991, AA

⁴⁵ National Bank of Ethiopia , Annual Report, 2003/4, Addis Ababa, pp.10

⁴⁶ World development Report, Ethiopia; Public Expenditure Review, 1997, November.

Table 5 Expenditures on GDP and Gross Domestic Savings (As percent of GDP)

Year	Domestic Absorption	Consumption Expenditure			Gross Capital	Resource Balance	Exports of Goods & NFS	Imports of Goods & NFS	Gross Domestic savings
		Total	Govt.	Pvt.					
1991/92	106.2	97.0	10.1	86.9	9.2	-6.2	4.5	10.7	3.0
1992/93	108.6	94.4	10.6	83.8	14.2	-8.6	8.3	16.9	5.6
1993/94	110.1	95.0	11.1	83.8	15.2	-10.1	11.4	21.5	5.0
1994/95	110.0	92.6	11.9	80.7	16.4	-9.0	14.5	23.5	7.4
1995/96	109.9	93.0	11.2	81.8	16.9	-9.9	13.1	23.0	7.0
1996/97	109.3	92.3	10.9	81.4	17.0	-9.3	16.2	25.5	7.7
1997/98	109.4	92.3	13.9	78.3	17.2	-9.4	15.9	25.3	7.7
1998/99	114.8	97.9	18.7	79.2	16.9	-14.8	14.1	28.9	2.1
1999/00	114.1	99.1	23.8	75.3	15.9	-14.9	15.1	30.0	0.9
2000/01	115.1	97.4	20.1	77.3	17.8	-15.1	14.7	29.9	2.6
2001/02	118.6	98.2	22.3	75.9	20.4	-18.6	15.5	34.1	1.8
2002/03	118.1	97.7	23.8	73.9	20.5	-18.1	17.1	35.3	2.3
2003/04	119.8	97.2	21.8	75.4	22.6	-19.8	16.8	36.6	2.8
Average: 1991/92- 2002/03	112.0	95.6	15.7	79.9	16.5	-12.0	13.4	25.4	4.4

Source: - Ministry of Fiancée and Economic Development

3.3.2. To Improve the Efficiency and the Role of Banks

Traditionally, development specialists have focused on banks and viewed stock markets as unimportant.⁴⁷ They note that much more corporate capital is raised from banks than from equity issues. This traditional view, however, fails to recognize that stock markets and banks may provide different financial services. Stock markets may positively affect economic development even though firms obtain the bulk of their capital elsewhere.

Empirically, the effect of stock markets on growth can be distinguished from the effect of banking development. To demonstrate this, a study is made that included 38 countries by

⁴⁷ World Bank's World Development Report, 1989

SS | 2

10 | 9
10

Ross Levine discussed over the issue by dividing these countries into four, the first group had greater-than median stock market liquidity (as measured by the value-traded ratio) in 1976 and greater-than-median banking development, where banking development is defined as bank credit divided by GDP. Group two had liquid stock markets in 1976 but less-than-median banking development. Group three had less-than-median stock market liquidity in 1976 but well-developed banks. Group four had illiquid stock markets in 1976 and less-than-median banking development. The result of the finding shows that countries with both liquid stock markets and well-developed banks grew faster than countries with both illiquid markets and underdeveloped banks. More interestingly, greater stock market liquidity implies faster growth no matter what the level of banking development. Similarly, greater banking development implies faster growth regardless of the level of stock market liquidity. Thus, it is not stock markets versus banks; it is stock markets and banks. Each of these components of the financial system is an independently strong predictor of growth. Clearly, stock markets offer something to the economy that banks do not. As suggested above, stock markets may play a prominent role in expanding opportunities for sharing risk and boosting liquidity. In contrast, banks may focus more on establishing long-term relationships with firms, so that they can acquire information about managers and firm prospects.⁴⁸

To grow, economies need both liquidity and information about firms. Thus, if stock markets provide the liquidity and banks the information, then banks and stock markets would each independently is associated with growth. But there is overlap. Like markets, banks help savers diversify risk and provide liquid deposits. Similarly, like banks, stock markets stimulate the acquisition of information about firms. Liquid markets encourage the acquisition of information about firms because investors want to make a profit by identifying undervalued stocks and exploiting this information. While overlap undoubtedly exists, the empirical findings of Ross Levine show that stock markets provide a sufficiently distinctive bundle of financial services, such that bank and stock market development each enjoy an independently strong link with long-run economic growth. Moreover, research indicates that banks and equity markets work together.⁴⁹

⁴⁸ Ross Levine, Stock Markets, Economic Development, and Capital Control Liberalization, pp. 3-8

⁴⁹ Ibid, pp. 7-8

A well-functioning equity market enables entrepreneurs to make long-term, more productive investments in physical capital because they have access to longer-term sources of funds. More productive capital implies higher returns for investors; thus, lenders as well as equity investors more confidently advance funds to these entrepreneurs. Greater stock market liquidity in emerging market economies thus is associated with an increase in the amount of funds raised through bond offerings and bank loans. Indeed, most capital accumulation is financed through bond offerings and bank loans.⁵⁰ As a result, corporate debt-equity ratios actually rise with greater stock market liquidity.⁵¹ Accordingly, the data strongly suggest that stock market development in emerging market economies tends to complement rather than replace bank lending.⁵²

In developing countries like Ethiopia, the financial sector is usually highly dominated by banking sector. Bank loans are an important source of capital through out the world, but limited by the amount of deposit banks are able to mobilize. As a result banks tend to be very conservative in their lending practices, there by penalizes younger or emerging companies whose business risks are higher than those faced by higher established firms.

Currently in Ethiopia there are nine banks, and 23 microfinance institutions. The number of branches reached 359. Of the total branches 224 belongs to the government. (See table 4) In terms of capital the government banks account for 66.8% the total banking capital of the country. Although the role of private banks in the country is improving it is still dominated by the government banks. The sum of the branches of the six private banks is only 115. Their aggregate capital represents 33.2%.⁵³

The total dependence of the financial system in the banking system in Ethiopia does not only suffers from the available size of fund, but because it is dominated by government owned banks, it is also directed as per the government's priority sectors without due regard to the banks cost of funds. This, according to Asrat Tessema's research, results in inefficient

⁵⁰ Colin Mayer, "New Issues in Corporate Finance," *European Economic Review*, June 1988.

⁵¹ Asli Demirguc-Kunt and Vojislav Maksimovic, "Stock Market Development and Financing Choices of Firms," *World Bank Economic Review*, May 1996.

⁵² Ross Levine, *Stock Markets, Economic Development, and Capital Control Liberalization*, 1997, Dept. of Economics University of Virginia.

⁵³ National Bank of Ethiopia, Annual Report, 2003/4, Addis Ababa, pp. 28-29

resource allocation and wide spread loan delinquencies. This in turn reduces the level of investment, productivity of capital and volume of saving.⁵⁴

Adding to the inaccessibility of the banking system to private investors is their highest involvement in the T- Bills and bond market issued by the government. The Ethiopian government issues treasury bills or bonds; these are usually directly held until maturity by domestic financial institutions. What needs to be given attention related to this is that the banks and other financial institutions are using the T-Bills and bonds as the only way out to reduce their excess liquidity. This is shown by the fact that the demand for treasury bills in the year 2003/04 is 61,143.2 million birr which is 58.9% over the preceding year. The amount T- Bills supplied by the government in the year 2003/04 is birr 51,645 million birr which is also increased by 74.1% from the preceding year. The amount supplied by the government satisfies only 84.5% of the demand. The paradox is that the benefit that banks and others are getting by purchasing the T- Bills is desperately low. It is stated that the average weighted yield is only .534% in the year 2003/04, if the effect of inflation is considered the rate is negative in real terms. However; the buyers are still running for it because of their excess liquidity. (See table 1) The excess liquidity of the banking sector is also shown by the fact that there is only one transaction in the inter bank money market in the whole year. Pertaining to the level of liquidity of the banking sector the report shows that the percentage increase in liquidity is 55.4% between 2001/02 and 2003/04 and it is 13.7% between 2002/03 and 2003/04, it is also stated that the actual reserves of commercial banks is in excess of what is required.⁵⁵ One can see how much these financial institutions and other participants of the T- bill market could have benefited if there is capital market where they can get alternative risk adjusted returns for their money.

The T- Bill and the bond market so far are not easily accessible by the general public. Since the banks and other financial institutions must hold the financial assets until maturity, they can not get back their cash for granting credit for the real investors even at a higher return because of the absence secondary market where these securities are traded. It can be argued that such government security trading takes on the characteristic of forced loans. Thus, the capital markets that do exist are extremely thin or informal in nature. As a result in order to

⁵⁴ Asrat Tessema, prospects and challenges for developing Securities Market in Ethiopia, An analytical review, Black well Publishing Ltd, 2003 pp. 55

⁵⁵ NBE, annual report , 2003/04 pp. 24 - 35

increase the availability of fund for real investors, and to create alternative options of using their cash for financial institutions; the Ethiopian government shall introduce a well regulated capital market that serves the public through mobilizing and channeling financial resources.

3.3.3. To Facilitate Private Sector Investment

Among the major contributions of stock market for economic development one is resource mobilization, in this stock markets serves as a conduit of resources from those with excess to those who need it. Securities market also helps in determining the fair price for the shares of companies. This in turn enables for share transaction to be made easily and quickly with low transaction cost. In the absence of capital market it is impossible for corporations to diversify their access to financial resources by strengthening their financial structure. Maintaining debt to equity ratio is important for robust business development. Moreover; without the existence of capital markets, banking sector may excessively dominate the finance market and can create a lot of barriers to the access for investment funds and often deny credit for long term risky and new investments.

In relation to this, one study shows that in many African countries, the allocation of credit often has been biased towards soft loans to government owned or controlled sectors rather than to the private sector. In particular, small firms are often completely rationed out of the formal bank loan market in the absence of explicit or implicit government guarantees and formal bankruptcy laws and priority rules. Banking systems often adopt cartelized structures regarding interest rates, fees, and services. Thus, common African government policies, such as limiting the size of foreign banks, limiting foreign investments and/or requiring a separation between banking and commerce and banking and insurance (universal banking) can all be viewed as implicit barriers to the efficient provision of financial services.⁵⁶

Investors usually demand appreciation of the value of their shares and the ability to convert their shares into cash when the need arises. However; this can not be easily achieved in a situation where there exists no market place for the buying and the selling of securities as it is

⁵⁶ Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

the case in Ethiopia. This discourages potential investors from capital formation process. Enterprises operating under these situations will be left with two options one is depending on internally developed fund (retained earning) which is usually not enough for major development projects or resort to a direct search market, which is far more uneconomical and time consuming both for the issuer and the buyer. Hence, without the appropriate financial intermediation put in place individual share owners would be unable to adjust their portfolios as required. This would increase the risk and uncertainty faced by investors, thus increasing the cost of capital for firms issuing equity for raising funds

As the data in the annual report of NBE shows, despite the macroeconomic, institutional and regulatory reform measures undertaken to encourage the private sector saving and investment during the last ten years (up to 2002/03) both domestic and foreign investment remain below expectation. This can readily be seen from the modest number of projects that went into operation.⁵⁷

Looking in the investment licensing profiles by the Ethiopian Investment Authority and Regional Investment Offices, a total of 2,872 projects with a total investment capital of birr 36,467 million, were approved in the year 2004/05. This represents the biggest number of investment projects approved from the year 1994/95 - 2004/05. The above approved projects, if successfully reach implementation stage, are expected to create employment opportunity for 146,233 permanent and 580,957 temporary workers. Nevertheless, the trend is not as such encouraging as only 202 (7.033%) of the approved projects with a capital of only 2082.48 million and created employment opportunity is also far below the expectation, which is only 10,019 (6.85%) permanent and 13,371 (2.31%) temporary workers.⁵⁸

Similarly the most recent statistics on investment in Ethiopia shows that between the period of July 1992 to July 2005, a total of 13,751 investment projects were licensed by the EIA and the regional Investment Offices. Out of these, however, 597 investments projects were canceled for various reasons. The remaining 13,154 investment projects with a planned capital of birr 149.98 billion which are expected to create 645,299 permanent employees and 1,242,736 temporary employment opportunities when they become fully operational. However, out of this only 21% domestic licensed investment projects with a total capital of

⁵⁷ National Bank of Ethiopia, Annual Report, 2003/4, Addis Ababa, pp. 75

⁵⁸ NBE, Annual Report Statistical Annexes, 2004/05

29.3 billion (19.54%) have become operational, 8912 (67.75%) with a total capital of 97.68 billion failed to implement, the remaining 11.08% are said to be under implementation. Similarly out of 1,312 licensed foreign investment projects with a capital of 38.21 billion birr, only 318 (24.24%) with a capital of 9.32 billion have become operational, out of the remaining 827(63, 03%) are failed to start implementation. The rest 167 (12.73) are said to be under implementation.⁵⁹ (See table no 6 given below)

**Table 6 Trend of licensed and operational investment project by Fiscal year
1991-1997 EFY (1998/99-2004/05)/
(Investment capital in million birr)**

Project	Fiscal year													
	1991(1998/99)		1992(1999/00)		1993(2000/01)		1994(2001/02)		1995(2002/03)		1996(2003/04)		1997(2004/05)	
	No. of proj.	Investment Capital	No. of proj.	Investment capital	No. of proj.	Investment capital	No. of proj.	Investment capital	No. of proj.	Investment capital	No. of proj.	Investment capital	No. of proj.	Investment capital
Licensed	713	10,060.06	624	14,127.02	687	8,856.00	801	9,192.63	1,217	13,437.86	2274	21,645.07	3,105	42,722.12
Domestic	674	3,764.91	561	6,740.35	635	5,675.70	756	6,119.67	1127	9,362.93	1918	12,713.70	2480	20,704.72
Foreign	30	1,379.92	54	1,626.84	45	2,923.27	35	1,474.12	84	3,368.82	340	7,094.34	615	15,643.72
Public	9	4,915.23	9	5,759.83	7	257.03	10	1,598.83	6	706.11	16	1,837.04	10	6,373.66
Operational	314	1,153.12	333	5,430.68	62	484.11	177	1,711.85	162	1,888.77	183	2,247.21	176	2,274.22
Domestic	301	763.32	309	2,899.20	53	400.18	171	1,606.59	152	1,687.65	91	412.00	104	955.33
Foreign	12	356.69	18	317.21	9	83.93	6	105.26	9	188.66	89	1,738.00	72	1,318.83
Public	1	33.11	6	2,214.27	-	-	-	-	1	12.46	3	97.21	-	-

The low rate of implementation of for the approved investment projects shows a need for further detailed study on the problems hindering the implementation of the investment projects. However; it is possible to mention that among the major reasons one is lack of capital. Thus, this gap can be filled by developing a security market which can help by channeling investment resources to the approved projects.

3.3.4. To Facilitate the Privatization Process

Privatization is an enhancement of the role of the private sector in an economy. The three principal forms are:

- (a) Privatization of state-owned enterprises,
- (b) Creation of new private enterprises, and
- (c) Re-privatization (i.e., returning nationalized property to original owners).⁶⁰

⁵⁹ Ethiopian Investment Agency, Statistics on Investment in Ethiopia, Vol. No. 8, Feb. 2006 Addis Ababa, pp8

⁶⁰ Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

The actual implementation of privatization, particularly of state-owned enterprises can be a difficult task without adequate financial structure and legal framework to engender privatization effort. As it is stated in the study made by Asrate Tessema one of the most notable problems associated with privatization of state enterprises is the lack of well developed domestic equity market. An inadequate supply of capital due to low savings, low gross national product and limited access to international capital market has been an impediment.⁶¹ The same study also highlights that the establishment of security market would ensure not only the existence of primary market for the initial public offering but also a secondary market for shares after firms have been privatized.

Ethiopia has been taking privatization program of the public enterprises since the establishment of the Ethiopian Privatization Agency in 1994. Before the privatization program began there were 456 enterprises under public ownership. From 1994 until 1997 the Agency had privatized 24 enterprises, 14 hotels and restaurants, and 117 small trade businesses. From 1997 until 2003 157 small trade businesses and hotels, 41 factories, 15 agricultural and agro industries as well as a mine were privatized by the agency. In general, a 3.2 billion birr amount of money has been made through these transactions. On the other hand, 12 public enterprises have been closed for economical and technical reasons.

In addition, until July 1999, about 36 enterprise units which were illegally seized during the DERG regime are subject to court orders to be returned to their original legal owners out of this six enterprises are already been returned while others are in process of completing the necessary formalities.

The evaluation of the overall performance of the Agency especially since 2001 is judged to be unsatisfactory. The Agency is facing a difficulty in smoothly and timely privatizing of the enterprises.⁶² To address this problem the Agency conducted a study using a group made up of both local and foreign experts. The finding of the research shows the main internal and

⁶⁰ Asrat Tessema, Prospects And Challenges For Developing Securities Market in Ethiopia, An analytical review, Black well Publishing Ltd, 2003 pp. 56

⁶² Privatization News, Biannual News Letter, vol. VI no. 2, Dec. 2003 pp. 2

external causes of the slow down in the process of privatization. Regarding the external causes the major problem identified are the lack of enough local business men who are capable both financially and entrepreneurship wise, the lack of the availability of bank loan, lack of experience in buying shares, and low participation of foreign investors.⁶³

The process of privatization faces a similar problem in developing countries especially in those with no capital markets where the shares of the enterprises are floated. Ethiopia has changed many public enterprises into share companies with the objective of allowing the participation of the public and to make it possible the selling of the bigger enterprises. According to the data in the privatization news up to 1992 the government changed 19 public enterprises to a share company.⁶⁴ However; as mentioned above the program is not as effective as it was intended, one of the many reasons for this may be because there is no well functioning and regulated capital market in the country. With the absence of secondary market investors will normally be hesitant to invest their money as it is very difficult to divest when ever they need their cash back.

As cited in Privatization News (2003, pp. 13), Countries like France, Chili, Japan, Jamaica, United Kingdom and Nigeria practiced privatization through the issuance of shares to the public. The report shows, by doing the work of privatization through issuing shares to the public, these countries has used the process of privatization not as a means of get ride of the public enterprises but also as a means of developing the size and liquidity of their capital market It is shown that privatization has benefited from the opportunities the securities market provides as it allows the wider public to participate in the privatization process and help partially if not totally, overcome the capital constraint needed for divestment.

Thus the absence of security market in Ethiopia may have a negative impact on the speed of privatization. As the data from the privatization Agency shows, most of firms that Ethiopia has privatized constitute small shops and hotels. The large size of the remaining enterprises and the relative shortage of capital in the hands of the domestic business sector require the participation of the public. Therefore; if privatization is to succeed share floating is the most convenient modality, and this requires the development of capital market.

⁶³ Privatization News, Biannual News Letter, vol. VI no. 2, Dec. 2003 pp. 2

⁶⁴ Privatization News, VOL. 1, No. 2 1992, pp. 22

3.3.5. Maximizing Foreign Capital Inflows

In recent years, most African countries have undergone unprecedented economic and financial reforms of similar proportions as the emerging countries in Latin America and East Asia. There is new emphasis on private sector development, deregulation, liberalization, and privatization, along with improvements in governance and democratization. As part of the reforms sweeping the continent, there has been a gradual shift away from bank-based capital markets to accommodate non-bank institutions in particular in favor of stock markets. There are currently fifteen stock exchanges in African countries, namely, Botswana, Cote d'Ivoire, Egypt, Ghana, Kenya, Malawi, Mauritius, Morocco, Namibia, Nigeria, South Africa, Swaziland, Tunisia, Zambia and Zimbabwe. Now days, African markets are increasingly displaying greater openness to foreign investors. Investors on Wall Street and in Europe have began including Africa in the global investment opportunity set as manifested vividly by floatation of funds targeting Africa, beginning with the funds created by the New York brokerage firms: Morgan Stanley Africa Investment Fund, Alliance Capital Management's Southern Africa Fund, and Robert Fleming's New South Africa Fund. Currently over a dozen African funds, with total investment level of \$1 billion, are trading in New York and Europe.

The report shows that there were none in 1992. Why this development and surge of interest? Fundamentally, there is an investor motive for diversifying risk globally. According to the 1993 World Bank report on developing economies, the non-bank private sources, in the form of bonds, equity portfolio flows and foreign direct investments have accounted for nearly all the recent growth in financial flows to developing countries. In particular, there has been explosive growth in private portfolio flows, both bonds and equity, to Latin American and East Asian countries. According to the 1996 IMF study, total net private capital flows (net direct foreign investment, net portfolio investment, and bank lending) to developing countries grew about four-fold from \$45.4 billion in 1990 to \$173.1 billion in 1993. On the other hand, net portfolio investments grew five fold between 1990 and 1993 (from \$18.6 billion to \$89.6 billion) and then declined to \$50.4 billion in 1994 following the Mexican crisis. By contrast, net portfolio investments to Africa have been negative during the same period (peak negative of \$0.9 billion in 1993).⁶⁵

⁶⁵Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

Thus by opening its door to foreign investors and establishing its own stock market Ethiopia can benefit from capital inflow like other developing countries with emerging stock market.

3.4. Viability of Developing Capital Market in Ethiopia

The analysis made so far on the importance of emerging stock market in Ethiopia and the substantially agreed fact that stock market development will contribute to the economic development of a country can justify the decision to emerge (to give formal organization and regulation to) capital market in Ethiopia.

It is difficult to judge as to whether Ethiopia's existing rudimentary share trading practice could be considered as emerging stock market or to say that there is no capital market (particularly secondary market) in Ethiopia (as it is the case in the report of the NBE 2003/04).

It is also difficult to find a consensus on the definition of an emerging market largely because countries fall along a spectrum of development from rudimentary to mature emerging market. However the following characteristics are mentioned as guide for understanding the issue:

A country with gross domestic product per capital substantially below the average for developed economies; greater government regulation limiting or banning foreign ownership in domestic companies; a lax and/or corrupt regulatory environment; inefficient back office operations including clearing and settlement capabilities; restrictions on repatriation of initial capital; dividends, interest and capital gains; greater perceived investment risk than in developed market and general perception by the investment community that the country should be considered emerging.⁶⁶

Leaving aside the question of judging as to whether Ethiopia's current share trading practice is to be considered as emerging or not for further study, in the next part a brief discussion is presented in the general development stages and the fundamental preconditions for emerging stock market in the country.

⁶⁶ Dan W. Hess, Emerging Equity Market in India: case study, School of Business, Seattle Pacific University, Washington, Vol. 24 No. 7, 1998 pp.17

Four stages of development have been discussed as common for all equity markets:⁶⁷

First, equity market tends to develop only after a country has achieved a degree of economic and political stability and began implementing growth oriented policies.

In the second phase, since the equity market now has some degree of credibility, pressure from abroad for greater accessibility and at home for a cheaper capital funding leads to loosening of regulation in the domestic capital market.

In the third stage, the market offers the prospect of higher, less volatile returns, and investors easily absorb new issues of stocks and bonds. Trading volume increases producing market efficiency.

In the final stage, equity risk premiums fall to internationally competitive levels relative to short term money market rates. At this stage the equity market begin to achieve the stable growth that marks a mature or developed country.

The stock market development phases discussed above are relevant for all countries.

Considering the current state of Ethiopia the first phase is more relevant. In this regard the government of Ethiopia has taken substantial macroeconomic changes since 1992. The most important of this includes: the liberalization of trade policy, privatization of public sector enterprises, financial sector reform, and deregulation of prices and exchange control. Import tariffs have been progressively reduced from maximum rate of 200% before reform, to a current maximum rate of 40%. Non-tariff barriers have been eliminated. Control over retail prices and interest rates have been eliminated. Although it is still closed for foreign investors, financial institutions are now allowed for local private sector. As the result of this by now there are 9 banks in the country, with 359 branches, (six of which are privately owned), there are 23 micro finance institutions with a total assets reaching 1.2 Billion, there are nine insurance companies with 123 branches all over the country (eight of which are privately owned), the reform introduced in exchange rate policy has also been decisive. This is evidenced by a substantially devaluated currency of the country and the starting foreign

⁶⁷ Ibid, pp. 18

exchange transactions as evidenced by the jump both in the number of trades and the amount traded.⁶⁸

The investment regime has also been liberalized through series of government proclamations to ensure broadened sector coverage and encourage FDI. Thus many of the regulatory and policy constraints that are implemented in the centralized planning system have been removed making the country conducive for investment. These changes are believed to encourage the confidence of both local and foreign investors. However; further reforms are required to create more conducive investment environment by developing: the financial sector, which is currently dominated by banks; the legal environment, foreign exchange policy, etc.

The overall macroeconomic reforms helped the country to experience economic growth. The report prepared by the Ministry of Finance and Economic Development shows that during the fiscal year 2003/04, the real GDP grew by 11.6%, which could be ascribed to strong performance in agriculture, industry, and services. Growth in the real GDP has been 6%, 5.4%, 7.7%, 1.6%, -3.9%, and 11.6% in the year 1998/99, 1999/00/ 2000/01, 2001/02, 2002/03, 2003/04 respectively. Similarly the growth in the real GDP per capita significantly improved in the recent years. The report shows that in the year 2003/04 real GDP per capita increased to 8.4%, as opposed to -1.2, and -6.6 in the year 2001/02, and 2002/03 respectively.⁶⁹ (Table no.7 given on the next page)

⁶⁸ NBE, Annual Report, 2003/04, pp. 50

⁶⁹ Ibid, pp.6

Table 7. Sectoral Contribution to GDP and GDP Growth

Items		Year					
		1998/99	1999/00	2000/01	2001/02	2003/03	2003/04
Real GDP	(In Millions of Birr)	15,294.1	16,112.3	17,354.4	17,632.2	16,941.5	18,900.9
Sector	Agriculture & Allied Activities	6,873.5	7,024.7	7,831.1	7,651.0	6,687.0	7,952.0
	Industry	1,700.9	1,731.3	1,818.1	1,923.4	2,012.2	2,150.8
	Services	6,719.7	7,356.3	7,705.2	8,057.8	8,242.3	8,798.1
Growth in Real GDP		6.0	5.4	7.7	1.6	-3.9	11.6
Real GDP Per Capital		248.0	253.8	265.6	226.4	245.2	265.8
Share in GDP (in %)	Agriculture & Allied Activities	44.94	43.60	45.12	43.39	39.47	42.07
	Industry	11.12	10.75	10.48	10.91	11.88	11.38
	Services	43.94	45.66	44.40	45.70	48.65	46.55
Growth in Real GDP Per Capital		2.9	2.3	4.7	-1.2	-6.6	8.4
Agriculture & Allied activities	Absolute Growth		2.2	11.5	-2.3	-12.6	18.9
	Contribution To GDP growth		0.99	5.01	-1.04	-5.47	7.46
	Contribution in %		18.5	64.9	-64.8	139.6	64.6
Industry	Absolute Growth		1.8	5.0	5.8	4.6	6.9
	Contribution to GDP growth		0.2	0.5	0.6	0.5	0.8
	Contribution in %		3.7	7.0	37.9	-12.9	7.1
Services	Absolute growth		9.5	4.7	4.6	2.3	6.7
	Contribution to GDP growth		4.2	2.2	2.0	1.0	3.3
	Contribution In %		77.8	28.1	126.9	-26.7	28.4

Source: Ministry of Finance and Economic Development and staff Computation

The other relevant issue is the inflationary and deflationary history of the country, the data from the Central Statistical Authority shows, Ethiopia has for long been a country with low inflation in Sub Saharan Africa. In the past, this was owing to strong currency, prudent monetary and fiscal policies (1960's - 1973), general price control (1974 - 1992) and implementations of economic reform and stabilization program (1992 - 2004). All in all

annual average rate of inflation during the last six years (1998/99 - 2003/04) was 3.7, for head line, 5.2% for food, and 1.2% for non food (core inflation).⁷⁰

Ethiopia by now has already put in place some of the necessary macro economic policies needed to re-emerge its capital market. Moreover; as a country with previous experience in operating capital market; it is possible to develop what is lacking through time. The only problem that might be considered as an obstacle currently is the question of political stability, and the committeemen of the leaders. In this regard the country has been in a serious turmoil since 1997 E.C. related with the election result disapproval of the opposition party. The case seems to be under control recently.

3.5. Comparative Analysis With Experience of Some African Countries

Historically, African financial systems have been dominated by bank finance often shouldered by the public sector. The recent enthusiasm in stock market development has also been accompanied by unprecedented financial and regulatory reforms. Measures have been taken ranging from placing appropriate regulatory infrastructure, such as market supervisory bodies to streamlining of existing operational and settlement procedures for smooth and efficient execution of market transactions. In many countries, there have been tax reforms that suspend and even abolish capital gain taxes, reduce dividend withholding tax rates and mitigate effects of multiple taxation. Other areas of reforms include: market competitive measures as reduction of official costs of transactions, listings and new issues; and removal of barriers to international capital flows in the form of elimination of rules that discriminate against foreign investors and legal reforms governing repatriation of capital.⁷¹

Pertaining to this, in addition to the various macroeconomic changes that are made since 1992 by the Ethiopian Government to encourage investment, many reforms that are believed to motivate foreign investors to invest in the country are made. Among the most important incentives include the following:

- Technology transferring agreement.

⁷⁰ Ibid, pp.22

⁷¹ Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

- Permission to acquire an external loan in foreign currency.
- Opening and operating foreign currency account.
- Making remittances out of Ethiopia for:
 - Profit and dividend accruing from investment.
 - Principal and interest payments on a external loans,
 - Payments related to technology transfer agreement registered in accordance with the proclamation.
 - Proceed from the sale of liquidation of an enterprise.
 - Proceed from the transfer of shares or of partial ownership of an enterprise to domestic investor
- Permission for expatriates for remitting funds by foreign currency.⁷²

Researches made by different individuals show that there are serious challenges and impediments to the development of capital markets in Africa. While it is difficult to generalize about the disparate financial systems of a continent comprising over fifty countries, the forthcoming discussion highlights certain challenges that are applicable in many countries, particularly of the Sub-Saharan region.

3.5.1. Size and Liquidity

Despite the positive and encouraging developments in the restructuring of African financial systems, stock market development in Africa is grossly incomplete.⁷³ This study also shows with the exception of South Africa, the emerging stock markets in Africa are by far the smallest of any region, both in terms of number of listed companies and market capitalization. The review of the data on number of listed companies in the following African countries in 1996 along with the time they started stock market is briefed below. Note that the year in the bracket shows the time of the capital market introduced in each country. Only 6 companies were trading in Swaziland (1990), 12 in Botswana (1989), 21 in Ghana (1989), 56 in Kenya (1954), and 183 in Nigeria (1961), 5 in Zambia (1994), 64 in Zimbabwe (64), 12 in Namibia (1992), 31 Ivory Coast (1976), 626 in South Africa (1887), compared to over 8479

⁷² Federal Negarit Gazeta, No. 27 2nd July, 2002, pp. 1776

⁷³ Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

in the U.S. Moreover, the listed companies consist mostly of foreign firms, a reflection of the weak private sector in these countries.⁷⁴

Pertaining to the number of listed companies a study made by the Addis Ababa Chamber of Commerce shows there were twenty two share companies whose shares were quoted and listed by the then share dealing group in the short lived stock market operating in Ethiopia in the Imperial Era.⁷⁵

Similarly the study made by a special task force of the National Bank of Ethiopia on the establishment of stock market in Ethiopia listed the names of 35 companies that satisfy the basic requirement set by the group for registration. Since this listing is made in 1999, it does not include many businesses that have flourished since 1999 up to now. If a similar listing is done now, the researcher believes the number could nearly double. To mention some of the most important of these includes businesses in banking sector such as Nib International Bank, Oromiya co-operatives Bank, newly established 23 microfinance institutions; Dashen brewery, the horticulture industry, the real estate industry, and almost all businesses in the education and health sectors. Thus it can be argued that if Ethiopia is to introduce its capital market there will not be a severe shortage of listed companies to participate in the market.

Besides as a country with prior experience, the management of the market can not be as difficult as it is for those countries, who developing it for the first time. In this regard, for example, different interested individuals that are members of the Addis Ababa Chamber of Commerce strongly argue over the need for the emerging of the market and also suggested the how of forming it. Similarly the NBE also formed a task group to make study on the viability of forming capital market in the country. The group's study finding recommended the market formation. Both parties suggested the prospective rules and regulations, institutional and legal infrastructures needed for the formation. Some of the criteria identified by both parties for the listing of the companies include: be legally registered as a public company, have a minimum paid up capital of 5 million birr, have a minimum of fifty shareholders, must have shown strong financial and operational performance at least for the last three years, must be willing to disclose all relevant information on their operation and submit a regular financial statement to the NBE and the share dealing group, must have no

⁷⁴ International Finance Corporation, Emerging Stock Markets Fact book, World Bank, 1997, Washington DC.

⁷⁵ Addis Ababa Chamber of Commerce, Proposal for the formation of Share Market in Ethiopia, March 1999

restriction clauses on the transfer of their shares, must get their books audited by external auditors, must strictly abide by the rules of the regulation of the share dealing group.⁷⁶

Related to market capitalization of some African capital markets as of December 1995; the data ranged from \$189 million in Namibia to \$397 million in Botswana, \$2,033 million in Nigeria and \$2,038 million in Zimbabwe. Again, the exception is South Africa with market capitalization of \$208,526 million (about ten times the combined capitalization of the remaining African stock markets), a testimony of what is possible even in Africa. Further, in many of the countries, the average listed company has a size of less than \$40 million, except in countries like Ghana, where the market is dominated by a few large companies (e.g., Ashanti Goldfields), compared to an average size of \$539 million and \$438 million in Taiwan and South Africa, respectively.⁷⁷

In relation to the role of the domestic private sector's investment when compared to the foreign investors, unlike the experience of Ethiopia during the Imperial Era, the present condition is positive. The data on the percentage share of investment capital in the country shows, from the total investment capital 60% belongs to the domestic private investors, 26% from the public sector and only 14% investment capital are contributed by foreign investors.⁷⁸

This shows that if Ethiopia is to introduce its own capital market the role of the local investors in both the demand and supply side will be expected to be satisfactory.

Considering the ease with which shares are traded, African stock markets suffer from an extremely low liquidity by comparison to the standards of other countries. Market turnover ranges from 0.1% in Swaziland to the maximum of 10% for Botswana. Others are: Nigeria (0.8%), Kenya (2.8%), Cote d'Ivoire (2.2), Namibia (1.6%) and Ghana (1.6%). In contrast, U.S and Germany achieve turnover ratios of 68% and 147 %, respectively, with Korea 93%, Thailand 70% and Mexico 56%. The low liquidity (rather illiquidity), more than market size, should be of great concern to Africa in light of emerging empirical evidence linking market liquidity to economic growth.⁷⁹

⁷⁶ NBE, A study Report on the Establishment of Stock Exchange Market in Ethiopia, 1999, Addis Ababa.

⁷⁷ Emenuga, C., "Development of Stock Markets in Sub-Saharan Africa," AERC Working Paper (1996)

⁷⁸ Ethiopian Investment Agency, Statistics on Investment in Ethiopia, Vol. No. 8, Feb, 2006

⁷⁹ Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

The lack of liquidity is attributable mainly to barriers to foreign portfolio flows that are still in place in many countries. Share holdings in these markets are typically distributed among the original direct investors of the listed foreign firms, the public sector and local institutional investors. As a case in point, Emenuga (1996) describes the Ghana Stock Exchange where original direct investors hold 69.4% of market value with 30.6% left for the public sector, local institutional investors and the public.⁸⁰ With a buy and hold attitude to investing, normally these three shareholder classes do not engage in trading except for terminal disinvestment. In the absence of free flow of foreign investment, therefore, little trading occurs.

In Nigeria, for example, only 0.8% of market value trade hands in a year; only 3% in Kenya and 1% of market value in Ghana. More interestingly, even the South African market, as advanced as it is in all other respects, suffers from an extreme illiquidity with a turnover ratio of a mere 6.5% in 1995. Partly owing to problems in the design of market microstructure and lack of quality personnel, there are poor brokerage services and slow settlement and operational procedures, where in some countries (e.g., Nigeria) it takes months to execute a single transaction. The settlement (share transfer) process in transacting on stocks in Africa is too long. Aside from Nigeria, in Kenya and Zimbabwe, for example, clearing and settlement takes up to two months. This problem is attributable to the manual-based clearing operations (combined with poor postal system), incompetent personnel and fraudulent practices (Emenuga, 1996).⁸¹

Transaction costs in African markets are the highest in the world. Investors get charged for brokerage fees, stamp duty and, in some cases, special charges by the regulatory bodies. Nigeria has the highest brokerage fees of 3%, with Ghana and Zimbabwe, each having 2%. The stamp duty varies, with 0.35% in Zimbabwe to 2% in Ghana. Total transaction costs range from 2% in Kenya to 4.75% in Nigeria. For a round-trip transaction in Nigeria, it costs a minimum of 9.5% of the share price, with a typical additional brokers' unofficial charge of 10% of price. In addition, that raising capital through going public, face exorbitant costs in terms of official fees, administrative and advertising costs. Thus, the microstructure of stock

⁸⁰ Emenuga, C. (1996), "Development of Stock Markets in Sub-Saharan Africa," AERC Working Paper

⁸¹ Emenuga, C. (1996), "Development of Stock Markets in Sub-Saharan Africa," AERC Working Paper

markets entails extraordinary transaction costs for individual investors and makes it very costly for firms to raise outside equity capital.⁸²

As a part of Africa, and as an emerging, the proposed capital market of Ethiopia can not be exception. The size and liquidity of the market will be influenced by the supply and demand of shares. According to the study made by Yishak Mengesha (2000), on the supply side the role played by the privatization process, the floating of the shares of the existing share companies, the shares to be issued by the potential share companies, and the issuance of government securities is expected to play a significant role. On the demand side, on the other hand, market participants may come from different sources. These includes: portfolio adjustment of individual asset holders; institutional savers such as insurance companies, pension funds, credit unions, microfinance institutions, and very large number of Edirs; and growing middle and high income groups of the populations may be regarded as potential sources of demand for shares. Thus as the review of most African countries with stock market shows, although it can not be liquid and efficient, Ethiopia can develop a capital market which is relatively thin, and illiquid at the beginning but which gradually improves. After all stock market development is a gradual process, unless we start it at some point taking the calculated risk we can not have it in a ready made form-tested and developed at once.

3.5.2. Incentives to Attract Inflow of Investment

In the world of international capital mobility where capital flows respond to the investment climate of host countries, the role of tax policies in promoting or retarding the development of capital markets cannot be overemphasized. Tax policies retard development if taxes are heavy, discriminatory and levied in multiple stages.⁸³

Countries seem to have recognized the role of sound tax policy in promoting capital markets. Many countries, including Botswana, Ghana, Kenya, Mauritius, Namibia and Swaziland, have abolished or suspended capital gains taxes. Dividend withholding taxes are reduced in Kenya and Nigeria. Although, equity had been subject to multiple stages of taxation, including corporate income tax, dividend withholding tax, personal income tax and remittance tax on foreign investment, recent measures have moved a long way toward the

⁸² Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

⁸³ Dan W. Hess, Emerging Equity Market in India, a Case Study, Seattle Pacific University, Seattle, Vol. 24, November 7 1998.

elimination of remittance tax and other discriminatory taxes against foreign capital.⁸⁴ Pertaining to this the Ethiopian government took many constructive reforms for facilitating foreign direct investment in the country.

Ethiopia has introduced a combination of investment guarantees and investment incentives measures intended to provide a supportive and reassuring business environment for potential foreign investors. Some of these include: 100% exemption from custom duties and import taxes on all capital equipment and up to 15% on spare parts; exemption from export taxes; Income tax holiday varying from one to six years depending on the sector and region of investment; tax deductible research and development expenditure; no tax on remittances of capital; the carrying forward of the initial operating losses; and investor's choice of the depreciation methods. The guarantee FDI includes full repatriation of capital and profit encompassing not only profits, dividends and interest payments on foreign loans but also on asset sale proceeds and technology transfer payments. There is also a guarantee against expropriation except in major causes of public interest in which case a full market value compensation will be made. Although, the steps taken so far in this respect are rewarding for the country and investors, more need to be done in order to ensure rapid inflow of FDI. These along with the institutional arrangements made relatively better opportunities are being created to benefit from FDI role in the proposed capital market of the country. One of the most recent indicators of this is a rapid flourishing of the horticulture industry.

3.5.3. The Banking Sector's Role

Some of the common African government policies, such as limiting the size of foreign banks, limiting foreign investments and/or requiring a separation between banking and commerce and banking and insurance (universal banking) can all be viewed as implicit barriers to the efficient provision of financial services. Moreover, policies that require banks and other financial institutions to make large-scale loans to public sector backed projects or to invest in publicly issued bonds, limit the ability of financial institutions to diversify and offer (sell) credible contracts to investors. Illiquid and Thin Securitized Finance: The absence of securitized debt market in Africa may be a reflection of extreme financial system underdevelopment characterized by severe agency and information costs, and the problems of contract enforceability. African financial systems are not only in a failure category, but

⁸⁴ Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

government policies typically limit the size and scope of financial service activities, particularly of foreign banks.⁸⁵

While there is no question that the banking system is the central part of any national and financial system, it is some times missed that the securities market are equally important, albeit in a different respect. While a country can not get along without a financial payment and clearing system, it is equally true that, if it is to have a market economy, it can not get along without any equity market either. According to Park and Agtmeal (1993, p.54), as cited in Dan W. Hess(1998 p. 19), financial systems that favors the banking system at the expense of the equity market are often doing damage to banking and impeding efficient economic growth.⁸⁶

The brief review the banking sector in Ethiopia shows that in Ethiopia there are 9 banks with 359 branches all over Ethiopia. Out of this 116 are situated in AA. The report covering the activities of the banks operating in Ethiopia shows that the total resource mobilized by the banking sector in the year 2003/04 increased to 10.1 million (by 35.4%) from the preceding year balance of birr 7.4 million. The deposit liabilities of the banking system climbed to birr 32.7 billion in the year 2003/04 compared to 27.9 billion birr balance a year ago showing an annual growth rate of 16.8%. It is also shown that the loan recovery trend is also improving. The lending trend of the banking sector in Ethiopia shows that in the years 2000/01, 2001/02, 2002/03, the credit granted to the public sector is greater than to what is granted to the private sector. However, in the year 2003/04 the private sector lending received above the public sector. In the year 2003/04 more than 88% of the total loan granted is provided to the private sector and cooperatives. This is a good indicator of the effect of the macro economic reforms introduced and the role of the private sector in the economy. One of the drawbacks of the lending system of the banking in Ethiopia is the collateral requirement. Many of the banks require minimum collateral of 100% to 150% of the loan depending on the purpose of the loan and the type of collateral. The DBE which provides a long term loan for projects requires up to 125% collateral for a loan extending up to 15 years. The collateral requirement is one of the major problems, especially for projects with good growth prospect but without adequate collateral. This would negatively affect the availability of fund for investment.

⁸⁵ Ibid,

⁸⁶ Dan W. Hess, Emerging Equity Market in India, a Case Study, Seattle Pacific University, Seattle, Vol. 24, November 7 1998.

Besides, the high level of out standing debt and the increasing trend in bad debt of the banks makes them rather highly cautious in allowing credit for private sector. The data in the same report shows the total out standing loan of the banking system is birr 31,597.6 million in the year 2003/04, the percentage increase from the 2002/03 is 11.3%. Out of the total outstanding loan the publicly owned banks accounts for 79.9% or 25,248.9 million. ⁸⁷(See table 8 given below)

**Table 8 Resource Mobilizing & Disbursing Activities of Commercial banks and DBE
(Specialized bank)**

Particulars	2001/02	2002/03	2003/04	Percent	Changes
	A	B	C	C/A	C/B
1. Deposit (net Change)	1,882.8	2,946.3	4,700.6	149.7	59.5
Demand	552.4	1,385.7	2,791.2	405.3	101.4
Savings	1,261.5	1,458.7	1,866.9	48.0	28.0
Time	68.9	101.8	42.5	-38.3	-58.3
2. Borrowing (net change)	-61.0	-63.3	75.4	-223.6	-221.0
Local	-67.5	-69.2	88.7	-231.4	-228.2
Foreign	6.5	6.9	12.4	90.8	79.7
3. Collection of loans	3,786.6	4,552.7	5,232.5	38.2	14.9
4. total Resources Mobilized (1+2+3)	5,608.4	7,436.7	10,008.5	78.5	34.6
5. Disbursement	3,165.6	4,097.9	6,211.7	96.2	51.6
6. Change I Liquidity (4-5)	2,442.8	3,338.8	3,796.8	55.4	13.7
Memorandum Item					
7. Outstanding Credit*	26,432.7	28,399.1	31,597.6	19.5	11.3

NB*includes overdraft facilities and government borrowing which are excluded from loans disbursed and collected.

The banking sector also suffers from excess liquidity. This is shown by the fact that there is only one transaction in the inter bank money market in the whole year. Pertaining to the level of liquidity of the banking sector the NBE report shows that the percentage increase in liquidity is 55.4% between 2001/02 and 2003/04 and it is 13.7% between 2002/03 and 2003/04, it is also stated that the actual reserves of commercial banks is in excess of what is

⁸⁷ NBE, Annual report, 2003/04, Addis Ababa, pp 25 - 35

required.⁸⁸ One can see how much these financial institutions could have benefited from their liquid cash for themselves and also for those investors who can use the funds for more productive sector of the economy.

3.5.4. Macro-economic and Political Factors

High macro-economic and political instabilities lead to high volatility in the financial markets. Research has shown that country risk, by implication, macro-economic risk, is the predominant source of variation in stock returns across countries (as opposed to industry-specific shocks). Further, international investors are concerned about political risk associated with the odds of adverse changes in government policies. They manifest in the form of expropriation, restrictions on repatriating capital and returns, differential treatment of domestic versus foreign-owned capital, taxation, etc. Thus, stability is valuable, both domestically and internationally.

Among the fundamental preconditions for the creation and development of a fertile environment for emerging stock market, one is the commitment of government officials and political stability. According to Dan W. Hess, (1998), the higher government officials should understand that equity markets do not always take the form of high risk gambling houses that drain away financial resources from the real economy and misuse human resources. Strong equity market growth in developing countries is usually partially the result of far sighted, strong leaders who had the vision, understood the issues and were prepared to face down the disbelievers and the fainthearted.⁸⁹

When considering the commitment of the leaders in Ethiopia towards developing capital market in the country, it is almost none. The potential benefit that stock market can offer to the economic growth is highly underestimated. Pertaining to this, what is surprising is that the various researches made so far in the country on the importance of developing stock market in Ethiopia justified its importance and recommended its establishment. To the knowledge of the researcher there is no research finding which clearly showed and recommended against the emerging of stock market in the country.

⁸⁸ Ibid, pp. 24 - 35

⁸⁹ Dan W.Hess, Emerging Equity Market in India: case study, School of Business, Seattle Pacific University, Washington, Vol. 24 No. 7, 1998 pp. 18

3.5.5. The Legal Frame Work

According to the study made by the special task force of the NBE, there is already a sufficient legal basis for the establishment of capital market in Ethiopia both in the commercial code of Ethiopia and the monetary and banking proclamation, No. 83/94. Historically the former share dealing group was established not by any specific government proclamation but by a set of rules and regulations laid out by the participating members of the group under the chairman ship of the NBE. Various articles of the Commercial Code of Ethiopia permit the issuance and trading of shares.⁹⁰

Pertaining to this, the report made by the Addis Ababa Chamber of Commerce shows that, the Ethiopian Commercial Code fully or partially covers issues related with: the provision on the issuance of different classes of shares; although not exhaustive, the eligibility requirement for companies wishing to issue their shares to the public is also indicated; provisions about the disclosure requirement of companies wishing to issue their shares to the public is also covered; however it is indicated to be weak; and adequate provision is included on corporate governance and on the protection of minority shareholders.⁹¹ Thus, to develop the proposed capital market, the existing commercial code will provide significant base. However; to make the market more conducive to both local and international investors, it has to be improved and updated to fit the current demand of stock market operations.

3.6. Measures to be taken In Developing Capital Market in Ethiopia

The stock market is one of the most important sources for companies to raise money. The experience of countries with operational capital market teaches us that the price of shares and other assets is an important part of the dynamics of economic growth. Rising share prices, for instance, tend to be associated with increased business investment and vice versa. Share prices also affect the wealth of households and their consumption. Therefore, concerned government bodies tend to keep an Argus eye on the control and behavior of the stock market and, in general, on the smooth operation of financial system functions.

In a countries where capital markets emerged a portion of the funds involved in saving and financing flows directly to the financial markets instead of being routed via banks' traditional lending and deposit operations. The general public's heightened interest in investing in the

⁹⁰ NBE, Study Report on the establishment of Stock Market in Ethiopia, July, 1999, Addis Ababa, pp. 63

⁹¹ Addis Ababa Chamber of Commerce, Proposal for the Formation of Share Market in Ethiopia, 1999, pp.24.

stock market, either directly or through mutual funds, has been an important component of this process. Statistics show that in recent decades shares have made up an increasingly large proportion of households' financial assets in many countries. In the 1970s, in Sweden, bank deposits and other very liquid assets with little risk made up almost 60 per cent of households' financial wealth, as against less than 20 per cent in the 2000s. The major part of this adjustment in financial portfolios has gone to shares but a good deal now takes the form of insurance saving. Similar tendencies are to be found in other industrialized countries. In all developed economic systems, such as the European Union, the United States, Japan and other first world countries, the trend has been the same: saving has moved away from traditional (government insured) bank deposits to more risky securities of one sort or another.⁹²

This is clearly a positive social trend. However, such riskier long-term saving requires that an individual possess the ability to manage the associated increased risks. Stock prices fluctuate widely, in marked contrast to the stability of (government insured) bank deposits or bonds. This is something that could affect not only the individual investor or household, but also the economy on a large scale.

Pertaining to the impact of the operation of capital market on the individual, institutional participants and the countries economy at large, many researchers come up with optimistic view about the contribution that stock market make to the economic development. There are, nonetheless, some with pessimistic view about the role of capital market. Among the proponents of the later view, one is Calamati, as cited in Jefferi (1995) Calamati conducted a study on some African market and concluded the undesirability of the market. The reason for his conclusion is mainly the volatility that is likely to be introduced in the market.⁹³

Another researcher named Singh (1993) shared Calamati's view. He argued that share prices do not often reflect the true long term expected earning of companies. Prices of shares are affected by other events, such as by the profit motives of market participants. He then concluded that developing countries should develop the banking sector rather than the stock

⁹²) Hagstrom, R.G. (2001), The Essential Buffet, John Wiley & Sons, Inc. New York.

⁹³ Jefferis, Keith, The Botswana Share Market and its role in the Financial and Economic Development, World Development, Vol. 23, No. 4, pp. 663 - 678

market which is often characterized by high volatility and speculative activities, with a consequence of more harm than good to the real economy.⁹⁴

Moreover; as opposed to the logic of efficient market hypothesis, experience thought us that investors may temporarily pull financial prices away from their long term trend level. Over-reactions may occur, so that excessive optimism may drive prices unduly high or excessive pessimism may drive prices unduly low According to the efficient market hypothesis (EMH), only changes in fundamental factors, such as profits or dividends, ought to affect share prices. (But this largely theoretic academic viewpoint also predicts that little or no trading should take place contrary to fact; since prices are already at or near equilibrium). But the efficient-market hypothesis is sorely tested by such events as the stock market crash in 1987, when the Dow Jones index plummeted 22.6 per cent— the largest-ever one-day fall in the United States. (However, this was part of a world-wide crash of stock markets which did not originate in the US.) This event demonstrated that share prices can fall dramatically even though, to this day, it is impossible to fix a definite cause: a thorough search failed to detect any specific or unexpected development that might account for the crash. It also seems to be the case more generally that many price movements are not occasioned by new information; a study of the fifty largest one-day share price movements in the United States in the post-war period confirms this.⁹⁵

The stock market, as any other business, is quite unforgiving of amateurs. Inexperienced investors rarely get the assistance and support they need. However; these market inefficiencies, may not be suggestive of the undesirability of the market. The fact is that security markets are asserting their positive role in the financial sectors of many developing countries. Market efficiency is strongly linked with the institutional set up, human capacity, and the macroeconomic environment at large. There have been innumerable

⁹⁴ Singh, Ajit, The Stock Market and Economic Development: Should developing countries Encourage Stock markets? UNCTAD Review, No.4, General , 1993

⁹⁵ Cutler, D. Poterba, J. & Summers, L. (1991), Speculative dynamics, Review of Economic Studies 58, pp. 520-546.

recommendations about how to make the stock market easier and safer for the casual, non-professional investor. In order to minimize the risks of financial market imbalances, it is important that there be a well thought-out legislative, regulatory, and supervisory infrastructure that functions properly, smoothly, and honestly. This is a never-ending task that requires the participation of all concerned. Thus in order to make the capital market to be emerged in Ethiopia less risky to investors the following steps shall be taken.

3.6.1. Developing Public Confidence and Informational Efficiency

Besides the basic macro economic reforms which are already made developing equity market requires additional regulatory reforms. Proper legal system must be in place. Such a system must have some form of contractual law, company law, and banking law along with the justice system that is able to enforce the laws effectively. Capital market participants need the assurance of those private contracts will be honored and enforced and appropriate dispute resolution mechanisms exist. Guy (1994, pp. 4 - 5) as cited in the Dan W. Hess, suggests a legal frame work that includes:

- A law that would deal with all aspects of the regulation of the market. A separate law, as opposed to trying to regulate the market through company law, would facilitate regulation and would provide flexibility to adapt to new situation.
- The creation of regulatory body responsible for the regulation of the market. Preferably this body shall be independent of the political structure. The exchanges should have their own regulations and compliance structure thereby acting as a first line of regulations. The government created would then provide general oversight and take up enforcement action on issues not properly handled by the exchange.
- Rules covering the public offerings of securities, on going company disclosure requirements and insider report.
- Provisions about secondary equity market operations and the depository and or settlement body that should developed. The exchanges, depository and other equity market intermediaries should be allowed to develop their organization while remaining under the oversight of the public regulatory body.
- Rules concerning the protection of minority share holders.
- Rules concerning certain fraudulent practices like insider wading and market manipulations, and

- Appropriate penalties to ensure compliance with the legislatives.⁹⁶

The government has a vital role to play in ensuring enforceability of private contracts. The mere existence of legislation, which declares and grants inalienable property rights, is insufficient. There ought to be an independent judiciary strongly enforcing and protecting these rights. Thus, accounting and legal standards are vital ingredients of financial market development. The lack of informational and operational efficiencies in capital market greatly detracts from public confidence and efficiency in the pricing of stocks, as well as liquidity and turnover. It also hampers the development of institutional funds and unit trusts, which are critical in attracting small investors to risk capital. Another reason that stock market development requires institutional development is that institutions, such as pension funds and insurance funds, are presumed to take a long-term view. One way to bring energy in the institutional development process is to employ capital market approaches to the process of privatization of state-owned enterprises. This may well be an important arena in experimenting with the development of pension funds through employee participation.

Moreover developing a well functioning capital market requires accurate, complete and timely information. Investor, brokers, traders and market makers can only make informed buying and selling decisions if they have access to information. The quality, adequacy and timeliness of information flows will, therefore, determine the overall effectiveness and efficiency of share market. The information flow should involve both macro and micro economic level data. The former includes information on the overall economic and business conditions, financial market conditions, and sector trend information; the latter involves company specific data such as operational results, financial positions statements, and reports on major issues related to the company.

3.6.2. Financial Intermediary Development

Two major models of financial intermediations are commonly applied by different countries. One is a structure of universal banks that are allowed to trade in securities and underwrite public offerings thus attempting to integrate banking and securities market services. The other is the structure of independent intermediaries, brokers, and investment bankers. The

⁹⁶ Dan W. Hess, Emerging Equity Market in India: case study, School of Business, Seattle Pacific University, Washington, Vol. 24 No. 7, 1998 pp. 23

decision on which method to be implemented in Ethiopia shall depend on the through research findings done by taking in to account the number and operational capacity of the available banks; and the possibility of establishing other independent intermediaries for the ultimate goal fostering the growth of the economy and satisfy the equity market needs.

According to the study made by Guy (1994, pp. 6, as cited in Dan W. Hess) points out that although integration provides certain efficiencies, there is evidence of the weakening effect it has on equity market development and the risk of abuses resulting from concentration of financial power and conflicts of interest. He provides evidence that countries with universal banking system has smaller and less efficient equity market and greater concentration of economic power than those countries that separate the banking and securities underwriting functions.⁹⁷

However Dan W. Hess states that since countries with emerging capital market may not have enough number of independent intermediaries that can effectively satisfy the operational need of stock market, they may use banks to set up independent fully capitalized subsidiaries as brokers, investment dealers and underwriters.

3.6.3. Promoting Financial Market Development through Regionalization

Among the different mechanisms through which countries develop their own stock market one is by integrating the market with other capital markets operating in different countries. Since emerging stock markets are currently thin and "balkanized", there is a talk about pooling resources and harmonizing securities and investment laws, as well as banking and financial regulations. Cross-border monitoring and enforcement of laws may enhance competition among the member countries in the region and enhance public confidence in the markets. For example, there is some cross-listing of securities between Namibia and Zimbabwe, and Ghana and Zimbabwe (e.g., the Ashanti Goldfields). Thus a step by step measure to integrate the local market at a regional and global level shall be considered in the long run.

⁹⁷ Ibid, pp.26

3.6.4. Human resource and Infrastructure Development

Sub-Sahara African countries face not only severe shortage of financial capital but severe shortage of human capital trained in financial markets. It can be done through improved business school curricula in universities and in colleges and training institutions, also training programs through the National and commercial banks, chamber of commerce's, etc. Human resource development should include all those with the potential to participate in the market place as securities dealers, brokers, fund managers, and regulators both in banking and other financial services. The need for human capital development and optimal deployment cannot be overemphasized. The investments made in human capital are long-term, with permanent returns, in terms of efficient deployment of existing resources and adapting to global change and information technology. Human capital development manifests itself in increased knowledge base, skilled labor, problem solving, better morale, innovativeness and resourcefulness, potentially resulting in higher value-added and hence economic growth of the country and its attractiveness as a repository of capital.

3.6.5. Promoting Capital Market Development through Privatization

Although there are well-studied mechanisms, such as employee stock ownership plans, mass privatization and voucher system, and privatization through mutual funds or active investors. In those countries where there are stock exchanges, privatization of state-owned companies enhances the depth of the existing markets, while being carried out in a fair way. Indeed, capital market development is an important means of depoliticizing privatization, by making it possible for large-scale privatizations to take place at fair pricing of assets to be sold. In addition, local capital markets allow for local investor participation and help alleviate concerns about foreign grab of assets in privatization. Small investors can participate in large scale privatizations through institutional funds or unit trusts. An important efficiency gain of privatization of state-owned enterprises is to mitigate, or even eliminate, the free rider problem associated with public monitoring. In principle, public enterprises are owned by all the citizens of the state, and no single individual has an incentive to monitor an inefficient management of the state enterprise it is costly to do so. Under privatization the free rider problem is reduced considerably as ownership becomes less diffused, giving rise to better monitoring by active investors. Beyond that, in the stock market economy which allows the transferability of ownership rights in the open market, corporate control contests and the threat of takeover serve as a powerful discipline against inefficiency in the management of

private enterprises. Thus, privatization allows firms to be subject to the full disciplining force of capital markets and frees up the government from running and sustaining losing enterprises. Once its burden of running companies is removed, the government will then focus on the delivery of its vital functions, such as education, health, justice, and infrastructure.⁹⁸

3.6.6. Globalizing the Capital Markets

The data from the Wall Street investment houses and international financial agencies make a compelling case for the benefits of global diversification that includes emerging countries. The implications for development capital and economic growth are accordingly enormous. It is only rational that investors take a global view in their holdings of their portfolios. Consequently, the evaluation of investment portfolio performance must be based on a global risk-reward ratio. The competitiveness of a country in attracting international capital depends on its role in improving the global risk-reward ratio faced by international investors.

3.6.7. Designing Efficient Regulatory Systems

An important ingredient for the growth in emerging equity market is the liberalization of government control and regulations that have distorted and impeded development by restricting access by foreigners. A genuine capital market development should be accompanied by a credible and rational regulatory scheme that promotes, rather than inhibits, both local and foreign private initiative, whereby investors and savers build confidence in the financial system. Some of these includes the removal of barriers on foreign direct and portfolio investment, more flexible foreign exchange arrangements, differential tax treatments that discouraged financial flows into equities and the reduction of excessive licensing and tariffs.⁹⁹

The environment should foster investment allocation to the most productive sectors and lead to growth in productivity and employment. More savings can be attracted into the formal financial system away from the informal sector, as the credibility of the formal system improves. Financial institutions play a crucial function as delegated monitors of ultimate users of funds (corporations and other borrowers) on behalf of ultimate suppliers of funds

⁹⁸ Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

⁹⁹ Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28 March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

CHAPTER FOUR

SUMMARY CONCLUSION AND RECOMMENDATIONS

4.1. Summery and Conclusion

In developing countries, particularly in Sub-Saharan Africa, financial markets are dominated by commercial banks, which have not been reliable sources of long-term financing. The non-bank sources of medium and long-term financing are generally, underdeveloped.¹⁰⁰ The short-term nature of commercial banks' assets and liabilities as well as regulatory reserve requirements in many countries render them (banks) incapable of supplying long-term capital. The high yielding short-term government treasury bills have, therefore, resulted in "crowding out" of the private sector as commercial banks hold large portions of their asset portfolios in the government bills.¹⁰¹

Ethiopia is not an exception to the above fact. The financial sector of Ethiopia is completely dominated by the banking sector. The availability of fund in the banking sector of Ethiopia is not only limited in amount, but is also highly depend on the capacity of borrowers to come with adequate collateral. Besides, like the case of other Sub Saharan African countries, the banks operating in Ethiopia use substantial part of their liquid asset for the purchase of T-Bills. Pertaining to this the data in the annual report of NBE (2003/04) shows us that in the year 2003/04, the total money provided to the business sector is only 6,211.6 million only, while the amount of money used for the purchases of treasury bills is birr 11,418 million.

Heavy reliance on banks system increases vulnerability of financial systems as exemplified by the Asian financial crisis in the 1990s. Having a multi-faceted financial system, which includes non-bank financial institutions, can protect economies from financial shocks.¹⁰²

In this regard, capital markets are considered better avenues of mobilizing domestic and international capital.¹⁰³ Capital markets have the potential to meet the fixed-capital needs of

¹⁰⁰ The World Bank, "Capital Market Integration in the East African Community." (Washington, DC: World Bank, 2002), 14

¹⁰¹ Ibid.

¹⁰² Jeffrey Carmichael , Michael Pomerleano, "Development and Regulation of Non-Bank Financial Institutions." *The World Bank Publications*. Accessed April 2, 2005.

the private sector. They can ensure the efficient and sustainable funding of governments, corporations, banks, and large-scale or long-term projects.¹⁰⁴ In view of these past practices and in light of the above results, we can say that stock market development is positively correlated to economic growth. Hence, this paper suggests that the government should play a more positive role in order to foster capital markets

In addition, capital markets facilitate the mobilization and allocation of medium and long-term funds for productive investment by:

- Providing a simple mechanism for the transfer of funds;
- Facilitating companies' access to a large number of local and foreign investors;
- Widening the array of financial instruments available to savers and investors
- Increasing the diversity and competition in the financial systems.
- Providing market signals on current situations and future expectations.

Generally, the effective functioning of capital markets requires the following:

- Existence of an exchange, clearing and settlement system.
- Existence of a legal system to enforce contracts.
- Availability of information on financial soundness and future prospects of companies.
- Governance of corporations in a manner that gives investors confidence that their funds will not be stolen or wasted.

. Money developing countries including Ethiopia are working towards reforming and deepening their financial systems. However; there are still countries that do not clearly internalize the issue and apply the reform as required. Pertaining to this, Summit Agrual, the most notable researcher in the on the role of stock market for economic growth, stated the following: " Even though, having recognized the importance of financial markets for economic growth many developing countries have increased their efforts towards improving

¹⁰³ Sam Q. Ziorklui, "Capital Market Development and Growth in Sub-Saharan Africa: The Case of Tanzania." *African Economic Policy Discussion Paper 79*. (2001).

¹⁰⁴

<http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/generaldescription/1Capital+Markets?opendocument>.

the financial systems of their countries to stimulate economic growth, they have mainly focused on banking systems reforms - removing interest rate controls, reducing government involvement in credit allocation, minimizing taxation of financial intermediaries, managing bank insolvency, now they need to focus on stock markets. Policymakers should encourage stock market development. They should remove impediments to stock markets, such as tax, legal, and regulatory barriers." ¹⁰⁵ Thus as various research findings recommends the expansion of capital markets plays a significant role to improve the ability to mobilize resources and efficiently allocate them to the most productive sectors of the economy. Ethiopia, as one of the poorest countries on earth, needs to evaluate the efficiency of its financial systems and make a modification accordingly. As it is shown in this paper, the private sector in the country is suffering from lack of fund for investment. Especially the availability of money for long term, promising investment projects of innovative young entrepreneurs is the victim of the collateral based credit system of banks. The failure to mobilize the desperate savings of house holds is another problem which worth mentioning. This is shown in the disproportionately low saving rate of the country nearly 2.8 in 2003/04, which is by far below the average rate for Sub Saharan African countries.

Thus to reap the benefits of capital market development Ethiopia shall emerge its own stock market. However; as a country with the majority of unsophisticated investors, a thorough cautionary measures shall be taken to minimize the harm that an inefficient capital market, unreasonable speculators and other market participants possibly cause.

¹⁰⁵ Sumit Agarwal, Stock Market Development And Economic Growth: Preliminary Evidence From African Countries,

4.2. Recommendations

In view of the benefit and challenges discussed in the previous sections with regard to the development of capital markets, in general, the following recommendations are proposed. They make specific reference to the case of Ethiopia.

- The Government of Ethiopia, and its major concerned parties like The National Bank of Ethiopia, The Ministry of Finance and Economic Development, Ministry of Trade and Industry, The Ethiopian Investment Authority, The Ethiopian Privatization Agency, Ministry of Trade Industry, and etc should be convinced on the role that capital market development plays in economic growth, so that they can show a genuine commitment for its establishment.
- As the benefit from the stock market largely depends on its capacity to mobilize funds from the surplus unit and make it available to the deficient unit. Its capacity depends on the number of individual institutional savers that it can attract. Attracting these participants among other things requires creating public awareness. Thus, whichever designated body for handling the operation of the market, should embark on a vigorous campaign to educate potential investors about the opportunities available in the market and how to effectively exploit them. The efforts to be made to improve public awareness of the opportunities available in the capital markets need to be strengthened by using a variety of means of communication such as media campaigns through the radio, television and newspapers, engaging in one-to-one meetings with eligible firms and potential investors, and distribution of literature to firms and potential investors across the country. A program of continuous education for the investor, the intermediary, the issuer and the regulator is extremely important for the successful development of the capital market. This education campaign should involve the development of financial journalists and improvements in the quality of financial market publications. Financial education should be strengthened in the secondary schools and particularly in the universities. As markets become more sophisticated, there is increasing need for investment advisors and other personnel who are capable of analyzing complex financial concepts such as options and other derivatives.

- Establishing a regulating body that will be responsible for the regulations and efficient operation of the capital market. This may take the form of self regulatory body, which is similar to the type used in most newly emerging capital markets. However; side by side another body which is established by the government should be there to supervise and give direction to the self regulatory body. The self regulatory body, which is made up of members, is responsible to draft the required rules and regulations that govern all participants.
- Applying successive macro economic reforms that are conducive to the development of the capital market in the country. If the macro economy is conducive to profitable business operation, a sufficient number of sound businesses can develop to a stage where access to securities markets is useful for their continued growth. This means that if there are not sufficient profitable businesses with good prospects for the future, there is little reason to have a securities market.
- Ensuring the development of the important institutional infrastructures, which provides the operational basis for the market, these relates to intermediaries that provide trading, investment management and financial advisory services; market and market-related service providers for stock exchanges, over-the-counter markets, market information services, transaction clearance and settlement systems, and securities transfer, registration and custody; and providers of ancillary services such as accounting and auditing, legal advice, and financial valuation and debt rating services.
- Facilitate the establishment of other regulatory infrastructure, this relates not only to the government body that has the power and responsibility to supervise the market, but also includes self-regulatory organizations such as stock exchanges, accounting standards boards, and accounting and auditing professional associations and similar organizations. It also includes their rules and regulations, procedures, and facilities such as stock exchange listing and trading rules or accounting and auditing standards, plus the monitoring and enforcement of these rules. In this regard empowering the existing professional associations, auditing firms, accounting consultancy firms, management Consultancy firms, the Ethiopian economic Associations, The Ethiopian

Accounting professional Associations, The Association of Certified Chartered Accountants of Ethiopia, etc can play role in assisting the capital market operations to get standardized.

- Ensure the development of legal infrastructure that provides the basis for the operational and regulatory framework. It provides for property rights, contractual relationships, forms of incorporation, and rights and responsibilities of participants in the market. It also specifies the powers and responsibilities of the government supervisory authority and self-regulatory organizations.
- An essential function of capital market is collecting, processing and conveying information for allocating funds and monitoring their use. Good information should be made available to make better choice among investment options on the basis of the expected return and risk and to monitor the performance of companies after investment so as to divest if things go wrong. However; there is an information asymmetry problem in the market which may cause selection problem and also moral hazard. In order to avoid or minimize such problems capital market structure shall be arranged in such a way to provide adequate and timely market and company level data to investors. The current situation in Ethiopia with regard to the availability of macro and micro economic information is lacking. Thus among the most important duties that are expected from the share governing body is to establish a reliable and standard system with the aim of collecting, compiling, analyzing, and disseminating basic financial data to investors.
- Nurture a progressive and sound banking system: The banking sector is vital to the development of the capital markets. A progressive and sound banking system is required to quicken the development of the financial market.
- Relax the minimum requirements for trading securities in order to accommodate companies that have shares that are transferable to members of the public, although they do not meet the stringent listing requirements. The challenge will be to simplify and ease listing conditions without compromising investor protection. Streamlining

public offering procedures and limiting the number of market agents involved in the issuing process are examples of simplification of the listing requirements.

- Continued privatization of state enterprises is essential as the most viable source of equity. In this regard, the implementation of the privatization through floating of shares to the public will increase the supply of equity in the market and trigger resurgence of primary equity activity. However, weak and non-performing public enterprises should not be dumped in the market in the guise of privatization.
- Pursuit of the development of institutional investors such as firms in the insurance industry, pension funds, and micro finance institutions is important in order to generate long-term funds that can be invested in the capital market.
- Encourage the free flow of capital across borders through the regional integration of capital markets.
- Developing a modern trading system to bring about liquidity, attract foreign investors and reduce transaction costs. Automation of trading will facilitate the ability of the market to cope with increase in new listings or increased trading and turnover particularly with the imminent privatization of many state-owned companies.
- Provide fiscal incentives: The current tax laws favor the use of debt instruments compared with equity. If the number of firms joining the stock market is to grow, then there is need to provide incentives for firms who may want to be listed on the Stock Exchange. One such incentive is differential taxation in favor of listed companies. Such an incentive will help increase the number of listed companies on the exchange and improve liquidity of the market.

- Follow prudent macroeconomic policies: There is need for the government to follow prudent macroeconomic policies. In order not to create financial instability, and uncertainty, which affects capital market development.
- A thorough revision that considers the costs and benefits of the different tax systems currently operational in Ethiopia shall be made in light of encouraging equity financing. The researcher feels the current trend as being against what should be done to encourage liquidity and equity investment. For example the tax related with share transferring transactions, the tax shield given for debt financing as opposed to equity financing.
- Research shall be made on the costs and benefits of permitting foreigners to invest in the banking sector and allowing foreign banks to operate in Ethiopia.
- The last but not the least is that, since establishing a capital market is not an easy task a thorough and highly specific research shall be conducted not on the benefit of capital market as it is already done by many other knowledgeable professionals, but on the how of implementing it in Ethiopia.

REFERENCE

- Abu Girma (1994), Problems and prospects for the emergency of stock markets in Ethiopia in the proceeding of annual conference on the Ethiopian Economy, AA August, page 207 - 255
- Addis Ababa Chamber of Commerce, Proposal for formation of Share Markets in Ethiopia, Addis Ababa, December 1998
- Addis Ababa Chamber of Commerce, Proposal for the formation of Share Market in Ethiopia, March 1999
- Araya Desalegne and Tewdrose Harege, (1994) Towards the Development Of Capital in Ethiopia, the proceeding of annual conference on the Ethiopian Economy, AA August, page .227 - 237
- Aserat Tessema (professor), "prospects and Challenges for Developing a Stock Market in Ethiopia: an analytical review"
- Asli Demirguc-Kunt and Vojislav Maksimovic, "Stock Market Development and Financing Choices of Firms," *World Bank Economic Review*, May 1996.
- Atje, Raymond, and Boyan Jovanovic. 1993. "Stock Markets and Development," *European Economic Review* 37 (2/3), pp. 632-40.
- Bencivenga, Valerie R. , Bruce D. Smith, and Ross M. Starr. 1996. "Equity Markets, Transactions Costs, and Capital Accumulation: An Illustration" *The World Bank Economic Review* 10 (2).
- Berthelemy, Jean-Claude, and Aristomene Varoudakis. 1996. *Financial Development Policy and Growth*, OECD Development Center.
- Boyd John and Bruce Smith. 1996. "The Co evolution of the Real and Financial Sectors in the Growth Process" *The World Bank Economic Review* 10 (2).
- Brigham, Eugene F. and Houston, Joel F., *Fundamentals of Financial Management*, the Dryden Press, Philadelphia 1998, p.111
- Colin Mayer, "New Issues in Corporate Finance," *European Economic Review*, June 1988.

Cutler, D. Poterba, J. & Summers, L, Speculative dynamics, *Review of Economic Studies* 58, (1991), pp. 520-546.

Dan W. Hess, Emerging Equity Market in India: case study, School of Business, Seattle Pacific University, Washington, Vol. 24 No. 7, 1998 pp.17

De Long, J. Bradford; Shleifer, Andrei; Summers, Lawrence H. and Waldmann, Robert J. "The Size and Incidence of the Losses from Noise Trading," *Journal of Finance*, July 1989, 44 (3), pp. 681-96.

Demirguc-Kunt, Asli, and Ross Levine. 1996a. "Stock Markets, Corporate Finance and Economic Growth: An Overview," *The World Bank Economic Review* 10 (2), pp. 223-239.

Demirguc-Kunt, Asli, and Ross Levine. 1996b. "Stock Market Development and Financial Intermediaries: Stylized Facts," *The World Bank Economic Review* 10 (2), pp. 291-321.

Devereux, Michael B., and Gregor W. Smith. 1994. "International Risk Sharing and Economic Growth," *International Economic Review* 35 (4), pp. 535-50.

Emenuga, C., "Development of Stock Markets in Sub-Saharan Africa," AERC Working Paper (1996)

Eshetu Chole and Mekonene Maniyazewal, The Macro Economic Performance of the Ethiopian Economy, In The First Annual Conference on Ethiopian Economy, 1991, AA

Ethiopian Investment Agency, Statistics on Investment in Ethiopia, Vol. No. 8, Feb, 2006

Federal Negarit Gazeta, No. 27 2nd July, 2002, pp. 1776

Feleke Mamo, Towards Promoting Capital Market in Ethiopia: Opportunities and Challenges, Mekele University, September, 2000, pp 103.

Frank fabozzi, Franco modigliani, Capital markets: Institutions and Instruments, School of management, Yale University, 1996

Garbed, Kenneth, "Securities Market ", McGraw-Hill Inc, New York, 1982, P. 423-424

Garcia, Valeriano F. "A Critical Inquiry into Argentine Economic History 1946 - 1970"
1986 Garland Publishing Co. New York.

Gebre Hiwot Ageba, Financial Markets and Institutions, Presented in the F.B.E. Addis
George Stigher, "Public Regulation of Security Market" Journal Of Business, April,
1964, P. 117 - 134

Goldsmith, Raymond W. 1969. *Financial Structure and Development*, New Haven, CN:
Yale University Press.

Gurley, John, and Edward Shaw.. "Financial Aspects of Economic Development," 1955,
American Economic Review, pp. 515-38.

Gurley, John, and Edward Shaw. Money in a Theory of Finance, Washington, DC:
Brookings Institutions. Journal of Applied Economics 1960.

Gurley, John, and Edward Shaw, "Financial Structure and Economic Development,"
Economic Development and Cultural Change, 1967, pp. 333 - 46.

Hagstrom, R.G. The Essential Buffet, 2001 John Wiley & Sons, Inc. New York

[http:// www. answer. com/library/legal Encyclopedia](http://www.answer.com/library/legal/Encyclopedia)

[http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/generaldescription/1Capital
+Markets?opendocument.](http://wbln0018.worldbank.org/html/FinancialSectorWeb.nsf/generaldescription/1Capital+Markets?opendocument)

Ikhide, Commercial Bank Offices and the Mobilization of Private savings-in Selected
Sub Saharan Countries, 1996, The Journal of Development Studies, Vol. 33 No. 1
PP.117-132.

Ingaham, Barbara), House hold Savings and credit, a Long View of Policy, 1992, pp. 1-
2/97

International Encyclopedia of social science, Vol. 14, the Macmillan Company & The
free Press, New York, 1968, p. 136

International Finance Corporation, Emerging Stock Markets Fact book, World Bank,
1997, Washington DC.

Jefferis, Keith, The Botswana Share Market and its role in the Financial and Economic Development, *World Development*, Vol. 23, No. 4, pp. 663 - 678

Jeffrey Carmichael , Michael Pomerleano, "Development and Regulation of Non-Bank Financial Institutions." *The World Bank Publications*. Accessed April 2, 2005.

Kenny C.j. and T.G. Moss, Stock market in Africa: Emerging Lions or White Elephants *World development*, 1998, Vol. 26, No. 5 , page 829 – 843

King, Robert G., and Ross Levine.. "Finance and Growth: Schumpeter Might Be Right," *Quarterly Journal of Economics* 108, 1993a No. 3, pp. 717- 38.

King, Robert G., and Ross Levine.. "Finance, Entrepreneurship and Growth: Theory and Evidence," *Journal of Monetary Economics* 32, 1993b pp. 513-42.

King, Robert G., and Ross Levine. 1993c. "Financial Intermediation and Economic Development," in C. Mayer and X. Vives, eds., *Capital Markets and Financial Intermediation* (Cambridge University Press, Cambridge).

Kohn, Meir, "Money, Banking, and Financial Markets" The Dryden Press, Chicago, 1991, p. 157

Korajczyk R. A. (1996) A measure of stock market integretion, *World Bank Economic Review*, Vol. 10 N0. 2, Page 267-289

La Porta, Rafael, Florencio Lopez-de-Silanes, Andarei Shleifer and Robert Vishny, 1996. "Law and Finance" NBER, WP No. 5661.

Levine R, and S. Zervos, Stock Market development and Long run Growth, *World Bank Economic Review*, 1996, Vol 10. No. 2 page 232- 239

Levine, Ross and Sara Zervos. 1998. "Stock markets, Banks, and Economic Growth" *The World Bank Policy Research Working Paper* No. 1690, December 1996.

Levine, Ross. 1991. "Stock Markets, Growth, and Tax Policy." *Journal of Finance* 46 (4): 1445-65.

Levine, Ross. 1997. "Financial Development and Economic Growth: Views and Agenda," *Journal of Economic Literature* 35 (2), pp. 688-726.

Liu, Lin, 1998. "Financial Development and Economic Growth: A Literature Review,"
Mimeograph. The World Bank, Washington, DC.

Macroeconomic Determinants Of Stock Market Development, *Journal of Applied
Economics, Vol. II, No. 1 (May 1999), 29-59*

McKinnon, Ronald I. 1973. Money and Capital in Economic Development, Washington,
DC: The Brooking Institution.

Meeting of the Intergovernmental Group of Experts Addis Ababa, Ethiopia, 25 - 28
March 1997, The Development of Capital Markets in Africa: Constraints and Prospects

Ethiopian Investment Agency, Statistics on Investment in Ethiopia, Vol. No. 8, Feb. 2006
Addis Ababa,

Miler Roger Le ray, " Modern Money and banking " McGraw Hill, Inc., USA, 1993,
P.101

Miller, Merton. 1991. Financial Innovations and Market Volatility. Blackwell,
Cambridge.

Modigliani, F. and Miller, M.H. 1958. "The Cost of Capital, Corporation Finance, and
the Theory of Investment" American Economic Review, 48 (3): 261-297

National Bank Of Ethiopia (1999), Study Reports On the establishments of a stock
market in Ethiopia(first Draft)

National Bank of Ethiopia, Annual Report, 2003/4, Addis Ababa,

NBE, Birritu, No. 88, A bilingual quarterly Bulletin, Feb, 2003 - April 2003.

Ness, Walter and Martinez, Alfonso. 1997. "The Stock Market in Argentina and Brazil",
the World Bank Policy Research Working Paper. Washington, DC.

Obstfeld, Maurice. 1994. "Risk-Taking, Global Diversification, and Growth." American
Economic Review 85(5), pp. 1310-29.

Olson, Jr., Mancur. 1996. "Big Bills Left on the Sidewalk: Why Some Nationals are
Rich, and Others Poor," Journal of Economic Perspectives 10 (2), spring.

Pagan, Marco. 1993. "Financial Markets and Growth: An Overview," *European economic Review* 37, pp. 613-22.

Pardy, Robert, "Regulatory and Institutional Impact on Security Markets Computerization", The World Bank, 1992,

Pardy, Robert, International Reform In Emerging Securities Markets, WPS No. 907, World Bank, Washington, 1993

Privatization News, Biannual News Letter, vol. VI no. 2, Dec. 2003

Robert D. Auerbach, "Money, Banking, and financial markets" second edition, Macmillan Publishing Comp. New York , 1985

Ross Levine, Stock Markets, Economic Development, and Capital Control Liberalization, 1997, Dept. of Economics University of Virginia.

Ross, Westerfield, Jordan, (2000), *Fundamentals of Corporate Finance*, Fifth Edition, Sam Q. Ziorklui, "Capital Market Development and Growth in Sub-Saharan Africa: The Case of Tanzania." *African Economic Policy Discussion Paper* 79. (2001).

Shaw, Edward S. 1973. *Financial Deepening in Economic Development*, New York: Oxford University Press.

Singh, A. 1997. "Stock Markets, Financial Liberalization and Economic Development," *Economic Journal* 107, pp. 771-82.

Singh, Ajit, *The Stock Market and Economic Development: Should developing countries Encourage Stock markets?* UNCTAD Review, No.4, General, 1993

Sumit Agarwal, ARC-STM Development and Economic Growth document, 2006
Sumit Agarwal, *Stock Market Development and Economic Growth: Preliminary Evidence From African Countries*,

The steering Committee for the formation of Addis Ababa Stock Exchange, Isn't Ethiopia Ready to stock Market? *Fortune* Volume 1 No 34, Dec. 24, 2000

The World Bank, "Capital Market Integration in the East African Community." (Washington, DC: World Bank, 2002), 14

Valeriano F. Garcia And Lin Liu, Macroeconomic Determinants of Stock Market Development, *Journal of Applied Economics*, Vol. II, No. 1 (May 1999), 29-59
World Bank,, Washington DC.

World Bank, 1989, World Development Report, Oxford University Press, New York,
World Bank's *World Development Report*,

World development Report, Ethiopia; Public Expenditure Review, 1997, November.

Yishak Mengesha, Towards Promoting Capital Market in Ethiopia: Opportunities and Challenges, Mekele University, September, 2000, pp. 4

—
- Eco growth - Factors
Short term / Long term
Globalization & Cap. markets