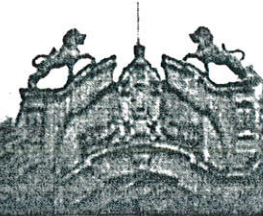


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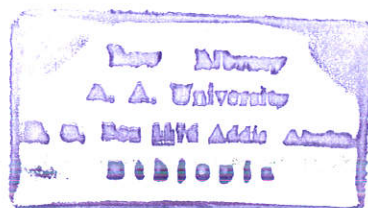
**INTRODUCING REGULATED STOCK MARKETS IN ETHIOPIA:
RELEVANCE TO THE BANKING SECTOR DEVELOPMENT AND
ROLE IN INVESTORS' PROTECTION**

BY: KAHSAY MULU

ADVISOR: YOHANNES ASSEFA (B.A, M.S., J.D.)

**SUBMITTED IN PARTIAL FULFILLMENT OF THE REQUIREMENTS
FOR THE MASTER OF LAWS DEGREE AT THE SCHOOL OF LAW,
ADDIS ABABA UNIVERSITY**

**ADDIS ABABA
NOVEMBER 2011**



Approval Sheet by the Board of Examiners

Introducing Regulated Stock Markets in Ethiopia: Relevance to
the Banking Sector Development and Role in Investors'
Protection

I hereby certify that this is My Original Work. Works of others
Included in this Thesis are Properly Cited.

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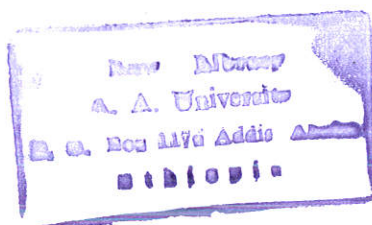
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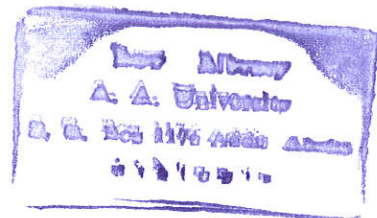


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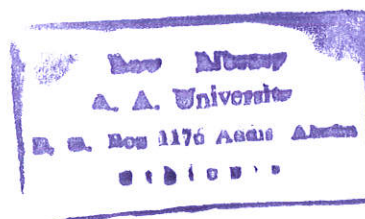
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Abstract

The banking sector is the dominant source of finance for businesses in Ethiopia. A key characteristic of the Ethiopian banking sector is that the stock of bank credit to the private sector (including nonfinancial public enterprises) remains very low, when compared with the situation in other developing countries. High degree of inefficiency characterizes the banking sector making it difficult for business to get the necessary finance or to start up or expand. The rate of company formation through initial public offer of shares and the separation between ownership and control in Ethiopian share companies is growing. The emerging corporate ownership structure is also a dispersed one. The main focus of this paper is, therefore, discussing the relevance of introducing stock market in light of the existing banking sector development in the country. Most importantly, the thesis discuss the role of introducing regulated stock markets in protecting investors in light of the growing dispersed company ownership structure and the existing institutional, regulatory, and legal framework in the primary offering market. In addition, the study discusses the factors that are identified as preconditions and determinants for stock market development along with review and analysis of the objective reality prevailing in Ethiopia with regard to these factors.

CHAPTER ONE

1. Introduction

1.1 Back Ground

The achievement of sustainable economic growth demands, among other things, considerable resources for investment and efficient utilization of these resources. Stock market development increases economic growth through a number of channels. Countries with [more developed] stock markets have banking sectors that issue more credit to the private sector than countries with [no] or less well developed stock markets¹. Therefore, stock market development is supposed to accelerate economic growth through overcoming external financing constraints that otherwise hinder firm expansion.

As part of the financial system, stock markets are expected to accelerate economic growth by providing a boost to domestic savings and increasing the quantity and the quality of investment². Better savings mobilization may increase the savings rate³ (Levine & Zervos, 1998). Stock markets are expected to encourage savings by providing individuals with additional financial instrument that may better meet their risk preferences and liquidity needs⁴.

Efficient stock markets may also reduce the costs of information⁵. They may do so through the generation and dissemination of firm specific information that efficient stock prices reveal. Stock markets are efficient if prices incorporate all available information⁶. Reducing the costs of

¹ Levine, R. (June 1997), "Financial development and economic growth: Views and agenda"(Journal of Economic Literature, No. 35), p.692.

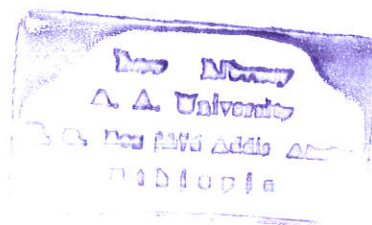
² Singh, A. (1997), "Financial Liberalization, Stock Markets, and Economic Development" (The Economic Journal, No. 107), p.774.

³ Levine, R., & Zervos, S. (1996a), "Stock Market, Banks and Economic Growth" (American Economic Review, 88), p.545.

⁴ Ibid.

⁵ Levine, R., & Zervos, S., *supra* note 3.

⁶ Fazzari, S., Hubbard, G., & Petersen, B. (1988), "Financing constraints and corporate investment" (Brookings Papers on Economic Activity, No.1), p. 191.



acquiring information is expected to facilitate and improve the acquisition of information about investment opportunities and thereby improves resource allocation. Stock prices determined in exchanges and other publicly available information may help investor make better investment decisions and thereby ensure better allocation of funds among corporations and as a result a higher rate of economic growth⁷.

Stock markets also provide an avenue for growing companies to raise capital at lower cost. Stock markets therefore are able to positively influence economic growth through encouraging savings amongst individuals and providing avenues for firm financing.

Stock markets are supposed to ensure through the takeover mechanism that past investments are also most efficiently used. Theoretically, the threat of takeover is expected to provide management with an incentive to maximize firm value. The presumption is that, if management does not maximize firm value, another economic agent may take control of the firm, replace management and reap the gains from the more efficient firm. Thus, a free market in corporate control, by providing financial discipline, is expected to provide the best guarantee of efficiency in the use of assets. Similarly, the ability to effect changes in the management of listed companies is expected to ensure that managerial resources are used efficiently⁸.

Stock market liquidity is expected to reduce the downside risk and costs of investing in projects that do not pay off for a long time. With a liquid market, the initial investors do not lose access to their savings for the duration of the investment project because they can easily, quickly, and cheaply, sell their stake in the company⁹. Thus, more liquid stock markets could ease investment in long term, potentially more profitable projects, thereby improving the allocation of capital and enhancing prospects for long-term growth.

⁷ Moloney, N. (2010), "How to Protect Investors; Lessons from the EC and the UK", New York, USA, Cambridge University Press, p.272.

⁸ Kumar, S. M. (1984), "Growth, Acquisition, And Investment", Cambridge, Cambridge University Press, p.234.

⁹ See Generally, Bencivenga, V. R., & Smith, B. D. (1992), "Financial intermediation and endogenous growth" (Review of Economic Studies, No. 58,), pp.195-209.

As a result, stock markets are springing up in most countries around the world. Stock markets have come to symbolize to many the essence of capitalistic economic relations. More than 23 African countries have also established stock markets, recognizing the role that such markets play in mobilizing capital. However, Stock markets in Africa remain immature. Except in South Africa and Zimbabwe for which market capitalization is 214.1 and 87.9 % respectively, average market capitalization is about 27 percent of GDP; it is as low as 1.4 percent in Uganda¹⁰. This contrast with emerging markets like Malaysia, which has a capitalization ratio of about 161 percent of GDP¹¹. Market liquidity is also very low: turnover ratios are as little as 0.02 percent in Swaziland compared with about 29 percent in Mexico¹². Low liquidity implies greater difficulty in supporting a local market with its own trading system, market analysis, and brokers, because of the low business volume. It also means less institutional investors. In most Sub-Saharan Africa (SSA) stock markets, informational and disclosure deficiencies prevent trading in most listed stocks. Further, supervision by regulatory authorities is often inadequate¹³. This is supposed to have a negative impact on investors' protection exacerbating the existing illiquidity.

However, Stock markets in SSA have contributed to financing for listed companies. Corporate financing patterns in Ghana, South Africa, and Zimbabwe suggest that stock markets are an important source of finance¹⁴. In Ghana, the stock market financed about 28 percent of total asset growth of listed companies between 1995–2002, in South Africa 16 percent between 1996–2000, and 8 percent in Zimbabwe between 1995–99. In all three countries, the stock markets were for these companies the single most important source of long-term finance¹⁵.

¹⁰ See Generally, IMF. (2006), "Regional economic outlook : Sub-Saharan Africa. World economic and financial surveys" (0258-7440). Washington, D.C., U.S.A., International Monetary Fund, Publication Services.

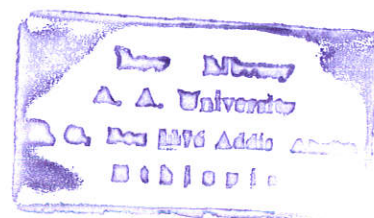
¹¹ Ibid.

¹² Ibid.

¹³ Ibid.

¹⁴ See Generally, Yartey, C. A. (2005a), "Stock Market Development, Corporate Finance and Economic Growth in Africa", Cambridge: University of Cambridge.

¹⁵ Ibid.



With regard to Ethiopia, although there were efforts by several institutions and individuals like the Addis Ababa Chamber of Commerce and Sectoral Association to introduce stock market in Ethiopia, they failed to procure permission of the government. It seems that the government has adopted a policy of following a bank based financial system and it is unconvinced to change it¹⁶.

A key characteristic of the Ethiopian banking sector is that the stock of bank credit to the private sector (including nonfinancial public enterprises) remains very low, when compared with the situation in other developing countries. The rate of company formation through initial public offer of shares and the separation between ownership and control in Ethiopian share companies is growing. The emerging corporate ownership structure is also a dispersed one. The main focus of this paper is, therefore, discussing the relevance of introducing stock market in light of the existing banking sector development in the country. Most importantly, the thesis discusses the role of introducing regulated stock markets in protecting investors in light of the growing dispersed company ownership structure and the existing institutional, regulatory, and legal framework in the primary offering market. In addition, the study discusses the factors that are identified as preconditions and determinants for stock market development along with review and analysis of the objective reality prevailing in Ethiopia with regard to these factors.

1.2 Statement of the Problem

Empirical evidence shows that the Ethiopian economy is growing and therefore requires more financial resources in order to maintain it. Huge capital is also required for the country's Growth and Transformation Plan (GTP), and the private sector is expected to play critical and leading role in the country's economic development plan¹⁷. A private firm in Ethiopia, like everywhere else, can finance investment either from funds generated by the business itself or from funds raised externally. However, most firms in Ethiopia have limited retained profit. These profits, let alone financing long-term riskier projects, may not be sufficient to finance the day-to-day working capital needs of the firms. New companies also have little in the way of retained

¹⁶ See FDRE Industrial Development Strategy, 2002/3, Pp.96-124.

¹⁷ See generally, Rucker, R. (2011), "A Market Potential Assessment And Road Map Development For The Establishment Of A Capital Market In Ethiopia". (Addis Ababas: Private Sector Development (PSD)Hub).

earnings. Bank loans are important source of capital throughout the world and this is supposed to be particularly suitable for developing economies, like Ethiopia, especially at the beginning stage of their development. However, the amount of external finance to be obtained through bank loan is very limited in Ethiopia for various reasons. The ratio of bank credit to the private sector is very low¹⁸. The majority of banks in Ethiopia rely almost exclusively on collateral-based lending and the amount of collateral banks request is the highest even by developing countries standards. It is also mostly limited to short term and limited by the amount of deposits banks are able to mobilize. The short term, limited nature, and the need for high collaterals are significant constraints for firms to obtain bank finance. Therefore, it is worth while to investigate whether introduction of regulated stock markets would help to overcome debt financing constraints that otherwise hinder firm expansion.

Currently banks, with the exception of the state-owned Commercial Bank of Ethiopia (CBE) and Development Bank of Ethiopia (DBE), are required to invest 27% of their annual net loan disbursements in five-year bonds at a 3% interest rate as per the new directive issued by the NBE¹⁹. The new directive, by compelling banks to invest in medium term bonds, would help to drain out the excess liquidity that has accumulated over the past years. The proceeds of the bond issues will also be used to finance national development projects. However, the new measure will reduce the funds available for the private sector loans. After the banks purchase government bonds equivalent to 27% of their annual net loan disbursements, the total amount of money available for the private sector borrowers stands at 48% of the total deposits of the banks because 25% of the total deposits of the banks will be dedicated to the legal and liquidity reserves. There is already a very high demand for greater access to credit in Ethiopia. Collateral requirement by banks are already very high; long-term loan is already very hard to find at Ethiopia's private banks, and this has already become a major challenge to the competitiveness of private firms. The new directive issued by the NBE would create a further excess demand for loans. As a result, banks would further be tempted to focus on short- term loan; they may also require even higher collateral. They may also require higher interest rates. The effects of all this will be making long-term loan even harder to find which in turn might hamper beneficial private sector investment

¹⁸ See Table 1 below.

¹⁹ Fortune, (2011), Volume 11, No. 571, APR.10.

So huge capital is needed both to maintain the current economic growth and for the country's Growth and Transformation Plan. The private sector is also expected to play critical and leading role in the country's economic development plan. Therefore, there must be a complementary source of capital for long term financing offered in addition or as a substitute to the loans from the commercial banks. The only option for firms is to look for another external finance: Equity financing.

In recent years, share companies have started selling shares to the wider public and thereby creating bigger shareholding base. The rate of company formation through initial public offer of shares (IPOs) is growing. According to Access Capital, 2010 research, in December 2010, 22 share companies targeted ETB 5.9 bn and an estimated number of 20 additional companies were looking for capital as well²⁰. This means that banks are increasingly being substituted by the general public as a source of funds by new share companies being established in a variety of sectors. While this has helped the companies to mobilize large amounts of capital from the public, it has also brought about the dispersion of corporate ownership among several thousands of shareholders in each of these companies²¹.

There is nothing wrong with this trend. In fact, equity financing is essential for the expansion of new firms whose main assets are the growth opportunities. However, this great opportunity brings with it a great challenge. High level of dispersed ownership means that corporate ownership (by shareholders) is separated from corporate control (by managers). The reason for this is that as the number of shareholders rises, control is delegated to managers and shareholders are limited to ineffective control via shareholder general meetings. But when ownership and control are widely separated, this will naturally lead to conflict of interests which is rooted in what is known as principal-agent problem. In a company where hired managers have different objectives than the diffused group of owners, then managers will have an incentive to use firm-specific rents to satisfy their own objectives, like providing a low level of effort or gaining personal

²⁰ See Generally, Access Capital (2010), "Banking Sector Review 2010", Addis Ababa, Ethiopia.

²¹ What is triggering the growth of dispersion of ownership is not clear. The rise of inflation might have made saving less attractive for the public driving investment towards the widely available publicly offered shares. See chapter three for full discussion.

control over corporate income and assets²². Such behavior obviously harms the performance and financial viability of the firm and illustrates the need for investors' protection. Therefore, it is important to describe the role of organized stock markets in protecting investors in light of the growing dispersed company ownership structure and the existing institutional, regulatory, and legal framework in the primary offering market. Description of the preconditions and determinants of stock market development as well as review and analysis of the objective reality prevailing in Ethiopia with regard to these factors is also important.

1.3 Objectives of the Study

General Objectives

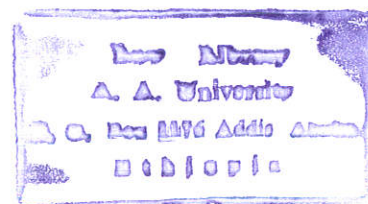
The general objective of this study is to discuss the role of introducing stock market in protecting investors in light of the growing dispersed company ownership structure and the existing institutional, regulatory, and legal framework in the primary offering market. It also aims at discussing the relevance of introducing stock market in light of the existing financial intermediation in the country. In addition to this, the study aims to undertake a comprehensive literature review with regard to the factors that are identified as preconditions and determinants for stock market development along with review and analysis of the objective reality prevailing in Ethiopia with regard to such factors. This will be done with the intention of identifying strengths and weaknesses and proposing specific and implementable recommendations for the development liquid stock markets in Ethiopia.

Specific Research Questions

The study aims to discuss the following specific research questions in light of recent empirical and theoretical studies. The specific research questions addressed by the thesis are:

1. How will the introduction of stock markets solve or minimize the '*agency costs*' that are supposed to exist in the publicly held share companies in Ethiopia as a result of the emerging separation of ownership from control and the dispersed company ownership structure?

²² Estrin, S. (2002), "Competition and Corporate Governance in Transition"(Journal of Economic Perspectives ,No. 16), p.111.



2. What is the relevance of introducing stock market in light of the existing institutional, regulatory, and legal framework for investors' protection in the primary offering market?
3. What is the relevance of introducing stock market in light of the existing banking sector development?
4. Assuming that the Government agrees to introduce a stock market, what are the necessary institutional, regulatory, and legal frameworks for stock market development and other determinants of stock market development?

1.4 Significance of the Study

This study presents and analyses relevant data, legislations and policies, and proposes specific and implementable recommendations for the development liquid stock markets in Ethiopia. This is important because of the limited investor and issuer base in Ethiopia. High degree of inefficiency characterizes the banking sector making it difficult for business to get the necessary finance or to start up or expand. Furthermore, because of the fact that the Government of Ethiopia is implementing a five years development program, the Growth and Transformation Plan- GTP, access to finance to the private sector would be very difficult as a result of increased demand for funding on the part of the government. This demonstrates the need for equity finance as a complementary source of capital for long term financing offered in addition or as a substitute to the loans from the commercial banks. But if equity financing is to complement debt financing, there is a need for investors' protection. As Ethiopian investors only have a small portion of their household income to invest, a fair priced – liquid – market is imperative in order to avoid creating systematic losses for the general public. Development of liquid stock markets in Ethiopia is also important for the development of the banking sector.

1.5 Research Method

This research has made use of both primary and secondary sources. Primary sources used include the commercial code, the bank proclamation, and other relevant legislations, policy, and programs of the Government of Ethiopia. Secondary sources include books, journals, reports, news papers and cyber sources.

1.6 Limitation of the Study

One of the basic research question which is considered by this study was how will the introduction of stock market solve or minimize the 'agency costs' that are supposed to exist in the publicly held share companies in Ethiopia as a result of the emerging separation of ownership and control and the diffused nature of share ownership. To answer this question, the method followed is to undertake a comprehensive literature review on the issue. The study does not attempt to unveil corporate governance malpractices that are likely to exist. Based on theoretical concepts, it assumes that such corporate governance malpractices are more likely to exist than not and proceeds to discuss the role of organized stock markets in protecting investors. So, the absence of standardized interviews with key stakeholders in order to ascertain the existence or otherwise of the assumed corporate governance malpractices can be taken as a limitation of the paper. In addition, some of the data on financial intermediation for the selected countries can be thought as old. These are the main limitations of the study.

1.7. Organization of the Study

The thesis discusses the relevance of introducing stock market in Ethiopia light of the existing banking sector development. Most importantly, it describes the role of introducing regulated stock market in Ethiopia in light of the existing institutional, regulatory, and legal framework for investors' protection in the primary offering market. It also describes the role of introducing regulated stock markets in solving or minimizing the 'agency costs' that are supposed to exist in the publicly held share companies in Ethiopia as a result of the emerging separation of ownership and control and the diffused nature of share ownership. In addition, the thesis describes the necessary institutional, regulatory, and legal frameworks for stock market development and other determinants of stock market development and then makes a review and analysis of the objective reality prevailing in Ethiopia with regard to such factors. Finally, the study proposes specific and implementable recommendations for the development liquid stock markets in Ethiopia.

To this end the paper is organized as follows. Chapter one of the thesis commences with discussion of the background of the paper, statement of the problem, objectives, significance, research methodology and organization of the study.

The second chapter makes review of relevant literature. It discusses the functions of a financial system focusing on the functions of regulated stock markets as part of a financial system.

Demirguc-Kunat and Levine also did some preliminary research on these issues which extended this analysis in three ways. First they expanded the set of stock market development indicators to include (1) the turnover ratio, which equals the value traded divided by market capitalization, (2) the ratio of value traded to GDP, (3) Lb2 measure of domestic asset pricing efficiency (the efficiency with which the market prices risk), and (4) the measure of integration into international stock markets. These additional stock market development indicators are intended to permit a more accurate characterization of the empirical ties between stock market and financial intermediary development.

The second way in which they improved the analysis of the relationship between stock market and financial intermediary development is to expand the set of indicators of financial intermediary development. Specifically, they used (1) the ratio of deposit money bank credit to GDP as an indicator of the size of banks in the economy, (2) the ratio of deposit money bank credit to bank credit plus central bank credit as an indicator of the importance of banks relative to the central bank, (3) the ratio of non-bank financial intermediary assets to GDP as a measure of the importance of financial intermediaries other than banks in the economy. This enlarged set of financial intermediary development indexes along with the augmented set of stock market development indicators was aimed to enhance their ability to document the linkages between stock markets and intermediaries as countries develop.

Finally, in addition to examining the cross-country relationships among the expanded set of stock market and intermediary indicators averaged over the 1978-1992 time period, they examined the relationship among these indicators over time while looking for particular policy changes in individual countries.

After constructing stock market development indicators, compiling stylized facts using these stock markets, and describing the operation of developing country stock markets, the authors find that the relationship between the development of stock markets and the functioning of financial intermediaries may be complementary⁷⁹.

Despite the difficulty of classifying financial systems into bank- and market centered, economists have engaged in a lively debate as to which one is superior, focusing on the hypothesis that bank

⁷⁹Ibid.

centered systems are particularly suitable for developing economies⁸⁰. In the 1980s, when the Japanese economy could do no wrong, bank-centered governance was widely regarded as superior because, as Aoki & Patrick⁸¹ and Porter⁸² argue, far-sighted banks enable firms to focus on long term investment decisions. According to Hoshi, Kashyap, & Scharfstein (1991), banks also deliver capital to firms facing liquidity shortfalls, thereby avoiding costly financial distress⁸³. Finally, banks replace the expensive and disruptive takeovers with more surgical bank intervention when the management of the borrowing firm underperformed⁸⁴.

In the 1990s, as the Japanese economy collapsed, the pendulum swung the other way. Kang & Stulz, 1998, Show that, far from being the promoters of rational investment, Japanese banks perpetrate soft budget constraints, over lending to declining firms that require radical reorganization⁸⁵. And according to Weinstein & Yafeh⁸⁶ (1998) and Morck & Nakamura⁸⁷, (1999), Japanese banks, instead of facilitating governance, collude with enterprise managers to

⁸⁰ One of the reasons given to support the claim that bank centered systems are particularly suitable for developing economies is the belief that stock markets might not perform efficiently in developing countries given the huge costs and the poor infrastructures. For instance, Mr. Singh, a Cambridge economist, in a 1999 paper, argued that setting up or expanding stock markets would be a "costly irrelevance" for developing countries[African countries] (Singh, 1999). Accordingly, he recommended that developing countries concentrate on improving their banking systems before further developing their stock exchanges [or setting up new ones] (Singh, 1999).

⁸¹ See generally, Aoki, M., & Patrick, H. (1993), "The Japanese Main Bank System: Its Relevance for Developing and Transforming Economies" (New York, Oxford University Press).

⁸² Porter, M. (1992), "Capital disadvantage: America's falling capital investment system" (Harvard Business Review, No. 70/ 5), p.72.

⁸³ Hoshi, T., Kashyap, A., & Scharfstein, D. (1991), "Corporate structure, liquidity, and investment:evidence from Japanese industrial groups" (Quarterly Journal of Economics ,No.106), 47.

⁸⁴ See generally, La Porta R. , Lopez-de-Silanes, Shleifer, & Vishny, supra note 75, pp.3-27.

⁸⁵ See generally, Kang, J., & Stulz, R. (1998), "Do banking shocks affect borrowing firm performance? An analysis of the Japanese experience" (Working Paper. Columbus, OH, Ohio State University).

⁸⁶See generally, Weinstein, D., & Yafeh, Y. (1998), "On the costs of a bank-centered financial system: evidence from the main bank relations in Japan" (Journal of Finance ,No. 53), pp.635-672.

⁸⁷ See generally, Morck, R., & Nakamura, M. (1999), "Banks and corporate control in Japan"(Journal of Finance , No.54), pp.319-340.

deter external threats to their control and to collect rents on bank loans. In the assessments by Edwards & Fischer (1994) and Hellwig (1999), German banks are likewise downgraded to ineffective providers of governance⁸⁸. Market-based systems, in contrast, rode the American stock market bubble of the 1990s into the stratosphere of wide support and adulation⁸⁹. Market-based systems are characterized by “strong securities markets, rigorous disclosure standards, and high market transparency, in which the market for corporate control constitutes the ultimate disciplinary mechanism” on management⁹⁰.

Recently, the dominant trends in substantive regulation even in the bank-centered systems favor increasingly stringent transparency and disclosure requirements to increase the liquidity of and confidence in securities markets⁹¹. In Germany and Japan, legal reforms allow or require the use of International Accounting Standards rather than the more opaque traditional accounting rules⁹². In France, Germany, and Japan regulatory agencies have been created or substantially reformed to police securities markets largely with respect to disclosure by corporate issuers of securities and the policing of insider trading⁹³.

2.1.2.2.3 Stock Market and Investors' Protection

The most commonly asserted function of stock markets is the protection of investors. However, what this ‘protection’ constitutes is never spelled out. There are different views in this regard. One such view is related to potential investors’ protection in order to help issuers sell securities to

⁸⁸ See generally, Edwards, J., & Fischer, K. (1994), “Banks, Finance and Investment in West Germany Since 1970” (Cambridge, UK, Cambridge University Press) and Hellwig, M. (1999), “On the economics and politics of corporate finance and corporate control” (working paper, Mannheim, University of Mannheim).

⁸⁹ La Porta R., Lopez-de-Silanes, Shleifer, & Vishny, *supra* note 75, p.10.

⁹⁰ John D. Coffee (2001), “The Rise of Dispersed Ownership: The Role of law and State in the Separation of Ownership and Control,” (The Yale Law Journal, 111 No. 1), p.3.

⁹¹ See generally, Cioffi, J. W. (December 2000), “Governing Globalization? The State, Law and Structural Change in Corporate Governance. Berkley Roundtable on International Economy (BRIE) (Journal of Law and Society, 27, (4)), pp. 572-600.

⁹² *Ibid.*

⁹³ *Ibid.*

the public. The public resists buying securities because of fears that any particular issue may be fraudulent. As a result, external financing mechanisms would tend to break down. Stock markets, by providing a mechanism for appraisal of the value of firms, allow investors to make informed decisions about the allocation of their funds thereby helping issuers to raise fund⁹⁴.

Securities purchasers (i.e. potential investors) rely in part on corporate information provided in financial reports to make their investment decisions. Availability of good information helps investors make informed decisions and provides better investor protection. Efficient stock markets (stock markets are efficient if prices incorporate all available information) by demanding regular disclosure of adequate, reliable and timely information help investors make better investment decisions.

Importance must also be attached to the means stock markets afford of readily transferring shares from hand to hand, an element which is vitally necessary to the creation of corporations. It is so certain that most people would be loath to give their money for even the highest grade securities, if they have no positive assurance that in case of necessity they could, at a moment's notice, and at a prevailing price obtain their value in cash by selling the same in a free market. But, when active secondary markets for securities exist, savers can be induced to provide the long-term funding that companies seek because savers are assured that the markets can provide them with liquidity⁹⁵. Thus, what is the equivalent of short-term investment for the security purchaser is transformed into long-term financing from the issuer's perspective. The more efficient matching of asset and liability maturities that result means less financial risk for companies and thus a more stable economic environment in general.

However, information risks also flow from the significant potential for incentive misalignment in the principal/agent relationship and another view of investors' protection is that stock markets protect investors by providing them with higher returns. Stock markets can enhance efficiency in the corporate sector by monitoring management and exerting corporate control. Shareholders cannot effectively verify the efficiency of the management and stock markets can monitor the

⁹⁴ See generally, Kitch, E. W. (1999), "Regulation of the Securities Market. (Encyclopodia of Law and Economics, USA, No. 3), pp.813-836.

⁹⁵ Huebner, *supra* note.24, p.501.

behavior of corporate managers and foster efficient use of company resources better than shareholders acting individually. Stock markets can also improve managerial efficiency by promoting competition through effective takeover or threat of takeover. This function of stock markets is discussed below in the context of the two types of corporate ownership structures.

2.1.2.2.3.1 Corporate Governance Mechanisms

There are two general types of corporate ownership structures: concentrated and dispersed. In concentrated ownership structures, ownership and/or control is concentrated in the hands of a small number of individuals, families, managers, directors, holding companies, banks and/or other non-financial corporations. Because these individuals or groups often manage, control or strongly influence the way that a company is run, they are called insiders. Hence, concentrated ownership structures are referred to as insider systems. Most countries, especially civil law countries, have concentrated ownership structures⁹⁶. The concentrated ownership structure is essentially characterized by the existence of controlling block holders in the company⁹⁷.

Dispersed ownership is the other type of ownership structure. In this scenario, a large number of owners each hold a small number of company shares. Small shareholders have little incentive to closely monitor a company's activities and tend not to be involved in management decisions or policies. Hence, they are called outsiders, and dispersed ownership structures are referred to as outsider systems. Common law countries such as the UK and the US tend to have dispersed ownership structures⁹⁸.

Each system, the concentrated and the dispersed, has advantages and disadvantages and thereby its own corporate governance challenges⁹⁹. These are briefly described below beginning with the concentrated ownership model.

⁹⁶ See generally, The Center for International Private Enterprise (CIPE), (March 2002), "Instituting Corporate Governance in Developing, Emerging and Transitional Economies", (A Hand Book).

⁹⁷ Ibid.

⁹⁸ Ibid.

⁹⁹ Ibid.



2.1.2.2.3.1.1 The Concentrated Ownership Model

Companies that are controlled by block holders enjoy certain advantages. Block holders have the power and the incentive to monitor management closely thereby minimizing the potential for mismanagement and fraud. Moreover, because of their significant ownership and control rights, block holders tend to keep their investment in a firm for long periods of time. As a result, block holders tend to support decisions that will enhance a firm's long-term performance as opposed to decisions designed to maximize short-term gains.

However, concentrated ownership systems predispose a company to certain corporate governance failures. One is that such systems cause sharking. Orts defines sharking as 'the misuse of authority and power by principals and quasi- principals within firms'¹⁰⁰. By way of illustration, he gives four general situation that may involve sharking within corporations :(1) conflicts between majority and minority share holders,(2) excess executive compensation, (3) financial reengineering of capital structure, and (4) down grading of creditors¹⁰¹.

Dominant shareholders pose threats on minority shareholders. A well-known problem in corporate law is the misuse of the authority of a controlling majority of shareholders to 'oppress' minority shareholders. The problem often arises in close corporation when controlling shareholders engage unfairly in a "freeze out" or "squeeze out" of a minority¹⁰². For example, block holders may transfer corporate assets by orchestrated transactions with related companies that skim profits from a publicly quoted firm in favor of privately owned ones¹⁰³. Many analysts also emphasize that if minority shareholders are not protected, then controlling owners or managers have incentives to strip assets from the firm—for example, by selling the assets of the enterprise to their own wholly owned subsidiary at a knocked-down price¹⁰⁴.

¹⁰⁰ See generally, Orts, E. W. (1998), "Shirking and Sharking: A Legal Theory of the Firm" (Yale Law and Policy Review, No. 16:265), pp.265-329.

¹⁰¹ Ibid.

¹⁰² Ibid.

¹⁰³ See Generally, Brian R. Cheffins (2002), "Corporate law and Ownership Structure: A Darwinian Link?" (University of New South Wales Law Journal, No.2).

¹⁰⁴ See generally, Estrin, supra note 21, pp.101-124.

It is also possible for block holders to extract benefits via high pay and bonuses for employed family members and associates, inappropriate related party transactions, (*excessive executive compensation*), systematic bias in business decisions and change in the capital structure, through special issuance of shares favoring the controller (*financial reengineering*)¹⁰⁵. In a study on shareholders and creditors rights in transition economies, Katharina Pistor concludes that ‘... The strong position of a block holder may, however, endanger the position of minority share holders’¹⁰⁶.

Even when no fraud is involved, the interest of block holders seems to be susceptible to conflict with minority interests. Block holders often prefer a strategy of long-term return on their investment which may easily come in square conflict with minority share holders who seek immediate return¹⁰⁷.

Large block holders that wield corporate power may not easily liquidate their holding negatively affecting liquidity. In addition, the few small holders cannot create enough liquidity, as the volume of stocks on the market will be low. On the end of the spectrum, small investor’s will not be ready to buy shares for fear of domination by block holders. This may discourage stock market development, which in turn discourages investment. For this reason, countries with this paradigm of corporate governance tend to have weak securities market, and low disclosure and market transparency standards; only a modest role is played by the market for corporate control, a greater part of the monitoring role being played by large banks¹⁰⁸.

In short, controlling block holders who wield their power irresponsibly waste resources and drain company productivity levels; they also foster investor reluctance and illiquid capital markets.

¹⁰⁵OECD, (2004), “Principles of Corporate Governance”, <http://www.oecd.org/dataoecd/32/18/31557724.pdf>

¹⁰⁶ Katharina Pistor (2000), “Patterns of Legal Change: Shareholder and Creditor Rights in Transition Economies” (European Bank Working Paper No.49), p. 21.

¹⁰⁷ See Generally, Raphael La-Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, and Robert W. Vishny (1998), “Law and Finance”, (Journal of Political Economy, No.6).

¹⁰⁸ Coffee, *supra* note 89, p. 25.

Shallow capital markets, in turn, deprive companies of capital and prevent investors from diversifying their risks.

2.1.2.2.3.1.2 The Dispersed Ownership Model

In contrast to the concentrated ownership model, owners in a dispersed ownership model rely on independent board members to monitor managerial behavior and keep it in check. Independent board members are expected to disclose information openly and equitably, assess managerial performance objectively, and to protect shareholders' rights vigorously. As a result, dispersed ownership systems are considered more accountable and less corrupt and tend to foster liquid capital markets¹⁰⁹. The existence of liquid market encourages investors to easily buy and sell securities. As a result, dispersed ownership model of corporate governance is characterized by strong stock markets, rigorous disclosure standards and high market transparency¹¹⁰.

Furthermore, separation of ownership and control often carries with it the benefit of hiring managers that are more qualified since executives are hired based on their managerial credentials than on their ability to finance the firm or their family connections with dominant share holders¹¹¹. The absence of block holders also creates a convenient working environment for professional managers since small, dispersed owners are unable to interfere with business of the management. Dispersed ownership of stocks has also the economic benefit of distribution of risks¹¹².

Despite these advantages, dispersed ownership structures have certain weaknesses.

Dispersed owners tend to be interested in short-term profit maximization. Hence, they tend to approve policies and strategies that will yield short-term gains, but that may not necessarily promote long-term company performance¹¹³. At times, this can lead to conflicts between

¹⁰⁹ Ibid.

¹¹⁰ Ibid.

¹¹¹ See generally, Brian R. Cheffins, *supra* note 103.

¹¹² Ibid.

¹¹³ Ibid.

directors and owners, and to frequent ownership changes because shareholders may divest in the hopes of reaping higher profits elsewhere both of which weaken company stability¹¹⁴.

The major disadvantage of this model corporate governance, however, is that it creates 'agency – cost', which arises because of what is known as 'principal-agent problem'. This, I will discuss below.

2.1.2.2.3.1.2.1 Principal-Agent Analysis

When human interaction is viewed through the lenses of the economists, it is presupposed that all individuals act in accordance with their self-interest. Moreover, individuals are assumed cognizant of the self- interest motivations of others and can form unbiased expectations about how these motivations will guide their behavior¹¹⁵. Conflicts of interest naturally arise. These conflicts are apparent when two individuals form an agency relationship: one individual (principal) engages other individual (agent) to perform some service on his behalf.

This relationship leads to the 'principal-agent problem', which is defined as the general problem of motivating one person, or organization to act on behalf of another¹¹⁶. The principal- agent problem arises because some decision-making authority is delegated to the agent who influences the welfare of the principal. The principal-agent theory provides a useful framework for analyzing situations in which there are numerous dispersed shareholders who hire professional managers to run the company.

In the modern corporation, the shareholders elect directors, who appoint managers. Directors are supposed to represent shareholders interests and to determine broad policies that managers will carry out. In order to conduct the complicated business of running a large firm, a full time professional management group must be given broad powers of decision¹¹⁷. Although managers' decisions can be reviewed from time to time, they cannot be supervised in detail¹¹⁸. This situation

¹¹⁴ See generally, CIPE, supra note 95.

¹¹⁵ Polutnik, L. (2005). "Manageraleconomics"(*The Black Weel Encyclopedia Of Management* , III , 2nd edition. (R. E. Mcauliffe, Ed.), Black Well Publishing, pp. 192-3.

¹¹⁶ Ibid.

¹¹⁷ See generally, G.Lipsey, R., Steiner, P. O., Purvis, D. D., & Courant, P. N. (1990), NewYork, GrandRapids,Philadelphia,Sanfransisco,London,Singapore,Sydney,Tokyo: Harper and Row.

¹¹⁸ Ibid.

raises a central issue in corporate governance: who will govern the corporation internally? There is no easy answer to this question but there are two views on this issue which I will discuss below.

The traditional, legal model of corporate governance: according to this view, shareholders hold the ultimate authority. In this view, shareholders exercise control through their legal rights to elect the board of directors. The directors in turn, hire top management, set overall strategy, and are responsible for making sure shareholders earn a fair return from well-managed operation¹¹⁹.

In spite of what the above view claim, many analysts of the modern corporation have long maintained that the traditional model is not a very realistic picture of how companies really work¹²⁰. *In this revisionist view*, several factors counteract the legal power of shareholders. The most important factor is the fact that, in a company with numerous shareholders who hire professional managers (agents) to run the company, shareholders are individuals who own very small number of shares and each of these dispersed smallholders will have little information and much less motivation to monitor management¹²¹. As a result, the later will take actions that are in their self- interest unless incentives are provided to do otherwise or unless they are constrained in some other manner. Accordingly, it is argued, a principal will expend resources in two ways to limit the agent's divergent behavior: (1) structure the contract to give the agent appropriate incentives to take actions that are consistent with the principal's interests, (2) monitor the agent's behavior over the contract's life¹²². Given that incomplete contracts occur frequently, due to bounded rationality, it is infeasible to structure a contract so that the interest of the principal and the agent are perfectly aligned¹²³. As a result, the principal incurs monitoring costs to observe the efforts of the agent or to create incentives for the agent to undertake actions that are more likely to assure efficient use of resources within the firm¹²⁴. Even so, there will be some divergence between the agent's actions and the principal's interests. Consequently, the firm's profit is less

¹¹⁹See generally, E.Post, J., T.Lawrence, A., & Weber, J. (2002), "Business and Society:Corporate Strategy,Public Policy,Ethics", McGraw-Hill.

¹²⁰ Ibid.

¹²¹ Ibid.

¹²² Polutnik, supra note 115, p.193.

¹²³ Ibid.

¹²⁴ Ibid.

than the profit-maximizing level and the reduction in the principal's welfare arising from this divergence is an additional cost of agency relationship which is referred to as 'the residual loss'¹²⁵

. In line with this, Jensen and Mecklin define agency costs as the sum of:

- 1) The monitoring expenditures by the principal,
- 2) The bonding expenditures by the agent, and
- 3) The residual loss¹²⁶.

2.1.2.2.3.1.2.2 Mechanisms for Mitigating Agency Costs

With the existence of costs derived from the agency conflicts discussed shortly above, it is necessary to establish control mechanisms so that the corporate governance process is instituted in a way to line up the interests of the involved parts and to minimize the *agency costs*. The control mechanisms can be classified in two categories: external and internal. Internal controls are arrangements within a corporation that aim to minimize risk by defining the relationships between managers, shareholders, boards of directors, and stakeholders. External controls are arrangements instituted by the market as a whole (external environment). In synthesis, the following control mechanisms are cited: *Internal mechanisms*: a) Property structure, b) Capital structure, c) Boards of directors, d) System of executives remuneration, e) Shared Monitoring, f) Multidivisional business structure; *External mechanisms*: a) Shareholders activity, b) Institutional investors activity, c) Pressures from competitive markets d) Legal and regulatory environment, e) Demanded accounting standards, f) Control by the stock market¹²⁷. An effective corporate governance system relies on a combination of internal and external controls¹²⁸.

In summary, the literature reviewed above suggests that Ethiopia should establish external control mechanisms for investors' protection. This includes appropriate legal and regulatory environment, demanded accounting standards, control by regulated stock markets. Given the emerging separation of ownership and control in publicly held share companies and the dispersed ownership pattern, the introduction of regulated stock markets seems to be of a paramount importance.

¹²⁵ Ibid.

¹²⁶ See generally, Jensen, M., & Meckling, W., supra note 34.

¹²⁷ See generally, Rogers, Ribeiro, & Securato, supra note 40.

¹²⁸ See generally, CIPE, supra note 96.

CHAPTER THREE

3.1 The Relevance of Introducing Regulated Stock Markets in Ethiopia to the Banking Sector Development

Financial System Development: Overview

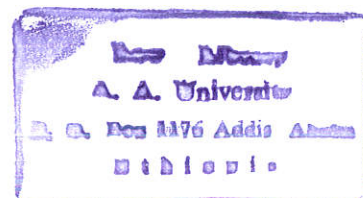
At the present, Ethiopia has 18 private banks (including the new 6 banks: Abay, Enat, Hawassa, Debub Global, Noah, Zam-Zam); 3 government owned banks; 10 insurance companies (including one government owned insurance company). There are also a number of banks and insurance companies in the pipeline to be set up. In addition to banks, there are more than 30 micro-finance institutions in the country.

Focusing on the banking sector, although Ethiopia's banking sector is growing, it is still underdeveloped. The ratio of bank credit to the private sector (including nonfinancial public enterprises) is very low. The degree of monetization is also low. Weak lending practices have plagued the banking industry in the past, and this issue is not substantially addressed even at the present. Long-term lending is still very hard to find at Ethiopia's banks. The majority of banks rely almost exclusively on collateral-based lending and the amount of collateral banks request is the highest even by developing countries standards. High incidence of non-performing loans is still a major challenge at least in the state owned banks.

Currently, Ethiopia does not have an organized stock market. Historically, there was a small share trading activity in Ethiopia, carried out by a Share Dealing Group. The 'State Bank of Ethiopia is said to have started the first institutional arrangement for share trading through the establishment of the "share exchange department" in May 1960, in order to encourage share trading¹²⁹. The share exchange department which is also known as share dealing group (SDU) was established not by any specific proclamation but by a set of rules and regulations laid out by the participating members of the group under the chairmanship of the NBE¹³⁰. The founding members of the then share dealing group were: (1) NBE itself, (2) the CBE, (3) the Ethiopian Investment Bank, (4) the

¹²⁹ NBE, (July, 1999), "Study Report on the Establishment of Stock exchange in Ethiopia".

¹³⁰ Ibid.



Addis Ababa Bank, (5) Saba Utility Share Company, and (6) Mr. Alfered Abel (an individual investor)¹³¹.

The share dealing group established by the NBE, served as a stock exchange. It had its own rules and regulations that consisted of 12 articles. A study made by the Addis Ababa Chamber of Commerce, shows that there were 22 share companies whose shares were quoted and listed by the SDU in the short lived stock market operating in Ethiopia in the emperial Era¹³².

The SDU was also involved in buying shares from existing active companies to issue their shares and offer them for sale to the public. 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. Later, the NBE, which succeeded the 'State Bank of Ethiopia' took over the activities and created a more integrated and organized market in cooperation with other financial institutions and few private company leaders in 1965. The practice of share registration, and transferring activities were further expanded and resulted in the establishment of a separate body, named 'Commercial Nominees P.L.C'

According to the study made by J.D. Von Pische (1968), former lecturer at Addis Ababa University, the business of stock market was moderately successful in its pioneering effort¹³³. It is to be noted that only 6000 shareholders had created a relatively functional stock market during Emperor Haile Selassie's reign¹³⁴.

The development of the stock market came to an end with the coming to power of the Derg regime in 1974 during which the Ethiopian financial system in general went through a system of

¹³¹ Ibid.

¹³² Addis Ababa Chamber of Commerce, (March, 1999), "Proposal for the formation of a share market in Ethiopia".

¹³³ See generally, Asrat, T. (1999), "Prospects and Challenges for Developing a Stock Market in Ethiopia: An Analytical Review" (R&D Management No.15), USA, Blackwell Publishing Ltd., pp50-64.

¹³⁴ Fekadu, P. G. (2010), "Emerging Separation of Ownership and Control in Ethiopian Share Companies: Legal and Policy Implication" (Mizan Law Review, No. 4), p. 24.

financial repression. When discussing the current stock market situation of Ethiopia, it becomes evident that there is an already functioning but unorganized market for stock exchange. A study made by Maxwell Stamp Plc¹³⁵, stated that as a result of the absence of regulated and organized secondary market, investors currently trade securities informally in a completely unregulated market with out access to information necessary to determine whether to buy, sell, or hold their securities¹³⁶.

This portion of the paper discusses the situation of the Ethiopian banking sector development in detail. More specifically, the following issues of banking sector development are discussed: bank credit expansion to the private sector, the utilization pattern of idle cash of the banks, the size of non-performing loans of banks, and high collateral-based lending practices of banks. These issues of the banking sector development are important because there is empirical evidence showing that countries with more developed stock markets have better financial intermediation on these dimensions than countries with no or less well developed stock markets. Therefore, the last part of this portion illustrates the relevance of introducing stock market in Ethiopia to enhance the country's banking sector, thereby the economic growth of the country, by drawing on the experience of the sampled countries with stock markets.

The countries for comparison are selected based on their relevance to the Ethiopian situation. Out of the 36¹³⁷ countries with stock markets, only 19 are low-income countries¹³⁸. Ethiopia is also a

¹³⁵ Maxwell Stamp Plc. Was a technical advisor of the project titled Technical Assistance for the Financial Sector Capacity Building Project- Capital Market Infrastructure Development. NBE was the executing agency of the Project. The project was supported by the World Bank.

¹³⁶ See generally, Sanders, (2009), "Legal, Regulatory, and Supervisory Framework Report. Financial Sector Capacity Building Project, Capital Market Infrastructure Development", (Maxwell Stamp Plc., Addis Ababa: National Bank of Ethiopia).

¹³⁷ Out of the 54 African countries, 23 have stock markets. Africa has also two regional stock exchanges: the Bourse Régionale des Valeurs Mobilières, or BRVM, located in Abidjan, Cote d'Ivoire; and the Bourse Régionale des Valeurs Mobilières d'Afrique Centrale, or BVMAC, located in Libreville, Gabon. The BRVM serves the countries of Benin, Burkina Faso, Guinea Bissau, Côte d'Ivoire, Mali, Niger, Senegal and Togo; the BVMAC serves the Central African Republic, Chad, Congo, Equatorial Guinea and Gabon. This means 36 countries have stock exchanges in effect

low-income country¹³⁹. This implies that Ethiopia shares similar economic features with these low-income countries and the financial intermediation pattern of these countries can be relevant to Ethiopia. The selection is also based on availability of information. Numerical data on financial intermediation for some of these [for 13 countries out of the 19] countries is available from IMF, International Financial Statistic database. UNDP's African Stock Markets Hand Book and World Bank, World Development Indicators, 2004, provide information on stock market development for eight (8) countries based on standard models of stock market development indicators. These countries are:

1. Cote d'Ivoire
2. Ghana
3. Kenya
4. Malawi
5. Tanzania
6. Uganda
7. Zambia, and
8. Zimbabwe

The eight countries above, as can be seen, are selected using convenience sampling technique based on availability of relevant information and their relevance for Ethiopia. Investigation of financial intermediation pattern in these countries is likely to expose their basic characteristics and the real similarities and differences between them. In addition to these countries, South Africa has been selected purposefully based on theoretical sampling, for the insights it generate. South Africa has the leading stock exchange in Africa. Therefore, inclusion of South Africa is supposed to offer explanations and indentify causes for the basic characteristics and the real similarities and differences among the other countries in terms of financial intermediation patterns. It will also help to conform or contrast the insights from both economic theory and empirical research on the issues at hand thereby making them more definitive and useful for Ethiopia.

¹³⁸ The World Bank Doing Business project 2011 stratifies almost all African countries based on income into three categories: high, middle, and low-income countries.

¹³⁹ World Bank Doing Business project, 2011.

3.1.1 Bank Credit Expansion to the Private Sector

Scholars usually utilize three financial intermediation variables when discussing financial intermediation development. The first indicator is liquid liabilities, which is defined as M3 (currency plus demand and interest-bearing liabilities of banks and non-bank financial institutions) as a percentage of GDP¹⁴⁰. According to Levine et al., this is a typical measure of 'financial depth' and thus of the overall size of the financial sector. The second indicator, commercial-central bank, is defined as commercial bank assets as a share of commercial bank plus central bank assets. This measure captures how the economy's savings are allocated to commercial banks¹⁴¹. The third indicator is private credit, defined as credit extended to the private sector as a ratio to GDP¹⁴². Levine et.al., emphasize the key importance of private credit¹⁴³.

A key characteristic of the Ethiopian financial sector is that the stock of bank credit to the private sector (including nonfinancial public enterprises) remains very low, when compared with the situation in other developing countries. This reflects low financial intermediation.

As noted above, there is empirical evidence showing that countries with more developed stock markets have banking sectors that issue more credit to the private sector as a share of GDP than countries with less well developed stock markets. Based on the fact that Ethiopia does not have an organized stock market, one expects Ethiopian financial intermediation to be low. This is in fact borne out by the amount of credit issued to the private sector in 2003. According to the IMF, International Financial Statistics, the credit issued to the private sector in Ethiopia, in 2003, was 24.3 percent of GDP. Table 1 below shows comparative financial indicators for selected ten (10) African countries including Ethiopia.

¹⁴⁰ See generally, Levine, R., Loayza, N., & Beck, T. (2000), "Financial intermediation and growth: Causality and Causes" (*Journal of Monetary Economics*, No.46), 31-77.

¹⁴¹ Ibid.

¹⁴² Ibid.

¹⁴³ Ibid.

Table 1: Comparative Financial Indicators for Selected SSA Countries, 2003

Countries	Bank Credit to private and NFPEs to GDP	M2 to GDP	Bank Credit to Private and NFPE to Deposits	Bank Credit to Gov. to Bank Deposits	Bank Liquidity Ratio
Cote d'Ivoire (2001)	14.8	29.3	98.4	24.2	27.6
Ghana	14.7	30.4	72.0	45.8	24.8
Kenya	20.3	40.3	59.1	36.7	16.7
Malawi	5.9	20.8	36.1	39.2	20.0
Tanzania	7.6	22.3	44.5	17.5	49.7
Uganda	7.6	19.0	51.5	47.3	33.5
Zambia	6.8	17.8	38.4	47.3	50.7
Zimbabwe (2001)	19.8	21.9	...	...	24.8
Ethiopia	24.3	59.1	52.4	41.8	47.0
South Africa	82.7	62.6	139.4	10.8	23.0

Source: IMF, International Financial Statistics, 2003.

3.1.1.1 Traditional Indicators of Stock Market Development of Selected Sub-Saharan African Countries

Previous research in the area of stock market development and financial intermediation has produced empirical evidence showing that countries with more developed stock markets have financial systems that issue more credit to the private sector as a share of GDP than countries with less well-developed stock markets. In Ethiopia, private sector credit by banks as a ratio of GDP is low. There is no organized stock market in Ethiopia. I have the view that financial intermediation (i.e. private sector credit) in Ethiopia is constrained by the absence of well-developed stock markets. To find out, one possible way is to investigate financial intermediation patterns of countries where there are already established stock markets to determine whether existence of stock markets in those countries has enhanced their financial intermediation. Since the level of development of stock markets is also relevant for financial intermediation, it should be assessed using standard models of stock market development indicators. Hence, it is important to investigate the financial intermediation patterns of countries where there are already established stock markets and to assess the level of development of the stock markets in each of these countries using standard models of stock market development indicators. The investigation and assessment of financial intermediation patterns and stock market development level in countries that are more or less in a similar stage of development to that of Ethiopia can give some indication about the relevance of introducing stock market in Ethiopia in enhancing its financial intermediation. Put, in other words, it will help us to answer questions like: why does Ethiopia has low private sector credit as a share of GDP; can development of stock markets help to improve private sector credit.

The most common traditional indicators used to characterize the extent of development of emerging stock markets are the number of listed companies, total market capitalization divided by GDP, total value traded divided by GDP, and the turnover ratio. While useful, each of these measures has shortcoming. Various literature on stock market development state that the size of the stock market is measured by the ratio of market capitalization (total value of listed shares) divided by GDP¹⁴⁴. The main argument for the assumption underlying the use of this variable as

¹⁴⁴ See generally, Levine & Zervos, *supra* no.4.

an indicator of stock market development is that the size of the stock market is positively correlated with the ability to mobilize capital and diversify risk¹⁴⁵. On the other hand there are two measures of stock market liquidity: total value of trades relative to GDP and total value of trades relative to stock market capitalization. The ratio of total value of trades to GDP measures the value of equity transactions relative to the size of the economy. Levine & Zervos argue that the ratio of total value of trades to GDP complements the measure of stock market size because a stock market may be large but inactive¹⁴⁶. The second measure of liquidity which is called the turnover ratio is equal to the ratio of total value of trade divided by market capitalization also complements the stock market size as well as total value of equity transactions relative to GDP, because market may be small compared to the whole economy but liquid¹⁴⁷. A perhaps better indicator of stock market liquidity is the turnover ratio¹⁴⁸.

In addition to the traditional indicators, institutional aspects such as the underlying legal and accounting rules and regulations can also indicate how developed a stock market is. Developed stock markets generally have prudential supervisory bodies, information disclosure rules, internationally accepted accounting standards, low transaction costs, and short settlement times¹⁴⁹. Disclosure and accounting standards indicators capture transparency and the quality of information, whereas investor protection and securities commission variables capture the existence of regulation and supervision¹⁵⁰.

It is also very important to see the correlations between the traditional indicators and the institutional indicators of stock market development. La Porta et al. found that countries with lower quality of legal rules and law enforcement [i.e. the institutional indicators] have smaller and narrower capital markets [i.e. the traditional indicators] and that the listed firms on their stock markets are characterized by more concentrated ownership. This implies that the institutional indicators of stock market development are critical for investors' protection.

¹⁴⁵ Ibid.

¹⁴⁶ Ibid.

¹⁴⁷ Ibid.

¹⁴⁸ Ibid.

¹⁴⁹ See generally, La Porta, *supra* note 77.

¹⁵⁰ Ibid.



From the above table it appears that the ratio of bank credit to private and NFPEs to GDP, which was 24.3 % in 2003, is comparable to the sampled eight countries. For Cote d'Ivoire, Ghana, Kenya, and Zimbabwe the ratio is in the range of 15 to 20 percent, but Malawi, Tanzania, Uganda, and Zambia have a ratio below 10 percent. These countries also record an M2 to GDP ratio in the lower range for the group. The only notable exception is South Africa which has a ratio of 82.7 percent. Better financial intermediation (higher ratio of bank credit to the private sector) in South Africa may be explained by the fact that the country has a well developed stock market. Key statistics on African stock markets is presented in Table 2 below.

Table 2: Indicators of Stock Market Development in Africa, 2004

Country	Number of Listed Companies	Turnover Ratio (in %)	Market Capitalization/GDP	Value Traded/GDP (in %)
Cote d'Ivoire	39	2.5	13.6	0.3
Ghana	29	3.2	30.7	0.8
Kenya	47	8.0	24.9	2.1
Malawi	8	11.1	9	1.0
Tanzania	6	2.5	6.2	0.2
Uganda	5	0.2	1.4	0.0
Zambia	11	1.1	8.0	0.1
Zimbabwe	79	3.9	87.9	14.0
South Africa	403	45.0	214.1	76.5
<i>Average Africa</i>	<i>113.6</i>	<i>8.0</i>	<i>36.9</i>	<i>7.2</i>
Average SSA(excluding south Africa)	39.2	4.4	22.1	1.8

Source: World Bank, World Development Indicators, 2004.

South Africa, with the most developed stock market had 403 listed companies with a market capitalization that constituted 214.1% of GDP. Zimbabwe with 79 listed companies had a market capitalization that is 87.9 % of GDP. The remaining stock markets are relatively small. Kenya, with 47 listed companies had a market capitalization that is 24.9% of GDP. Ghana, also with only 29 listed companies had a market capitalization that is 30.7% of GDP. Zambia, Tanzania, Uganda, and Malawi had even fewer listings and market capitalizations that are insignificant relative to GDP (see table2). It is interesting to note that those countries also had a ratio of bank

credit to private sector below 10 percent. This implies a positive relationship between stock market development and financial intermediation which is consistent with the theoretical and empirical literatures discussed in the literature review part.

When it comes to Ethiopia, while one expects financial intermediation to be lower (because it doesn't have a stock market at all) than in the eight countries (because they have stock markets even their level of development is very low), this is not borne out by the financial intermediation indicator noted in Table 1. That is, in 2003, credit issued to the private sector in Ethiopia was 24.3 percent of GDP which is slightly higher than these countries except South Africa. However, a closer inspection shows that this does not necessarily mean intermediation is so stronger in Ethiopia on this dimension.

When analyzing the ratio of bank credit to the private sector, a key determinant is often the government deficit, and the amount of financing that the government is seeking from the banking system. Government deficits that have to be financed by domestic resources provide an opportunity for the banking system for a relative safe investment of their deposit base, thereby raising the lending rates, and decreasing the amount of resources channeled to private sector credit¹⁵¹. An important issue is the extent to which the pressure of government domestic financing requirement has led to crowding out of the credit to the private sector¹⁵². Regression analysis reported in Christensen (2004), covering 27 SSA countries over the period 1980-2000, regressing private sector lending on domestic government securitized debt, found evidence of some crowding out: an expansion of domestic debt of 1 percent relative to broad money is associated on average with a decline of the ratio of private sector lending to broad money of 0.15 percent¹⁵³. However, another study by Sacerdoti, (2005) indicates that the relationship between domestic debt and bank credit to the private sector is not very close¹⁵⁴. Yet, a closer analysis by the same researcher indicated that there were few countries in Sub-Saharan Africa in which the

¹⁵¹ See generally, Sacerdoti, E. (2005), "Access to Bank Credit in Sub-Saharan Africa: Key Issues and Reform Strategies". (IMF Working Paper, WP/05/166 . International Monetary Fund).

¹⁵² Ibid.

¹⁵³ See generally, Christensen, J. (2004), "Domestic Debt Markets in Sub-Saharan Africa" (IMF Working Paper 04/46 . Washington: International Monetary Fund).

¹⁵⁴ Sacerdoti, E., supra note 151.

pressure of the government domestic financing requirement has contributed to a decline in the ratio of private sector credit to M2¹⁵⁵. Among these are Ghana, Uganda, Malawi, Kenya, and Zambia.

According to the study, in Ghana lending to the government at end-2003 represented more than half of the total domestic assets of the banking system(see also Table 1 above), reflecting the large fiscal deficits in the past, and the high reserve requirements that oblige banks to hold at least 35 percent of their deposit liabilities in government securities. In the 2000-03 periods the pressure on banks to finance the government has not declined, but a shift is apparent in 2004. In Malawi and Uganda the move of the commercial banks toward allocating a large part of their deposit base to government financing is instead a recent phenomenon; in the former the ratio rose from 16.8 percent at end-2000 to 39 percent at end- 2003, and in the latter from 35.2 percent at end-2000 to 47.3 at end-2003(See Table 1 above for 2003). In Kenya this ratio has also increased significantly in 2000-03 (from 29.5 percent to 36.7 percent), as the fiscal deficit doubled to 2.3 percent of GDP over this period. A similar increase has occurred in Zambia (from 16.8 percent at end-2000 to 47.3 percent at end-2003), also associated to a rising fiscal deficit.

In all other SSA countries (except Gambia) the relatively low ratio of bank private sector credit to GDP is not attributable to the government's need for domestic financing, but reflects the high liquidity ratio maintained by the banks, whose propensity to lend remains weak . In Ethiopia, the study states, the rising ratio between 2000 and 2003 of bank credit to government to deposits has not been a cause of crowding out, but rather is the consequence of the high liquidity of the banks, which have been offered an outlet for investment by the government in the form of government securities. Table 4 summarizes the reserve and liquidity position of Ethiopian banks.

Furthermore while Ethiopia's ratio of bank private sector credit to GDP is slightly higher than the eight countries, the ratio of loans to deposit is lower than Cote d'Ivoire, Ghana, Kenya, and Zimbabwe and equivalent with Tanzania, Uganda, Zambia and Malawi (seeTable1). The important point I would like to make here is that credit issued to the private sector in Ethiopia which was 24.3 percent of GDP in 2003 does not necessarily imply stronger financial intermediation in Ethiopia on this dimension. Rather this may be attributable to the relatively low

¹⁵⁵ Ibid.

GDP of the country. Note also that Ethiopia's gross domestic saving rate in 2003 was only 7.5 percent, and 3.6 percent in 2005 the lowest even in East Africa. See Table 3 below.

Table 3: Comparative Domestic Saving Rate (in percent of GDP), 2003

Cote d'Ivoire	Ghana	Kenya	Malawi	South Africa	Tanzania	Uganda	Zambia	Zimbabwe	Ethiopia	Sub-Saharan Africa
20.5	10.9	6.2	-11.7	18.2	12.0	6.3	12.9	-21.1	7.5	20.8

Source: IMF *World Economic And Financial Surveys*, Regional Economic Outlook : Sub-Saharan Africa, 2006.

Finally, another explanation for why the countries at issue do not have much larger debt-to-GDP ratios than Ethiopia relates to high interest rate spreads. There is a wide concern that bank spreads are too high in Africa. Analysis conducted in a number of FSSA reports indicate that the causes of the spreads in most SSA banking system are the relatively large share of NPLs, high operating costs, difficulties in obtaining and using collateral, and the absence of efficient judicial procedures to facilitate loan recovery¹⁵⁶ (Sacerdoti, 2005). Countries in which spreads are particularly high are Zambia, (35.8 percent in 2002), Ghana (20.5 in 2002), and Uganda (19.5 percent in 2003).

¹⁵⁶ Ibid.

Table 4: Interest Rate Spreads at the Sampled African Countries

Country	Spread between reference lending and deposit rates
Cote d'Ivoire	N.A. ¹⁵⁷
Ghana(2002)	20.5
Kenya(2004)	14.9
Malawi	N.A
South Africa	N.A
Tanzania (2002)	11.9
Uganda (2003)	19.5
Zambia(2002)	35.8
Zimbabwe	N.A

Sources: FSSA Reports

Although high cost of loans was a problem in many of the sampled countries as the table above shows, this certainly was not the case in the Ethiopian banking sector. Table 5 shows the pricing power of Ethiopian Banks (measured by Interest Rate Spreads) for the years 2003-06.

Table 5: Interest Rate Spreads at Ethiopian Banks, 2003-2006

	Interest rate spread		Lending rate		Deposit rate	
	State-owned	private	State-owned	private	State-owned	Private
2003	5%	6.5%	8%	9.4%	3%	3%
2004	5%	6.4%	8%	9.4%	3%	3%
2005	5%	6%	8%	9%	3%	3%
2006	5%	6%	8%	9%	3%	3%

Source: Reproduced from *Kiyota (2007)* which gives sources as Annual Report of Individual Banks

From the above figures it seems clear that interest rate spreads at Ethiopian banks was a very borrower-friendly in comparison with the sampled countries. The important point I want to make

¹⁵⁷ N.A = not available

Particularly, the following concepts are discussed in this chapter. (1) Stock Market Development and Economic Growth; (2) Stock Market and Financial Intermediary Development; (3) Stock Market and Investors' Protection. In this chapter, I also discuss, the two general types of corporate ownership structures: concentrated and dispersed; principal-agent problem; and the mechanisms for mitigating agency costs.

Chapter three is the most important part of the thesis. It has 4 parts. The first part discusses the relevance of introducing stock market in Ethiopia light of the existing banking sector development. To that end, it investigated financial intermediation patterns of countries where there are already established stock markets and assessed the level of development of the stock markets in each of these countries using standard models of stock market development indicators. The second part described the role of introducing regulated stock market in Ethiopia in light of the existing institutional, regulatory, and legal framework for investors' protection in the primary offering market and the role of introducing regulated stock markets in solving or minimizing the 'agency costs' that are supposed to exist in the publicly held share companies in Ethiopia as a result of the emerging separation of ownership and control and the diffused nature of share ownership. The third part described the necessary institutional, regulatory, and legal frameworks for stock market development and made a review and analysis of the objective reality prevailing in Ethiopia with regard to such factors. Lastly, the fourth part described other determinants of stock market development and then made a review and analysis of the objective reality prevailing in Ethiopia with regard to such factors.

Finally, chapter four proposes specific and implementable recommendations for the development liquid stock markets in Ethiopia.

CHAPTER TWO

LITERATURE REVIEW

2.1 The Financial System and Real Economic Activity.

2.1.1 Functions of the Financial System

Broadly speaking, a country's financial system includes all institutions involved in moving savings from households and firms whose income exceeds their expenditures and transferring it to other households and firms who would like to spend more than their income allows²³. Varieties of institutions take funds from the public and lend them to borrowers or otherwise invest the funds.

The financial system interacts with real economic activity through its various functions by which it facilitates economic exchange. It plays an important role in mobilizing funds and transforming them into assets that can better meet the needs of investors. By facilitating portfolio diversification, financial intermediaries allow savers to maximize returns to their assets and to reduce risk²⁴. Financial intermediaries transfer resources across time and space, thus allowing investors and consumers to borrow against future income and meet current needs²⁵. This enables deficit units (those whose current expenditures exceed current income) to overcome financing constraints and the difficulties arising from mismatches between income and expenditure flows. Financial institutions play an important role in easing the tension between savers' preference for liquidity and entrepreneurs' need for long-term finance²⁶. Therefore, at any given level of saving, an efficient financial system will allow for a higher level of investment by maximizing the proportion of saving that actually finances investment²⁷. With an efficient financial system,

²³ Stiglitz, & Boadway. (1997), "Principles of Macro-Economics and the Canadian Economy", New York, W.W Norton & Company, Inc, p.347.

²⁴ See generally, Huebner, S. (1910), "Scope and Functions of Stock Markets"(The Annals of the American Academy of Sciences ,No. 3), pp. 483-505.

²⁵ See generally, Pango, M. (1993), "Financial Markets And Growth"(European Economic Review, No. 37,) pp.613-622.

²⁶ Huebner, supra note 24, p.494.

²⁷ Pango, supra note 25, p.637.

resources will also be utilized more efficiently due to the ability of financial intermediaries to identify the most productive investment opportunities²⁸.

Financial systems play an important role in creating a pricing information mechanism. By providing a mechanism for appraisal of the value of firms, financial systems allow investors to make informed decisions about the allocation of their funds²⁹. Financial intermediaries can also mitigate information asymmetries that characterize market exchange. One party to a transaction often has valuable information that the other party does not have. In such circumstances, there may be unexploited exchange opportunities. In the case of a firm, information imperfections can result in sub-optimal investment. When a manager cannot fully and credibly reveal information about a worthy investment project to outside investors and lenders, the firm may not be able to raise the outside funds necessary to undertake such a project³⁰. In a market plagued by information imperfections, the equilibrium quantity and quality of investment will fall short of the economy's potential. Financial intermediaries can mitigate such problems by collecting information about prospective borrowers³¹.

The financial system can enhance efficiency in the corporate sector by monitoring management and exerting corporate control³². Savers cannot effectively verify the quality of investment projects or the efficiency of the management. Financial intermediaries can monitor the behavior of corporate managers and foster efficient use of borrowed funds better than savers acting individually. Financial intermediaries thus fulfill the function of "delegated monitoring" by

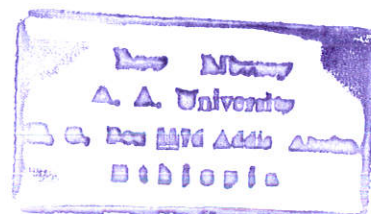
²⁸ Levine & Zervos, *supra* note 3, p.567.

²⁹ Moloney, *supra* note, p.292.

³⁰ See generally, Myers, S., & Majluf, N. (1984), "Corporate Financing and Investment Decisions When Firms Have Information That investors Do Not Have" (*Journal of Financial Economics*, No.13.), pp.187-221.

³¹ *Ibid.*

³² See generally, Stiglitz, J. (1985), "Credit Markets and the Control of Capital" (*Journal of Money, Credit and Banking*, 17), 133-152.



representing the interests of savers³³. Financial markets can also improve managerial efficiency by promoting competition through effective takeover or threat of takeover³⁴.

2.1.2 Financial Markets

Financial market is defined as a 'market for the exchange of capital and debt instruments'³⁵. Financial markets are consisted of both capital and money market. A capital market is a securities market in which stocks and bonds with long term maturities are traded. A money market is a financial market for dealing in short- term negotiable instruments such as commercial paper, certificates of deposit, banker's acceptances, and Government Treasury Securities³⁶.

2.1.2.1 Classification of Financial Markets

Financial markets can be classified into categories on the basis of the type of the financial claim. The markets in which debt instruments are traded are called debt market. And the markets in which common and/or preferred stocks are traded are called stock markets.

It is also possible to classify financial markets based on the time of maturity of the claims. Financial securities which mature greater than one year are considered as a part of the capital market which is defined as a market in which money is provided for periods longer than a year, as the raising of short-term funds takes place on the money market. The capital market includes the bond market for debt instruments and the stock market for equity securities.

A third way to classify financial markets is by whether the financial claims are newly issued or not. A distinction is made in the case of both the equity and debt capital markets between the primary market and the secondary market. A primary market is a market for financial claims that are newly issued. In this market the original investor and an intermediary are involved. The issuance of shares in the primary market should go through certain legal requirements. For

³³ Diamond, D. (1984), "Financial Intermediation and Deligate Monitoring" (Review of Economic Studies, 51), p.399.

³⁴ See generally, Jensen, M., & Meckling, W. (1976), "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownersdhip Structure"(Journal of financial Economics, 3), pp.305-360.

³⁵ Black's Law Dictionary (2004), (B. A. Garner, Ed.) USA: Thomson West.

³⁶ Ibid.

example, in the USA, the issuance of shares and other securities in the primary market is regulated by the securities act of 1933³⁷. Primary market provides opportunity to issuers of securities; government as well as companies, to raise resources to meet their requirements of investment and/or discharge some obligation. Secondary market refers to a market where securities are traded after being initially offered to the public in the primary market and/or listed on a Stock Exchange. Secondary market comprises of equity markets and the debt markets. In this market outstanding equity\ securities change hands and funds flow from the buyer to the seller.

The stock (secondary) market has further two components, namely the over-the-counter (OTC) market and the exchange-traded market. OTC markets are essentially informal markets where trades are negotiated. OTC markets operate on an ad hoc basis with no regulatory infrastructure. The 'market' is simply a collection of individual transactions relating to similar securities. There may be established market customs and practices but there is no organized market. On the other hand, an organized market operates under a set of standard rules relating to admission to trading, the process of trading and the settlement of transactions³⁸.

2.1.2.2 Function of Stock Markets

There are a growing number of literatures that define the functions of stock market in an economy³⁹. Review of the literature indicates that well functioning stock markets have the following specific functions:

- 1 Enhance savings mobilization;
- 2 Help in resource allocation;
- 3 Promote efficient financial system;
- 4 Help improve capital structure;
- 5 Allow de-concentration of ownership;
- 6 Improve accounting and auditing standards;

³⁷ Miller, & Jentz (2008), "Business Law Today"(8 ed.). USA: Thomson West, p.853.

³⁸ Macneil, I. G. (2005), "An Introduction to the Law On Financial Investment", Portland, Oregon, USA: Hart Publishing, p.374.

³⁹ See, for example, Jefferis, 1995; Levine & Zervos, 1996a; Samuel, 1996; Stiglitz J. , 1998; Arestis, Panicoso, & Lunitel, 2001.

- 7 Help privatization efforts and private sector development;
- 8 Help in improving corporate governance;
- 9 Provide effective tools for monetary and fiscal policy.

2.1.2.2.1 Stock Market Development and Economic Growth

History shows that there exists a direct relation between financial development and economic growth⁴⁰. As part of the financial system, the stock market is expected to accelerate economic growth by providing a boost to domestic savings and increasing the quantity and the quality of investment⁴¹. The stock market is expected to encourage savings by providing individuals with an additional financial instrument that may better meet their risk preferences and liquidity needs. Better savings mobilization may increase the savings rate⁴². Stock markets also provide an avenue for growing companies to raise capital at lower cost⁴³. Stock markets therefore are able to positively influence economic growth through encouraging savings amongst individuals and providing avenues for firm financing.

The stock market is supposed to ensure through the takeover mechanism that past investments are also most efficiently used⁴⁴. Theoretically, the threat of takeover is expected to provide management with an incentive to maximize firm value. The presumption is that, if management does not maximize firm value, another economic agent may take control of the firm, replace management and reap the gains from the more efficient firm⁴⁵. Thus, a free market in corporate control, by providing financial discipline, is expected to provide the best guarantee of efficiency

⁴⁰ See generally, Casagrande Neto, Cintra Neto and Magliano Filho, cited in Rogers, Ribeiro, & Securato (2008), "Corporate Governance, Stock Market and Economic Growth in Brazil (*Journal of Corporate Governance*, No. 6), pp. 222-237.

⁴¹ Singh, *supra* no.2, p.780.

⁴² Levine & Zervos, *supra* no.4, p.541.

⁴³ Ibid.

⁴⁴ Kumar, *supra* note 8, p.239.

⁴⁵ Ibid.

in the use of assets⁴⁶. Similarly, the ability to effect changes in the management of listed companies is expected to ensure that managerial resources are used efficiently⁴⁷.

Efficient stock markets may also reduce the costs of information. They may do so through the generation and dissemination of firm specific information that efficient stock prices reveal. Stock markets are efficient if prices incorporate all available information. Reducing the costs of acquiring information is expected to facilitate and improve the acquisition of information about investment opportunities and thereby improves resource allocation. Stock prices determined in exchanges and other publicly available information may help investor make better investment decisions and thereby ensure better allocation of funds among corporations and as a result a higher rate of economic growth.

Stock market liquidity is expected to reduce the downside risk and costs of investing in projects that do not pay off for a long time⁴⁸. With a liquid market, the initial investors do not lose access to their savings for the duration of the investment project because they can easily, quickly, and cheaply, sell their stake in the company⁴⁹. Thus, more liquid stock markets could ease investment in long term, potentially more profitable projects, thereby improving the allocation of capital and enhancing prospects for long-term growth.

The theories discussed above suggest a strong relation between stock market development and economic growth. In fact, currently it is generally accepted that a developed financial system provides positive impacts to the economy, in terms of productivity, capital accumulation, increase of savings and investments and economic growth⁵⁰. Furthermore, there exists considerable empirical evidence that corroborates such strong relation ship.

Levine & Zervos, who analyzed 41 stock markets in the period of 1976-1993 in 24 different countries, had found strong correlations between development of the stock market and economic

⁴⁶ Ibid.

⁴⁷ Ibid.

⁴⁸ Bencivenga & Smith, *supra* note 9, p.201.

⁴⁹ Ibid.

⁵⁰ Andrezo and Lima, cited in Rogers, Ribeiro, & Securato, *supra* note 40, p.227.

growth⁵¹. In another study, by the same authors, enclosing the financial and stock markets of 49 countries, in the period of 1976-1993, an investigation had been made if some measures of the stock market and the banks development predict future economic growth rates, capital accumulation, improvements in the productivity and increase of savings. The authors had discovered that the stock market liquidity, measured by the value of the shares traded relative to the size of the stock market and of the economy, is positively and significantly correlated with the current and future rates of economic growth, capital accumulation and increase of productivity⁵². The size of the stock market, volatility, and its integration with international stock markets had not been significantly related with the growth⁵³. The authors had still discovered that the banking development jointly with the liquidity of the stock market predicts future growth rates, capital accumulation and improvement of the productivity. With these results, they had concluded that the markets and the financial institutions supply important services for the long term economic growth⁵⁴.

From the theoretical and empirical literature reviewed above, it is possible to conclude that there is a strong association between stock market development and economic growth. However, there is no consensus if the financial development occurs from the economic growth or if it is the opposite. Some scholars argued that financial development leads economic growth⁵⁵. Yet, others argued that financial development passively follows economic growth by responding to the increasing demand for funds due to economic prosperity⁵⁶. While the debate on causality is still unsettled, existing historical and econometric evidence suggests that better functioning financial markets, i.e., markets that are able to meet the needs of savers and investors efficiently, have a positive effect on future economic growth⁵⁷.

⁵¹ Levine & Zervos, *supra* note 3, p.542.

⁵² *Ibid.*

⁵³ *Ibid.*

⁵⁴ *Ibid.*

⁵⁵ See generally, Schumpeter, J. A. (1934), "The Theory of Economic Development" Cambridge, Harvard University Press.

⁵⁶ Robinson, J. (1952), "The Role of Interest and Other Essays" London, Macmillan.

⁵⁷ Levine, *supra* note 1, p.721.

The economic history literature has documented cross-country and country specific evidence that illustrates the importance of financial systems in early industrial development. Using data from 1790 to 1850, Rousseau and Wachtel found quantitative evidence that supports the hypothesis that early industrial growth in the United States was finance-led⁵⁸. These authors conclude that by providing debt and equity finance to the corporate and government sectors, the financial system was critical to the modernization process, which it predated⁵⁹. Using data on the United States, United Kingdom, Canada, Norway and Sweden, Rousseau & Wachtel, 1998 conclude that financial intermediation was an important factor in the industrial transformation of these countries⁶⁰. Other studies include Corosso⁶¹ who documented the role of early US investment banking in mobilizing savings to raise capital; Cameron, Crisp, Patrick, & Tilly⁶² who examined European countries, Russia and Japan; and Haber⁶³, who compared the cases of Brazil, Mexico and the United States. These studies provide evidence that supports the proposition that better functioning financial systems play an important role in economic growth.

Several studies have also provided econometric evidence that supports the view that financial development is a potent predictor of future economic growth⁶⁴. The results in these studies have made significant progress in establishing that to some extent, the causal relationship runs from financial development to economic growth.

⁵⁸ Rousseau, P. & Wachtel, P. (1998), "Financial intermediation and economic performance: Historical evidence from five industrialized countries,"(*Journal of Money,Credit and Banking*, ,No. 30(4)), pp. 657-678.

⁵⁹ Ibid.

⁶⁰ Ibid.

⁶¹ Corosso, V. (1970), "Investment Banking in America", Cambridge,: Harvard University Press.

⁶² Cameron, R., Crisp, O., Patrick, H., & Tilly, R. (1967), "Banking in the Early Stages of Industrialization. A Study in Comparative Economic History" New York, Oxford University Press.

⁶³ See generally, Haber, S. (1991), "Industrial concentration and the capital markets: A comparative study of Brazil, Mexico, and the United States, 1830-1930" (*Journal of Economic History*, No.51), pp.559-580.

⁶⁴ See for instance, King, Levine, & Ross, 1993a; King & Levine, 1993b; Levine, 2000; Levine, Loayza, & Beck, 2000; Beck, Levine, & Loayza, 1999.

The findings from studies based on aggregate data have been supported by studies that use disaggregated data on the industry and firm level. Using a large sample of industries from many countries, Rajan & Zingales, found evidence indicating that financial development mitigates financing constraints for industries that rely most heavily on external finance⁶⁵. These authors find that such industries grow faster in countries with more developed financial systems⁶⁶. Demirgüç-Kunt & Maksimovic⁶⁷, and Beck & Levin⁶⁸, provide further international firm-level evidence on the positive effects of access to a well-functioning financial system on firm growth. These studies have generalized the results from the literature on the effects of financing constraints on investment initiated by Fazzari, Hubbard, & Petersen, 1988 who used data from the manufacturing sector of the United States⁶⁹. Several studies have shown that the results on the links between financing constraints and investment by manufacturing firms hold also for developing countries⁷⁰.

It is important to reiterate that while the above large amount of historical and econometric evidence suggests that financial development facilitates economic growth, this does not rule out the possibility of a causal relationship in the reverse direction. It is perfectly possible that financial systems develop in response to higher economic growth or in anticipation of future prosperity. These two causal processes are not mutually exclusive and may very well be a natural feature of the links between finance and economic growth. In line with this Andrezo and Lima argued as follows:

⁶⁵ See generally, Rajan, R., & Zingales, L. (1998), "Financial dependence and growth" (American Economic Review, No. 88), pp. 559-586.

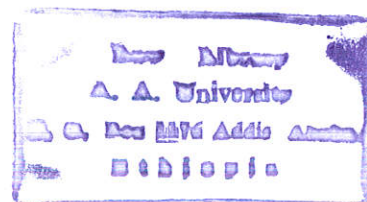
⁶⁶ Ibid.

⁶⁷ See generally, Demirgüç-Kunt, A., & Maksimovic, V. (1996) "Stock Market Development and Financing Choices of Firms" (World Bank Economic Review, No.10/2), pp.341-369.

⁶⁸ Beck, T., & Levine, R. (2000), "New firm formation and industry growth: Does having a market-based or bank-based system matter?" (University of Minnesota, Carlson School of Management, Working Paper 0004).

⁶⁹ Ibid.

⁷⁰ See, for example, the study by Bigsten, et al., 1999 on manufacturing firms in Cameroon, Ghana, Kenya, and Zimbabwe; Athey & Laumas, 1994 on Indian firms; Tybout, 1983 on Colombian firms.



An industry can, initially, receive financings on the basis of supply leading and, after developing itself, move to the phase of demand following. However, another industry can continue in the phase of supply leading. Thus, the two phenomena occur simultaneously in the economy, therefore each sector has its timing, depending more on the governmental policies or on the private demand⁷¹.

2.1.2.2.2 Stock Market and Financial Intermediary Development

The natural place to look in the finance literature for a link between stock market and financial intermediary development is in the literature on corporate capital structures. Corporate finance literature studies the determinants of the optimal debt-equity ratio. Almost by definition, therefore, it views debt and equity financing as substitutes. Thus, this literature yields the straightforward and intuitively appealing prediction that stock market development - where stock market development implies a lower cost of equity financing - would cause the optimal debt-equity ratio to fall. According to this literature, when a company's investment plans require external finance, a choice has to be made between equity and debt financing. Equity financing refers to financing through the issue of share capital, the most common form being ordinary share capital. Debt financing refers to financing through loans under which a company enters into a debtor/creditor relationship with a lender.

As a result, Traditional comparisons classify financial systems into bank and market centered based on the institutions financing firms. Bank centered financial systems⁷², such as those of Germany and Japan, are compared to market-centered systems⁷³, such as those of the United States and the United Kingdom⁷⁴. Relatedly, relationship- based corporate governance, in which a

⁷¹ Andrezo and Lima, cited in Rogers, Ribeiro, & Securato, *supra* note 40, p234.

⁷² A bank centered financial system may be defined as a system based on debt finance and control by banks in the dual role of shareholders and major creditors with a characteristic feature of concentration of ownership. Katharina, *supra* note 105.

⁷³ On the other hand, a market-centered system is defined as a system based on equity finance and control primarily by stock markets with a characteristic feature of diffused ownership. Katharina, *supra* note 105.

⁷⁴ See generally, Allen, F. & Gale, D. (2000), "Comparing Financial Systems", MIT Press, Cambridge, MA.

main bank provides a significant share of finance and governance to each firm is contrasted with market-based governance, in which finance is provided by large numbers of investors and in which takeovers play a key governance role⁷⁵.

Unfortunately, the classification of financial systems into bank and market centered is neither straightforward nor particularly fruitful. There may be some countervailing complementarities between stock market development and debt financing⁷⁶. Empirical evidence shows that, on average, countries with bigger stock markets also have higher ratios of private debt to gross domestic product (GDP), contrary to the view that debt and equity finance are substitutes for each other⁷⁷.

An informative working paper by Pardy and Dong-He, 1992 presents preliminary evidence along these lines. Using data on 32 developing countries over the 1984-1990 period, they summarize the relationship between one measure of stock market development - the ratio of market capitalization to GDP - with three measures of financial intermediary development - the ratio of M1 to GDP, the ratio of M2 minus M1 to GDP, and the ratio of credit to the private sector to GDP. The results are consistent with three propositions (1) countries with more developed stock markets also have more "financial depth" as defined by the ratio of M2 minus M1 to GDP or the ratio of M1 to GDP; (2) countries with more developed stock markets have financial systems that issue more credit to the private sector as a share of GDP than countries with less well developed stock markets; and (3) richer developing countries - as defined by GDP per capita - have more developed stock markets - as defined by the market capitalization to GDP ratio - than poorer countries⁷⁸.

⁷⁵ La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. (2000), "Investor protection and corporate governance" (Journal of Financial Economics, No58), p.3.

⁷⁶ See generally, Seward, J. K. (1990), "Corporate financial policy and the theory of financial intermediaries" (Journal of Finance, No 45), pp.351-77.

⁷⁷ See generally, La Porta, R., Lopez-de-Silanes, F., Shleifer, A., & Vishny, R. (1997), "Legal Determinants of External Finance" (Journal of Finance No.52), pp.1131-1150.

⁷⁸ See generally, Pardy, R., & Dong-He. (1992), "Financial deepening and the development of the stock market in developing countries: Summary of some correlation patterns" (mimeo, The World Bank).

here is that high interest rate spreads generated by the banks in many of the sampled countries might have reduced demand for credit and generated excess liquidity in those countries. Hence, taking these factors into consideration, financial intermediation is weaker in Ethiopia than even in those eight countries with less developed stock markets.

3.1.1 2 Barriers to Financial Intermediation

In the discussion above, it has been demonstrated that the stock of bank credit to the private sector is low when compared with the situation in the sampled countries. This is still a problem today.¹⁵⁸ On the other hand, there is very high demand for greater access to credit in Ethiopia.¹⁵⁹ Given such a very low private sector credit and the high demand for greater access to credit, now it is appropriate to ask: what is it that deters Ethiopian banks to extend more credit to borrowers?

¹⁵⁸ Access capital Banking Sector Review 2010 indicated that 'long-term lending (i.e. loans with maturities of five years or longer) is still very hard to find at Ethiopia's private banks. From data available in banks annual reports on the loan maturity of their loans, we estimate that more than 60 percent of loans are short-term at most private banks.... The availability of long-term lending remains a challenge....'

¹⁵⁹ A research conducted by the E-CLIR indicated that 'there is very high demand [unmet] for greater access to credit in Ethiopia. Business respondents unanimously noted the need for expanded access to affordable credit. In Dire Dawa, several micro-enterprises complained of their inability to expand operations because they could not obtain the relatively low-value loans needed to purchase productive assets. One respondent, an international investor considering Ethiopia, advised his consortium to eliminate Ethiopia because of the lack of local financing, among other reasons. Whether micro or corporate, lending is constrained and limited. A significant number of potential investors must therefore rely on self financing or simply forgo investing altogether.

Data collected from the Central Statistics Authority (CSA) also shows that out of the 533 establishments covered by a survey, 125 (23.5%) of them cited high collateral requirement by banks as the main reason for not solving their working capital problem.

The second world Bank Investment Climate Assessment survey report released on August 24, 2009 also indicated that "60 percent of the managers of the 600 respondent firms said finance is one of the major problems [challenging the competitiveness of private firms]." Source: Reporter, 24 Aug, 2009 Edition.

It is widely recognized that for bank intermediation to deepen it is necessary that financial information on borrowers is of good quality and controllable¹⁶⁰. To that end, Fund and Bank advice has centered on a number of recommendations directed at fostering an improved credit culture. One such important recommendation is ensuring more accurate information on the financial status of borrowers, through improved quality of annual accounts and financial statements, professional development of accounting personnel, updating of property and company registries, establishment of credit bureaus, and possible introduction of rating systems. The idea here is that banks rely on information intermediaries to make lending decisions. In line with this Capiro & Demirguc-Kunt, (1998), argued that lenders will be unwilling to enter into long-term contracts if the accounting and auditing infrastructures are not adequate or information systems and contract enforcement mechanisms are absent. Strengthening accounting and auditing is a key requirement for widening access to banks by companies¹⁶¹.

When it comes to Ethiopia, the country lacks any properly legislated regulatory standards governing the presentation of financial statements and the auditing of such statements. As a result, the credibility of financial information is diminished by the variability of its quality¹⁶². This includes financial statements provided to banks for providing finance to the private sector. Because of the fact that financial information prepared by companies in Ethiopia is not credible, banks do not rely on audited financial statements in granting loans¹⁶³. The low level of development of the accounting and audit practice in Ethiopia has also been confirmed by a review report by the World Bank. This review report states that there is no requirement for compliance with Accounting and Auditing Standards in any of the country's laws and regulations including for specific sector entities¹⁶⁴. This report further states that there are no enforcement

¹⁶⁰ Sacerdoti, *supra* note 151.

¹⁶¹ See generally, Capiro, G. J., & Demirguc-Kunt, A. (1998), "The Role of Long Term Finance: Theory and Evidence" (The World Bank Research Observer, No.13,), pp.171-89.

¹⁶² See generally, Martin, R. (June 2005), "Ethiopian Accounting and Auditing Standards Development Road Map" (A Report to Ministry of Trade and Industry).

¹⁶³ *Ibid.*

¹⁶⁴ See generally, World Bank. (November 2007), "Reports on Observance of Standards and Codes-Ethiopia".

mechanisms of financial reporting in the country because of lack of capacity in the regulatory institutions and the absence of penalties in the regulations¹⁶⁵. Unlike Ethiopia, review of the regulatory framework for stock markets indicated that in all the countries studied, reasonable regulations have been put in place to achieve the key objective of increasing the quality of financial information.

3.1.1.3 Institutional and Infrastructural Indicators of Stock Market

Development of Selected Sub-Sahara African Countries

Table 2 above has presented the most common indicators used to characterize the extent of development of stock markets. In addition to the traditional indicators, institutional aspects such as the underlying legal and accounting rules and regulations can also indicate how developed a stock market is. Developed stock markets generally have prudential supervisory bodies, information disclosure rules, internationally accepted accounting standards, low transaction costs, and short settlement times. These institutional indicators are needed to augment the traditional indicators to provide a more complete description of the extent of stock market development. The following tables (Table 6-14) present some of these institutional indicators for the sampled countries which are available from the African Stock Markets Handbook, published by the United Nations Development Program (UNDP) on the occasion of the 2003 African Capital Markets Forum.

Kenya Stock Exchange Profile

Officially established in 1954, Nairobi Stock Exchange (NSE) in Kenya is one of the oldest stock markets in Africa. Having evolved from a voluntary association, recognition from the London Stock Exchange as an overseas stock exchange was central for its credibility. Uncertainty of the post-independence years, economic slump after the oil crisis and a 35% capital gains tax severely hampered the performance of the stock exchange. However, the NSE benefited from structural reforms in the 1980s and early 1990s as well as from internal capacity building. A major push, however, was the privatization of former state-owned enterprises that did not only increase the market value, but also improved public awareness about such investment

¹⁶⁵ Ibid.

instruments. This trend was supported by the removal of restrictions on foreign investments and the licensing of venture capital funds, dealing firms and other collective investment vehicles¹⁶⁶.

NSE required the existence of Audit Committee but does not require the existence of Nominating Committee; Particulars of board members like qualifications and experience; contracts between company and directors or shareholder¹⁶⁷. Table 6 below summarizes the institutional and Infrastructural Indicators of Stock Market Development Kenya.

Table 6: Institutional and Infrastructural Indicators of Stock Market Development Kenya (Nairobi Stock Exchange -NSE)

Market Regulator	Capital Markets Authority
Governing Law	Capital Markets Authority Act
Clearing & Settlement	Manual, transaction by transaction
Central Depository	None
Reporting Requirement	Half year unaudited and full year audited accounts.
Accounting/Auditing Standard	International Accounting and Auditing Standards.

Ghana Stock Exchange Profile

Ghana Stock Exchange (GSE) began trading in 1990. Between 1990 and 1996, a number of state-owned companies were prepared for listing. Ghanaian investors, however, have a high-yielding and safe investment opportunity in government treasury bills with up to 45% interest. Yet in the subsequent years, many of the listed companies have outperformed the treasury bills. After a difficult beginning, the demand for stocks has risen to an extent that surpasses the limited stock available, creating surplus demand. Government incentives to encourage going public include three lists with different listing requirements to further local access to the stock exchange and a

¹⁶⁶ Bohnstedt, A., Hannig, A., & Odendall, R. P. (2000), "Capital Market Development In Uganda -Private Sector Opinions On Listing"(Financial Systems Development (FSD) Project 2000 (FSD Series No. 2). Kampala, Uganda: Bank of Uganda – German Technical Co-operation.

¹⁶⁷ Mensah, S. (2003), "Corporate Governance In Africa: The Role Of Capital Market Regulation"(Presented at the 2nd Pan African Consultative Forum on Corporate Governance, Nairobi).

reduction of corporate tax from 45% to 32%. While privatization has furthered trading on the GSE, local firms were reluctant to go public¹⁶⁸.

GSE required the existence of Audit Committee be confirmed at listing but does not require the existence of Nominating Committee; outside directors; Particulars of board member (qualifications and experience); contracts with related parties; whether company is in compliance with governance guidelines of regulatory authority; does not exact penalty if issuer failed to disclose information that results in loss to investors or failed to publish financial statements¹⁶⁹.

Table 7 below summarizes the institutional and Infrastructural Indicators of Stock Market Development of Ghana.

Table 7: Institutional and Infrastructural Indicators of Stock Market Development of Ghana

Market Regulator	Securities Exchange Commission
Governing Law	Stock Exchange Act (1971)
Clearing & Settlement	Manual, transaction by transaction
Central Depository	None
Reporting Requirement	Half year unaudited and full year audited accounts.
Accounting/Auditing Standard	Not specified in Listing Rules.
Brief History	The Ghana Stock Exchange (GSE) was incorporated in July 1989 and was officially recognized as an authorized stock exchange under the Stock Exchange Act in October 1990. Trading on the GSE commenced on 12 November 1990. A council comprising representative of stakeholders from the capital market governs the GSE. The Council acts as the Board of Directors with all powers and functions of a Board under the Companies Code.

¹⁶⁸ Bohnstedt et al, supra note 165.

¹⁶⁹ Mensah, supra note 166.

Zambia Stock Exchange Profile

The World Bank, the International Finance Corporation and UNDP as well as the Zambian government contributed to the establishment and the first two years' operating costs of the Lusaka Stock Exchange (LuSE). Joint efforts were made to set up a modern infrastructure to meet general international investment standards with, for example, a central depository system. LuSE has a tiered market with official listings that need to fulfill the listing requirements in the first tier, and quoted companies in the second tier. The latter comprises public companies not yet admitted to the official list, and will allow smaller and medium companies to raise capital. LuSE has been able to attract the listing of private sector companies, including international banks, through the incentive of lower corporation tax for listed companies. A major push for LuSE was expected from planned privatization. Yet an attempted coup in 1997 and the ensuing unstable political situation as well as a balance of payment crisis had a far-reaching impact on the economy in general¹⁷⁰. Table 8 below summarizes the institutional and Infrastructural Indicators of Stock Market Development of Zambia.

Table 8: Institutional and Infrastructural Indicators of Stock Market Development of Zambia

Market Regulator	The Securities and Exchange Commission (SEC)
Governing Law	The Securities Act (1993)
Clearing & Settlement	Automated
Central Depository	Central Shares Depository (CSD)
Reporting Requirement	Half year and full audited annual accounts
Accounting/Auditing Standard	
Brief History	The Lusaka Stock Exchange (LuSE) is the only exchange in Zambia. The Securities Act was passed on 17 December 1993 and the LuSE commenced business on 21 February 1994.

¹⁷⁰ Bohnstedt et al, supra note 165.

Uganda Stock Exchange Profile

The Uganda Securities Exchange (USE) Ltd. is owned by the licensed brokerage firms in the country and licensed by the CMA to operate as an approved stock exchange and perform self-regulatory functions in its operations and to its members. Up until 2000, an open outcry trading system was used, with trades being registered on a board. Efforts were under way to acquire the infrastructure for electronic trading at the USE. A Central Depository System (CDS) has been installed with Bank of Uganda. The USE Rules and Regulations, approved by the CMA and published in May 1997, provide a professionally set-up basis for allowing trade in a fair and efficient securities market, as do the stipulations contained in the USE Listing Rules Manual. The "basic conditions to be fulfilled by an applicant for listing", e.g. the amount of minimum capital required, the time a company must have published or filed its accounts, the request that the accounts must have been drawn up and audited in accordance with standards regarded as "appropriate for companies of international standing and repute," the evaluation of profit forecasts or the minimum number of shareholders etc., fully complied with international usage. Low confidence in the financial sector, concern about dilution of ownership, exchange rate fluctuation, the financial disclosure requirements were cited as hindrance for listing. Government's preference to look for strategic investors for privatizing some state owned enterprises contributed to the low level of tradable stock in the Exchange¹⁷¹.

Although the Exchange was initially used to float shares upon privatization of government owned enterprises, the number of companies listed in the Exchange through initial public offering is very limited. By 2008, the Exchange (USE) has 9 listed companies including 3 cross-listed companies.

As of 2007, The Exchange had 7 licensed stockbrokers, dealers and investment advisors and one licensed member to engage in investment advisory services only. Currently the Exchange uses a manual trading structure with open outcry system. There are three main securities traded in the Exchange: ordinary shares, corporate bonds and government bonds.

Using stock market development indicators discussed above, the Uganda Stock exchange size (Market Capitalization divided by Gross Domestic Product) was about 28.7 % of GDP in

¹⁷¹ Ibid.

2007. The liquidity of the Exchange as measured by the turnover ratio has grown from 0.2 (20004) to 0.4 in 2008. But, The USE is still illiquid. Both the Exchange and the Authority are still urging the government to reform of the pension sector, stimulate supply of securities through fiscal incentives, develop market intermediaries in order to improve liquidity of the market, issue municipal bonds, tax incentives, promote contributions to saving/insurance/retirement schemes, energize the contractual saving industry, and provide resources to the capital market. They are also engaged in massive public awareness campaign and are still insisting on increased public education on instruments of savings and investment promotion¹⁷². Table 9 below summarizes the institutional and Infrastructural Indicators of Stock Market Development of Uganda.

Table 9: Institutional and Infrastructural Indicators of Stock Market Development of Uganda

Market Regulator	Capital Markets Authority (CMA)
Governing Law	None
Clearing & Settlement	Transaction by transaction
Central Depository	None
Reporting Requirement	Half year and full audited annual accounts
Accounting/Auditing Standard	International Accounting and Auditing Standards.
Brief History	The Uganda Securities Exchange (USE) was licensed to operate as an approved Stock Exchange in June 1997 by the Capital Markets Authority (CMA). The USE became operational in January 1998 with the listing of the East African Development Bank 4 year bond.

Tanzania Stock Exchange Profile

Dar-es-Salaam Stock Exchange (DSE) was incorporated as a private limited company in September 1996 in accordance with the Tanzania Companies Ordinance without having a share

¹⁷² Uganda Securities Exchange, 'Annual Report, 2008'.

capital. The exchange is not set up for profit. It was only created to facilitate the government economic reform agenda with a future objective of wider share ownership and raise medium and long-term capital. After two years of preparatory work, the DSE commenced its activities on the 15th of April 1998.

Currently DSE has 6 licensed stockbrokers and about 11-licensed investment advisors. Some of the stockbrokers are also included in the list of investment advisors. Trading at DSE is conducted through an Automated Trading System which is currently operating on a local area network. This electronics system matches bids and offers. Matched orders are displayed on the computer terminals in the trading room and projected in the public gallery.

In addition to the annual listing fee of 0.05 percent of the market capitalization of the listed securities and the holding of annual shareholder meetings, listed companies are required to submit semi-annual financial reports to the DES and also to notify the DSE and the public of any previously undisclosed price sensitive information. There are also on-going corporate governance reports regarding the progress attained in complying with the Governance Guidelines¹⁷³.

The Capital Markets and Securities Authority (The Securities Authority) was established under the Capital Markets and Securities Act, 1994 (The Securities Act) as an autonomous body "for the purpose of promoting and facilitating the development of an orderly, fair and efficient capital market and security authority in Tanzania". The Securities Authority is the regulatory and supervisory body for the capital markets. It licenses and regulates investment intermediaries and investment professionals, monitors and regulates exchanges and supervises the issuance of and trade in securities. The Securities Authority has since promulgated a number of rules and regulations including those covering guidelines for the issuance of corporate bonds and commercial paper and disclosure guidelines for cross-listing.

In 2002 the Securities Authority enacted the Guidelines on Corporate Governance Practices by Public Listed Companies in Tanzania (the Governance Guidelines) "with the ultimate objective of realizing shareholders long-term value while taking into account the interest of other stakeholders". At the core of the Governance Guidelines is an effort to promote a high standard

¹⁷³ www.worldfinance.com.

of self-regulation within public listed companies in Tanzania and achieving an international standard of governance. The provisions highlight practices relating to the board of directors, audit committees, supply and disclosure of information, shareholder participation, etc. Emphasis extends beyond descriptions of accountability within respective roles to principles of operation aimed at fostering efficient communication both within the company and between the company and the Securities Authority¹⁷⁴.

Using the traditional stock market development indicators, the Dar- es- Salaam Stock Exchange size was about 24 % of GDP in 2008 (It was 6.2% of GDP in 2004). The liquidity of the Exchange as measured by the turnover ratio was 0.1 in 2008 (it was 2.5 in 2004). The number of listed companies has grown from 6 (2004) to 14 (2008)¹⁷⁵. Table 10 below summarizes the institutional and Infrastructural Indicators of Stock Market Development of Tanzania.

Table 10: Institutional and Infrastructural Indicators of Stock Market Development of Tanzania

Market Regulator	Capital Markets and Securities Authority (The Securities Authority).
Governing Law	Capital Markets and Securities Act (1994) Amended 1997
Clearing & Settlement	Electronic, transaction-by-transaction
Central Depository	Electronic
Reporting Requirement	Half year and full audited annual accounts
Accounting/Auditing Standard	International Accounting and Auditing Standards.
Brief History	Although the Exchange was incorporated in 1996, it only began its first day of trading in April 1998, when the first company TOL Ltd was listed. Foreign investors are restricted from participating in the secondary market. Thus, the DSE is not open to foreign investors.

¹⁷⁴ Ibid.

¹⁷⁵ Securities Africa Limited, (2009), African Stock Market Statistics 2008. Johannesburg.

Malawi Stock Exchange Profile

The Malawi Stock Exchange was inaugurated in March 1995 and opened for business for the first time on 11 November 1996, under the aegis of the Reserve Bank of Malawi, with 2300 Malawian citizens buying shares in the first company to be listed, Malawi's largest insurance firm, the National Insurance Company. International Finance Corporation, a World Bank affiliate, and the Financierings Maatschappij Ontwikkelingslanden, a Dutch development bank with close ties to the Dutch Ministry for Development Co-operation, provided 40% of the \$500,000 required for establishing the stock market in Blantyre, and the European Union sponsored seminars and publicity campaigns. The Exchange has a modest market listing. More stringent listing rules are currently being prepared. Membership of the Exchange is corporate and individual. It has a supervisory committee, which comprises representatives of the central bank, the Government and the private sector¹⁷⁶. Table 11 below summarizes the institutional and Infrastructural Indicators of Stock Market Development of Malawi.

Table 11: Institutional and Infrastructural Indicators of Stock Market Development of Malawi

Market Regulator	The Stock Exchange Committee
Governing Law	Capital Market Development Act
Clearing & Settlement	Transaction by transaction
Central Depository	None
Reporting Requirement	Half year and full audited annual accounts
Accounting/Auditing Standard	International Accounting and Auditing Standards.

Cote d'Ivoire Stock Exchange Profile

The BRVM is the regional stock exchange in French speaking West Africa (Benin, Burkina Faso, Côte d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo). It was created in 1998 to replace the old Ivorian Bourse des Valeurs d'Abidjan. Table 12 below summarizes the institutional and Infrastructural Indicators of Stock Market Development of Cote d'Ivoire.

¹⁷⁶ UNDP. (2003), "African Stock Markets Hand Book" (United Nations Development Program).

Table 12: Institutional and Infrastructural Indicators of Stock Market Development of Cote d'Ivoire

Market Regulator	Conseil Régional de l'Epargne Publique et des Marchés Financiers (CREPMF)
Governing Law	N.A
Clearing & Settlement	N.A
Central Depository	None ¹⁷⁷
Reporting Requirement	Half year unaudited and full year audited accounts.
Accounting/Auditing Standard	

Zimbabwe Stock Exchange Profile

Zimbabwe's first stock exchange opened in 1896 in Bulawayo. It operated for six years. When it closed, efforts were made to reactivate the stock exchange but without success. The present Zimbabwe Stock Exchange was founded in 1946 in Bulawayo. In December 1951, a second floor was opened in Harare. In January 1974, the Zimbabwe Stock Exchange Act was promulgated as Act 27 of 1973 (chapter 198) which formalized the establishment of the present Zimbabwe Stock Exchange (ZSE) with its head office in Harare. Thus, the ZSE, as it exists now dates from 18 January 1974. A revised ZSE Act was published in 1996 as Chapter 24:18. Table 13 below summarizes the institutional and Infrastructural Indicators of Stock Market Development of Zimbabwe.

¹⁷⁷BRVM now has electronic system

Table 13: Institutional and Infrastructural Indicators of Stock Market Development Zimbabwe

Market Regulator	ZSE Committee
Governing Law	Zimbabwe Stock Exchange Act (1973)
Clearing & Settlement	Transaction by transaction
Central Depository	None
Reporting Requirement	Half year and full audited annual accounts
Accounting/Auditing Standard	International Accounting and Auditing Standards.

South Africa Stock Exchange Profile

The JSE Securities Exchange (JSE) was founded in November 1887. Following the closure of the open outcry trading floor on 7 June 1996, an order driven centralized automated trading system known as the JSE Equities Trading (JET) system was introduced together with dual trading and negotiated brokerage. JSE has formed technical alliance with the London Stock Exchange, whereby South Africa companies can have primary listings in both Johannesburg and London. The JSE has adopted the London Stock Exchange's SETS System, and the JSE has been using the FTSE rules to classify its companies¹⁷⁸. Table 14 below summarizes the institutional and Infrastructural Indicators of Stock Market Development of South Africa.

Table 14: Institutional and Infrastructural Indicators of Stock Market Development South Africa

Market Regulator	Financial Services Board
Governing Law	Stock Exchanges Control Act (1985)
Clearing & Settlement	Electronic- STRATE
Central Depository	Electronic central scrip depository- STRATE
Reporting Requirement	Half yearly income statements and balance sheets
Accounting/Auditing Standard	Local accounting and auditing reporting system.

¹⁷⁸ UNDP, supra note 175.

The above review of the legal, regulatory and institutional framework for stock markets regulation indicates that in most cases, reasonable regulations have been put in place to achieve the key objectives of transparency and disclosure. However, this does not mean that such legal, regulatory and supervisory frameworks meet the highest international standards and principles for stock market regulation. Many stock markets faced gaps and insufficiencies of legal framework. There were and still are also serious informational and disclosure deficiencies. Further, supervision by regulatory authorities is often far from adequate. The less developed of the stock markets [on the basis of traditional indicators] suffer from a far wider range of such deficits¹⁷⁹. Most importantly, enforcement of rules and regulations is increasingly challenged by weak judiciary systems making it difficult to obtain convictions when rules are violated. Thus, securities regulators have been working hard to administer the law, identifying violators but the normal process of enforcement was not equipped to apply the laws¹⁸⁰.

The infrastructural indicators also show that many stock markets of the sampled countries used slow manual systems. Even though markets are gradually adopting electronic systems¹⁸¹, there are still substantial stock markets which trade manually¹⁸² and use manual clearing and settlement¹⁸³. Similarly, most markets do not have central depository systems¹⁸⁴. Such bottlenecks slow down trading and induce inactivity.

South Africa is the exception to the above general trend. With the most developed stock market based on the traditional indicators, South Africa has also better legal, regulatory and supervisory framework for stock market regulation.

¹⁷⁹ Yartey, C. A., & Adjasi, C. K. (August 2007), "Stock Market Development in Sub-Saharan Africa: Critical Issues and Challenges" (IMF Working Paper African Department (WP/07/209).

¹⁸⁰ Mensah, *supra* note 167.

¹⁸¹ See note 166 above.

¹⁸² Malawi, Kenya, BRVM, Ghana, and Zimbabwe stock exchanges trade manually

¹⁸³ Malawi, Kenya, Ghana, Zimbabwe, Uganda, and BRVM stock exchanges use manual clearing and settlement.

¹⁸⁴ Malawi, Kenya, Ghana, Zimbabwe, and Uganda stock exchanges do not have central depository systems.

In South Africa, the King I Report helped improve the legal, regulatory, and supervisory framework. The report was aimed at promoting the highest standards of corporate governance in South Africa. Although this was a groundbreaking report, changes in the global economic environment and legislative developments necessitated its updating. As a consequence, the second King Report on Corporate Governance for South Africa was produced¹⁸⁵. The King II Report was designed to elaborate on the practices of good governance as defined by the law. Therefore, where legal deficiencies were identified, the Report made recommendations to the relevant authorities. The South African securities market has also been reformed. The original Johannesburg Stock Exchange merged with the South African Futures Exchange and the Bond Exchange of South Africa¹⁸⁶. Most importantly, the listing requirements of the Securities Exchange South Africa (JSE) have been extensively revised. JSE has formed technical alliance with the London Stock Exchange, whereby SA companies can have primary listings in both Johannesburg and London. The JSE has adopted the London Stock Exchange's SETS System, and the JSE uses the FTSE rules to classify its companies¹⁸⁷.

After the reforms, the South African financial system has emerged as a sophisticated and well developed sector of the economy. The increased importance of financial services to the economy has resulted in increased investor activity on the local stock market by local and international investors. Foreign investors have played a catalytic role by applying pressure for market reform and for higher corporate governance standards¹⁸⁸. Furthermore, South Africa has been admitted to the World Trade Organization (WTO), giving further impetus to domestic regulatory reforms towards a market-oriented corporate culture¹⁸⁹. As a result, the JSE has become the leading exchange in Africa not only on the basis of the traditional indicators of stock market development but also on the basis of the institutional indicators of stock market development.

¹⁸⁵ UNECA. (2007), "An Overview of Corporate Governance and Accountability in Southern Africa". (Addis Ababa, Ethiopia, United Nations Economic Commission for Africa).

¹⁸⁶ Ibid.

¹⁸⁷ UNDP, *supra* note 176.

¹⁸⁸ Armstrong, P., Segal, N., & Davis, B. (2005), "Corporate Governance: South Africa, a Pioneer in Africa. Global Best Practice" (Johannesburg: The South African Institute of International Affairs).

¹⁸⁹ UNECA, *supra* note 185.

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¹⁸⁵ UNECA. (2007), "An Overview of Corporate Governance and Accountability in Southern Africa". (Addis Ababa, Ethiopia, United Nations Economic Commission for Africa).

¹⁸⁶ Ibid.

¹⁸⁷ UNDP, *supra* note 176.

¹⁸⁸ Armstrong, P., Segal, N., & Davis, B. (2005), "Corporate Governance: South Africa, a Pioneer in Africa. Global Best Practice" (Johannesburg: The South African Institute of International Affairs).

¹⁸⁹ UNECA, *supra* note 185.

The recent World Economic Forum, Competitiveness report, ranked South Africa 1st out of 139 countries for its regulation of securities exchanges. This implies the Financial Services Board (FSB) seriousness in complying with the IOSCO principles for maintaining effective and transparent capital markets in South Africa. In fact, the FSB was confirmed to be in compliance with most of the IOSCO principles of securities regulation in a recent Financial Sector Assessment Programme¹⁹⁰. FSB has also devoted special attention to enhance its enforcement powers. To that end, violations of all the laws administered by the FSB, including insider trading, market misconduct and material misstatements by public companies, are sanctioned through an administrative tribunal, called the Enforcement Committee. The Enforcement Committee has powers to impose unlimited administrative penalties, compensation orders, and cost orders. The Enforcement Committee plays an important role in maintaining the integrity of the markets¹⁹¹.

It has been stated earlier that most stock market development indicators are highly correlated with banking sector development. This is especially true with disclosure and accounting standards indicators because these indicators improve transparency and the quality of information available for banks. Therefore, countries with well-developed stock markets measured by these indicators tend to have well developed financial intermediaries. This seems the reason why South Africa has the highest ratio of bank private sector credit to GDP.

On the other hand, most stock markets of the sampled countries suffer from the problem of low liquidity. Liquidity as measured by the turnover ratio is as low as 0.2 percent in Ghana compared with 45 percent in South Africa. Low liquidity means that it will be harder to support a local market with its own trading system, market analysis, brokers, and the like because the business volume would simply be too low.

Although various macro-economic factors can cause illiquidity in the stock markets it appears that institutional factors partly contributed to the exchanges illiquidity. Poor liquidity of stock markets in many of the sampled countries may be the result of inefficient legal, regulatory and supervisory framework as well as low level of development of the accounting and auditing

¹⁹⁰ Tshidi, D. (20 April, 2011), IOSCO Annual Conference. (The 36th IOSCO Annual Conference. Cape Town).

¹⁹¹ Ibid.

framework. All these factors have bearing on the processing, accuracy, reliability and timely supply of required information for the effective operation of the banking sector.

Therefore, as critical information intermediaries, the role of accounting and audit to the well functioning of the banking sector is paramount. The development of legal, regulatory, and supervisory framework that meets the highest international standards and principles for stock markets regulation is also a must. Without these institutional inputs, it is difficult, if not impossible, to produce adequate, credible, and timely information on borrowers financial status.

3.1.2 The Utilization Pattern of Idle Cash of the Banks in Ethiopia

The ratio of excess liquidity varies from year to year, but is roughly over 50% of the total deposits (Table15). It stands at 61% of total deposits up until June 2010¹⁹². To reduce the excess liquidity, the banks had to invest in low interest yield Treasury Bills (T- bills). The Treasury yield rate is generally below 1%, reflecting the supply–demand imbalance in the formal money market¹⁹³. Table15 below summarizes the reserve and liquidity position of Ethiopian banks. From the table we can see that bank liquidity ratio in Ethiopia is the highest for the group of countries sampled (see table 15 cum table 1 above).

Table 15: Reserves and Liquidity at Ethiopian Banks (millions of Birr except for ratios)

	Nov-07	Dec-07	Jan-07	Nov-08	Dec-08	Jan-09
Reserve Position						
Net deposits	56,955	57,368	59,618	69,484	70,747	69,654
Reserve requirement	5,695	5,737	5,962	10,423	10,612	10,448
Actual reserve	11,047	12,446	11,676	17,083	17,222	15,218
Excess reserve	5,352	6,709	5,714	6,660	6,610	4,770
Actual reserve ratio	19.40	21.69	19.58	24.59	24.34	21.85
Liquidity requirement						
Net current deposits	53,035	53,609	55,810	66,437	67,651	66,474
Liquidity requirement	7,955	8,041	8,372	16,609	16,913	16,618
Liquid assets	29,985	30,748	30,816	26,738	26,818	25,501
Excess liquidity	22,029	22,706	22,444	10,129	9,906	8,883
Actual liquidity ratio	56.54	57.35	55.22	40.25	39.64	38.36

Source: Reproduced from National Bank of Ethiopia website

¹⁹² Fortune, supra note 19.

¹⁹³ Ibid.

3.1.3 The Size of Non-Performing Loans of Banks

Furthermore, banks have also been burdened by the accumulation of non-performing loans which has aggravated the situation. Table 16 below compares Ethiopian banks NPLs with the sampled countries including South Africa.

Table 16: Prudential Indicators

Country	Gross NPL to total loans
Cote d'Ivoire	N.A
Ethiopia (2003)	40.5
Ghana (2002)	28.6
Kenya (2004)	22.9
Malawi	N.A
South Africa (2000)	4.5
Tanzania (2002)	9.2
Uganda (2003)	7.2
Zambia (2002)	28.8
Zimbabwe	N.A

Sources: FSSA reports and Article IV consultations Staff Reports

From the above table it is clear that NPLs were by far the highest in Ethiopia. Of course, NPLs were largely concentrated in state-owned banks (though a few private banks were not immune)¹⁹⁴. According to Access Capital, in recent years, non-performing loans, in private banks, have improved substantially and now average only about 5 percent of total loans. This is an important improvement but how is this improvement coming about?

3.1.4 High Collateral-Based Lending Practices of Banks

According to Access Capital, this improvement is partly attributable to the firmer supervision and oversight from the central bank. In fact, current bank regulations have criminalized management error or economic downturn so that losses on loans can lead to a jail term for those responsible

¹⁹⁴ Access Capital, supra note 20.

for giving the loan¹⁹⁵. Therefore, the law, by making it a criminal offense to lend money to a borrower who becomes unable to repay the loan, forces bankers to take excessive collateral in order to protect themselves from jail terms.

Accordingly, banks and microfinance institutions tend to require at least 200% collateral¹⁹⁶. That is the value of collateral required is normally twice the value of the loan, meaning that an asset can only be used to obtain financing up to 50% of its value. Although 200% is not outrageous (125% is normal in mature economies), requirements can be higher¹⁹⁷. The second world Bank Investment Climate Assessment survey report released on August 24, 2009 indicated that 'the amount of collateral banks request has increased and become the highest in the developing world'.

Moreover, the quality of evaluation is generally considered inadequate, with poor understanding of market and income production values by evaluators¹⁹⁸. Consequently, existing collateral of a borrower (as opposed to new collateral the borrower wishes to purchase at a market price) is likely to be undervalued, thus further reducing the amount available against the asset. Even worse is that banks prefer to take pledges of the business as a going concern effectively tying up all assets of a business for any significant loan¹⁹⁹.

Another reason for over-collateralization is that too few banks are sufficiently analyzing repayment capacity of the borrower as the basis for lending²⁰⁰. Responsible lending is based on realistic assessment of cash-flow and revenue projections. Once the borrower can prove its ability to repay the loan, the bank takes collateral as security against default or fraud and encourages the likelihood of repayment. The primary purpose of the collateral is not to pay off the loan in case of

¹⁹⁵ Licensing and Supervision of Banking Business Directive No. Sbb/29/2002

¹⁹⁶ E-CLIR, (January 2007), "Ethiopia Commercial Law & Institutional Reform and Trade diagnostic" (Task Order No. 13, the Seldom Project . Addis Ababa, Ethiopia: United States Agency for International Development).

¹⁹⁷ Ibid.

¹⁹⁸ Ibid.

¹⁹⁹ Ibid.

²⁰⁰ Ibid.

default, but to prevent default²⁰¹. However, a significant number of loans in Ethiopia appear to be based on collateral as basis for repayment, not on the ability of the borrower to repay. Soundness of business plan/project and prospect to generate future cash flows and firms ability to provide transparent information including audited accounts are considered as having minimal importance in granting of loans and advances to firms in Ethiopia. As a result, banks are taking collateral they would not need and which could be available for secondary lending²⁰².

3.1.5 The Nexus between Stock Market and Banking Sector Development

Various explanations can be given for the underdevelopment of the Ethiopian banking sector. One such explanation is that banks in Ethiopia lack “information capital”. Information about potential borrowers is lacking. Audited reports are rarely required and when they are available are highly unreliable. There are no institutions that collect and analyze information about firms and businesses. Thus, when banks allocate credit they are operating almost in the dark. In such circumstances they are likely to give credit to those who are not really credit worthy and hence the high incidence of non-performing loans. Table 16 above shows that the incidence of non-performing loans is the least in South Africa and the highest in Ethiopia.

The lack of adequate information and the associated high incidence of non-performing loans is also likely to make them excessively risk averse, and hence the excess liquidity²⁰³. Bank liquidity ratio is the highest in Ethiopia in comparison with the sampled countries. To do away with the high incidence of non-performing loans banks had to require high collateral.

²⁰¹ Ibid.

²⁰² Ibid.

²⁰³ Other explanation for the excess liquidity of banks relates to the lending cap, action taken by the NBE as part of inflation containment measures, which has been in place since 2009. This measure is believed to have increased the amount of liquid assets held by the commercial banks particularly those in the private sector. However, the lending cap, which might have contributed to the excess liquidity of the banks, is a short lived one (2009-April 1, 2011) and is being lifted on April 1, 2011. Yet, the NBE which announced the lifting of the lending cap on the said date has come up with another mechanism to the lending cap.

Deposit mobilization by the commercial banks has also been affected. Excess liquidity means that banks do not seek additional savings when the deposits they already have are sitting in their vaults. Indeed interest bearing long-term deposits would increase their cost of fund at a time when lending is very low and the banks had to invest in low interest yield T- bills. Banks have therefore failed to be active in mobilizing savings. This can be seen from the low saving rate of the country²⁰⁴. Therefore, the Ethiopian banking sector is characterized not just by excess liquidity and low levels of lending but also low levels of savings with one feeding the other.

Experience in mature economies show that responsible lending is based on realistic assessment of cash-flow and revenue projections not on collateral as basis for repayment. This means that credit based on company financial statements and management skills would have been the best procedures to follow for Ethiopian banks. However, for financial statements to be relevant for loan decision making, the necessary conditions for establishing the accuracy and reliability of such statements must be in place. It has been stated elsewhere that for bank intermediation to deepen it is necessary that financial information on borrowers is of good quality and controllable. When a company cannot fully and credibly reveal information on all material matters regarding the company including the financial situation, performance, ownership, and governance of the company, lenders will be unwilling to advance funds to such company. One way to ensure more accurate information on the financial status of borrowers is through improved quality of annual accounts and financial statements. To that end there must be a system that imposes mandatory periodic and on-going disclosure obligations at least on listed companies.

This requires deep stock markets with efficient price discovery based on information disclosed as a result of the rules of the markets. Banks need accurate information about a firm's condition in order to assess risks appropriately. This demands that a company has well-documented and thoroughly audited books that are made available to banks. In other words, banks must satisfy themselves that companies have an effective disclosure system in place as a lending Prerequisite. However, there is no such disclosure system and accounting and audit practice in Ethiopia is underdeveloped. This is one of the major causes forcing banks to depend on high collateral

²⁰⁴ As per the data in the Report of the NBE 2003/4, average gross domestic saving rate for the years between 1991 and 2002/3 was only 4.4%. In the year 2003/4, it was only 2.8%.

requirements, invest in low interest yield T-bills which is generally below 1%, and suffer from bad loans. The introduction of a well functioning stock market is likely to be relevant to mitigate such problems of the banking system. The relevance of such stock market runs as follows.

As a detailed discussion below will show, the development of stock markets, through the instrument of mandatory disclosure, improves the standard of financial reporting and the quality of information made available to banks. This means, stock markets can mitigate the lack of 'information capital' on the part of banks by the generation and dissemination of information about prospective borrowers. As a result, when banks allocate credit they are unlikely to give credit to those who are not really credit worthy and hence, stock markets can mitigate the high incidence of non-performing loans. This in turn mitigates financing constraints for companies that are credit worthy. By so doing, a well functioning stock market should enable entrepreneurs to make long- term, more productive investments in physical capital. More productive capital implies higher return for entrepreneurs, which in turn helps banks to advance more funds confidently to these entrepreneurs. This ultimately mitigates the current tendencies of the banks of being very conservative in their lending practices-high dependence on collateral and thereby reducing the existing level of liquidity. Stock markets, by evening out the information asymmetry between banks and potential borrowers –by empowering banks with vital information which enables them to identify the credit worthy borrower from the credit unworthy one, enhance efficient resource allocation by banks. In short, the introduction of efficient stock market in Ethiopia is likely to enable banks to serve as informed agents or intermediaries on behalf society by building information capital necessary for the efficient allocation of resource.

3.2 The Role of Introducing Regulated Stock Markets in Ethiopia in Protecting Investors

The most commonly asserted function of Stock Markets is the protection of investors. However, what this 'protection' constitutes is never spelled out. There are different views in this regard. One such view is related to potential investors' protection in order to help issuers sell securities to the public. The public resists buying securities because of fears that any particular issue may be fraudulent. As a result, external financing mechanisms would tend to break down. Stock

markets, by providing a mechanism for appraisal of the value of firms, allow investors to make informed decisions about the allocation of their funds thereby helping issuers to raise fund²⁰⁵.

Securities purchasers (i.e. potential investors) rely in part on corporate information provided in financial reports to make their investment decisions. Availability of good information helps investors make informed decisions and provides better investor protection. Efficient stock markets (Stock markets are efficient if prices incorporate all available information) by demanding regular disclosure of adequate, reliable and timely information help investors make better investment decisions.

Importance must also be attached to the means stock markets afford of readily transferring shares from hand to hand, an element which is vitally necessary to the creation of corporations. It is so certain that most people would be loath to give their money for even the highest grade securities, if they have no positive assurance that in case of necessity they could, at a moment's notice, and at a prevailing price obtain their value in cash by selling the same in a free market. But, when active secondary markets for securities exist, savers can be induced to provide the long-term funding that companies seek because savers are assured that the markets can provide them with liquidity²⁰⁶. Thus, what is the equivalent of short-term investment for the security purchaser is transformed into long-term financing from the issuer's perspective. The more efficient matching of asset and liability maturities that result means less financial risk for companies and thus a more stable economic environment in general.

However, information risks also flow from the significant potential for incentive misalignment in the principal/agent relationship and another view of investors' protection is that stock markets protect investors by providing them with higher returns. Stock markets can enhance efficiency in the corporate sector by monitoring management and exerting corporate control. Shareholders cannot effectively verify the efficiency of the management and stock markets can monitor the behavior of corporate managers and foster efficient use of company resources better than shareholders acting individually. Stock markets can also improve managerial efficiency by promoting competition through effective takeover or threat of takeover. These roles of stock

²⁰⁵ Kitch, *supra* note 94.

²⁰⁶ Huebner, *supra* note 24.

markets are discussed below in the context of the two types of corporate ownership structures. Special emphasis is given to the emerging dispersed corporate ownership structure in the publicly held share companies. Accordingly, the second part of this chapter (3.2.1) discusses the role of introducing regulated stock markets in Ethiopia in light of the existing institutional, regulatory, and legal framework for investors' protection in the primary offering market. the third part of this chapter (3.2.2) discusses the role of introducing regulated stock markets in Ethiopia in solving or minimizing the "agency costs" that are supposed to exist in the publicly held share companies as a result of the emerging separation of ownership from control and the diffused ownership structure.

3.2.1. The Role Of Introducing Regulated Stock Markets in Ethiopia in Light of the Existing Institutional, Regulatory, and Legal Framework for Investors' Protection in the Primary Offering Market

The Commercial Code of Ethiopia has been facilitating the formation of share companies since its enactment in 1960²⁰⁷. However the formation of share companies was suspended during the Military Regime and was resumed only during its final years when it issued a policy of mixed economy and mainly after the collapse of the regime in 1991. Most of the companies formed at the beginning were private limited companies. For example, among the 125 companies formed from 1991 till the end of 1993, 119 was private limited companies and only 6 were share companies²⁰⁸. Although the rate of company formation improved subsequently, it was the number of private limited companies that increased at the accelerated rate as opposed to that of share companies²⁰⁹. Most of the share companies formed during this period often had five or a few more members. It was only since roughly 2005 that share companies started selling shares to the

²⁰⁷ J.D. Von Pischke (1968), "Shares and Share Trading in Addis Ababa", (Addis Ababa, College of Business Administration, Hailesillassie I University), p. 4, note 1.

²⁰⁸ Abu Girma (1994), "Problems and Prospects for the Emergence of a Stock Market in Ethiopia," in Getachew Yoseph and Abdul Hamid Bedri Kello (Eds.), *The Ethiopian Economy: Problems and Prospects of Private Sector Development* (Addis Ababa, Proceedings of the Third Annual Conference on the Ethiopian Economy), p.217.

²⁰⁹ Ibid.

wider public and thereby creating bigger shareholding base²¹⁰. Table7 below shows the number of share companies formed between 2003 and 2009.

Table17: Number of share companies formed between 2003 and 2009 in Ethiopia²¹¹

Year of formation	Number of share companies formed
11 Sept. 2003-10 Sept. 2004	17
11 Sept. 2004-10 Sept. 2005	14
11 Sept. 2005-10 Sept. 2006	11
11 Sept. 2006-10 Sept. 2007	30
11 Sept. 2007-10 Sept. 2008	17
11 Sept. 2008-6 August 2009	21

Source: The Department of Trade Registry at the Ministry of Trade and Industry

The rate of company formation through initial public offer of shares (IPOs) is growing. According to Access Capital research, in December 2010 22 share companies targeted ETB 5.9 been and an estimated number of 20 additional companies were looking for capital as well. A number of factors are probably triggering the growth of companies that are accessing the primary market as a source of funds. One important factor could be the limited capacity of the banks in the country to finance big and risky projects. As indicated above, the majority of banks in Ethiopia rely almost exclusively on collateral-based lending and the amount of collateral banks request is the highest even by developing countries standards. The impact of too high collateral-based lending is that access to long-term credit from existing banks is limited. This seems to have forced newly emerging companies to find a complementary source of capital for long term financing offered in addition or as a substitute to the loans from the commercial banks. As a result, banks are increasingly being substituted by the general public as a source of funds by new share companies being established in a variety of sectors²¹².

The development of the primary market is promising because, among other things, it can fill the gap of long term capital requirements needed by companies. However, in the absence of a secondary market such development may not be sustained. Although the public is currently

²¹⁰ Fekadu, supra note 134.

²¹¹ At the Federal Government level.

²¹² Access Capital, supra note 20.

buying shares in the primary market their money is tied up as transferring is difficult because of the absence of a secondary market. Current share holders in share companies who want to transfer their shares for one reason or another can only do it if a secondary market exists.

As a result of the absence of regulated and organized secondary market, investors currently trade securities informally in a completely unregulated market with out access to information necessary to determine whether to buy, sell, or hold their securities²¹³. This results in uncertainty as to the risks and rewards of the investment as well as uncertainty as to pricing of securities. This clearly shows why a stock market is relevant for Ethiopia: When active secondary markets for securities exist, investors can be induced to provide the long-term funding that corporations seek because investors are assured that the markets can provide them with liquidity. Thus, what is the equivalent of short-term investment for the security purchaser is transformed into long-term financing from the issuer's perspective. This also shows the interdependent and inseparable nature of the primary and secondary markets: when there is no organized, well regulated, and active secondary market, potential investors will not trust the primary market. The fact that the public is already buying shares in the primary market without organized well regulated, and active secondary market should not undermine the importance of such secondary market.

Another factor making the primary market quite popular as a source of funds can be the limited investment possibilities available for Ethiopians. Ethiopians who are able and willing to invest domestically have very limited investment possibilities: they can put their assets into savings accounts (current return 5%), government bonds (current return 5.5%) and/or buy company shares in the primary offering market. But, the inflation rate is much higher than the return of the savings account and the government bonds. In July 2011 for instance, the inflation rate stands at 39.2 %. Therefore, the saving incentive, is absent as the interest rate is 34.2 % lower than the inflation rate. Such negative interest rates were going on for some years in the past and this is possibly the cause that has forced some people to buy company shares hoping to achieve returns higher than the current inflation.

The popularity of the primary market in Ethiopia should be encouraged for several reasons. First, it helps raise capital for projects whose outputs are in the highest demand by society, and those enterprises which are most capable of raising productivity. Without the primary market,

²¹³ Sanders, *supra* note 136.

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²¹³ Sanders, supra note 136.

companies must rely on internal resources (retained earnings) for investment funds or on bank financing. Such forced reliance on self-finance or on bank financing penalizes young companies whose products may have greater future demand. These new and growing enterprises often have little in the way of retained earnings.

Banks in Ethiopia are also very conservative in their lending policies, thereby penalizing younger or emerging companies whose business risk is higher than those faced by established firms, and yet contribute to the dynamism and future growth potential of the economy through innovations. Even worse, currently banks, with the exception of the state-owned Commercial Bank of Ethiopia (CBE) and Development Bank of Ethiopia (DBE), are required to invest 27% of their annual net loan disbursements in five-year bonds at a 3% interest rate as per the new directive issued by the NBE. The new directive, by compelling banks to invest in medium term bonds, would help to drain out the excess liquidity that has accumulated over the past three years. The proceeds of the bond issues will also be used to finance national development projects. However, the new measure will reduce the funds available for the private sector loans. After the banks purchase government bonds equivalent to 27% of their annual net loan disbursements, the total amount of money available for the private sector borrowers stands at 48% of the total deposits of the banks because 25% of the total deposits of the banks will be dedicated to the legal and liquidity reserves. As indicated above, there is already a very high demand for greater access to credit in Ethiopia; collateral requirement by banks are already very high; long-term loan is already very hard to find at Ethiopia's private banks, and this has already become a major challenge to the competitiveness of private firms.

The new directive issued by the NBE would create a further excess demand for loans. As a result, banks would further be tempted to focus on short-term loan; they may also require even higher collateral. They may also require higher interest rates. The effects of all this will be making long-term loan even harder to find which in turn might hamper beneficial private sector investment. This demonstrates the need for equity finance as a complementary source of capital for long term financing offered in addition or as a substitute to the loans from the commercial banks. Secondly, the market can serve to increase the national savings rate by creating incentives to invest. Since securities are risky investments, they generally earn higher returns than more secure instruments such as bank savings deposits. Thirdly, the primary market can improve companies' capital

structure. Healthy debt/equity ratios are important for a robust economic system. In the absence of equity markets, debt/equity ratios inevitably rise. Finally, equity sales provide for a wider participation in enterprise management and for a wider distribution of corporate profits. These factors would help allay the fear that a few individuals or groups would dominate the private sector. Wider distribution of corporate profits develops a general sense of ownership and an assumption of responsibility on the part of the citizen.

In order to embrace the above and other benefits, it is important to encourage the development of the primary market which is increasingly becoming popular. To that end, there must be adequate protection for investors in the primary offering market. However, review and analysis of Ethiopia's legal, regulatory, and institutional framework reveals that there is no adequate protection for investors in the primary offering market for the following reasons:

- 1) There is no requirement that issuers of securities prepare and file a Registration Statement and Prospectus with an independent government agency for review and approval prior to offering and selling securities to investors
- 2) There is no requirement that the Registration Statement and Prospectus contain full, fair, accurate, and timely disclosure of material facts and information regarding the issuer, the securities, and the offering prior to offering and selling securities to investors
- 3) There is no requirement that the Registration Statement and Prospectus contain Audited Financial Statements. With regard to the banking sector, Proclamation No. 592/2010 requires banks to provide Audited Financial Statements to NBE, but it appears that these Audited Financial Statements are not independently reviewed by NBE
- 4) There is no requirement that issuers' Financial Statements be prepared in accordance with defined internationally accepted accounting principles. With regard to the banking sector, the Bank Proclamation merely provides that the NBE may direct banks to prepare financial statements in accordance with unspecified international financial statement standards
- 5) There is no requirement that audit of issuers' Financial Statements be prepared in accordance with defined internationally accepted auditing standards (the Bank Proclamation merely provides that audits be carried in accordance with unspecified internationally accepted auditing standards)

- 6) There is no requirement that issuers wait until receiving independent government agency permission before offering and selling securities to investors (however, the Bank Proclamation does require that any transfer of shares that makes any person an influential shareholder shall be approved by NBE before such transfer is recorded in the register of shares)
- 7) There is no requirement that issuers affirmatively provide the Prospectus to potential investors prior to offering and selling securities to investors
- 8) There is no requirement that issuers offer securities to investors only by use of the Prospectus
- 9) There is no provision for stopping, halting, or suspending the offer or sale of unregistered securities or other securities offered and sold in violation of law
- 10) There are no adequate anti-fraud provisions in the event of material misrepresentations and omissions of material facts and other fraudulent conduct
- 11) There is no inspection, investigative, or enforcement mechanisms for helping to ensure compliance by issuers, underwriters, investors, and other market participants
- 12) There are no adequate civil, criminal, or administrative penalties for non-compliance with the registration and anti-fraud provisions.

But, even in the absence of such protection, there are a number of share companies under formation who do not even provide the potential investors with a business plan and investors are buying shares. This may lead to fraudulent conduct on the part of issuers. As a result, the public will start to resist buying shares because of fears that any particular issue may be fraudulent. As a detailed discussion below will show, the introduction of efficient stock market in Ethiopia will help potential investors in reducing the amount of fraud. In the absence of it potential investors will either resist buying shares or have to invest real resources to protecting themselves against fraud. A well-functioning stock market, by providing an effective deterrent against fraud, reduces this cost for buyers and makes it possible to sell shares at higher prices thereby helping issuers raise capital.



3.2.2 The Role of Introducing Regulated Stock Markets in Ethiopia in Solving or Minimizing the Agency Costs

The discussion shortly above has stated that the number of companies under formation through initial public offer of shares is growing for various reasons even though there is no adequate protection for investors in the primary offering market. Another important development is the emerging of a dispersed ownership structure. There are also various reasons explaining the emergence of such structure of corporate ownership including the following:

1. the design of company promoters who not only lower the minimum shareholding threshold to enable small income group to buy shares, but also provide the upper limit of share subscriptions preventing the emergence of block holders²¹⁴
2. As far as share companies engaged in banking business are concerned, there seems to be a governmental policy against block holding²¹⁵
3. The rise of inflation might have made saving less attractive for the small income group driving investment towards the widely available publicly offered shares²¹⁶

Dispersed corporate ownership structure exists when shares are dispersed among many investors, each with an insignificant fraction of the total and no way of exerting control over the management. What amounts to effective control over the management is not clearly defined. For,

²¹⁴ For most of the initial public offerings (IPOs), the minimum shareholding is 5000 ETB (5 shares) while the maximum allowed is 5 percent of the total shares offered.

²¹⁵ Article 11 (1) of Proclamation 592/2008 (Proclamation-No-592, 2008) which regulates banking business, prohibits any person other than the FDRE Government from holding more than 5 percent of the shares in bank. Moreover, while Article 2 (11) defines a shareholder who owns 2 percent or more of the shares as an influential shareholder, the Proclamation refers to fitness criteria to be met by such a person under Article 4 (1). The Proclamation also states that a share transfer that will make a person an influential shareholder be approved by the National Bank under Article 10 (1). Taken together, these provisions seem to show that, the government's policy is towards diffuse ownership in the financial companies.

²¹⁶ In Habesha Cement S.C, for instance more than 40% of the shareholders have 5000 ETB (5 shares) each which is the minimum allowed holding, whereas 90% of the shareholders in Buna Bank (i.e., 10,350 out of 11,500) own less than 100,000 shares each. Likewise, in Brehan Bank S.C, the size of shareholders owning less than 100,000 is 95% percent, (i.e., 5708 out of 6000 shareholders). Source: Fekadu, P. G., *Emerging Separation of Ownership and Control in Ethiopian Share Companies*, 2010.

example, LLS (1999) used a definition of effective control of 20 percent ownership or more by a single entity/individual. But, a definition of effective control of 10 percent ownership or more by a single entity/individual is also possible. See also Article 11 (1) of Proclamation 592/2008 below. Generally, a dispersed corporate ownership structure presupposes the absence of one person who has a big block of shares enabling him/her to exercise control. But, effective control could also be exerted by a small group of shareholders rather than by a single owner. Table 18 below provides evidence of a high degree dispersion of ownership in some of the non financial and financial companies.

Table 18: Share Ownership Structure in Some of the Non Financial and Financial Companies

Name of Company	Combined holdings of highest 10 holders in %	Average holding in %	Combined holdings of Directors in%	No of shareholders	The highest single holding in %
NON FINANCIAL COMPANIES					
Cheha Business S.C	5.64	0.564	3.954	177*	0.564
Ehil Berenda Ehil Negadewoch S.C	9.0	0.909	6.363	110*	0.909
Papirus school S.C	3.89	0.432	3.03	231	N.A
Shola S.C	4.295	0.359	7.51	110	N.A
Sky Bus S.C	1.138	0.020	0.399	2793	
Yeshera Tera Berhan Limat S.C	6.57	0.657	5.921	152*	0.657
Crystal Tannery S.C	6.666	0.083	2.583	630	N.A
FINANCIAL COMPANIES					
Brehan Int. Bank*	undisclosed	0.016	Undisclosed	6000	1.4%
Buna Bank	undisclosed	0.008	Undisclosed	11,200	0.9 %
Zemen Bank	9.37	0.034		2,878	2%
Awash Int. Bank	undisclosed	0.037	Undisclosed	2700	Undisclosed

Source: Ministry of Trade and Industry

*All the shareholders in these companies have evenly equal number of shares.

Dispersed corporate ownership structure has led to large theoretical and empirical literatures dealing with managerial agency problems and the inefficiencies these create. High level of dispersed ownership means absence of owners of big blocks of shares (block holders). In a company with numerous shareholders, the absence of such block holders gives rise to the surrender by shareholders of control to managers. A key drawback of this arrangement is that managers are often not owners, and thus they will not bear the brunt in terms of lost investment and lost profits if the company fails to perform. As a result, managers may take actions that hurt the value of shareholders' investment. They, for example, may not be as vigilant as they should in overseeing the internal operations of the company, they may steal the profits of a company, they may engage in more distorted and wasteful diversion practices such as setting up intermediary companies into which they channel profits. Managers may also be tempted to pay inflated transfer prices to affiliated entities, or to overpay themselves, put relatives in management, and undertake some wasteful projects. Such behavior obviously harms the performance and financial viability of the firm and illustrates the need for investors' protection.

Although the need for investors' protection in Ethiopia stems from the emerging dispersed ownership structure in publicly held share companies, it extends beyond solving the principal-agent problem. Even in a concentrated company ownership model the same problems would arise. Dominant shareholders are likely to pose threats on minorities. Arranging for purchase of additional shares on favorable terms which is not available otherwise, is just one of many examples. In other cases, block-holders may transfer corporate assets by orchestrated transaction with related companies that skim profits from a publicly quoted firm in favor of privately owned ones. It is also possible for block holders to extract benefits via high pay and bonuses for employed family members and associates, inappropriate related party transactions, systematic bias in business decisions and changes in the capital structure, through special issuance of shares favoring the controller. Therefore, it is evident that both dispersed and concentrated company ownership have inherent risks. Failure to institute the appropriate mechanisms to protect investors jeopardizes the well-being of the entire economy.

Hence, the next question that must be asked is: what control mechanisms are available to protect investors against expropriations by managers and/or dominant shareholders in Ethiopian publicly

held share companies. As discussed above, effective investors' protection relies on a combination of internal and external control mechanisms.

With regard to the internal control mechanisms scholars such as La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) identify six different types of shareholder rights that may or may not be present in any country's company law. They also aggregate these rules into shareholder rights index –called “antidirector rights index”. The variables within the index are used as proxies for the stance of the law toward investors' protection. If present, each of the following six shareholder rights provides an important investor protection:

1. The right to proxy voting by mail;
2. Absence of the obligation provided by law compelling shareholders to deposit their shares prior to shareholders' meeting;
3. Cumulative voting or proportional representation of minorities on board of directors;
4. Legally recognized right of shareholders to sue directors or to challenge the decisions of shareholder meetings in court;
5. The minimum percentage of share capital that entitles a shareholder to call ordinary general meeting is less than or equal to 10 percent; and
6. Shareholders have pre-emptive rights when new shares are issued that can be waived only by a shareholder vote.

The “anti director rights index” mentioned above is a summary measure of shareholder protection. This index ranges from zero to six and is formed by adding one when: the country's law allows shareholders to mail their proxy vote to the firm (and zero otherwise); shareholders are not required to deposit their shares prior to the General Shareholders' Meeting; cumulative voting or proportional representation of minorities in the board of directors is allowed; an oppressed minorities mechanism is in place; the minimum percentage of share capital that entitles a shareholder to call for an Extraordinary Shareholders' Meeting is less than or equal to 10 percent; and shareholders have preemptive rights that can only be waved by a shareholders' vote. Countries that score one point for each of these variables obtain six points.

These indices are also in conformity with the OECD Principles on Corporate Governance. The principles are adopted by the governments which are members of the OECD itself. The OECD Principles on Corporate Governance cover five areas of concern: 1) the rights of shareholders, (2)

the equitable treatment of shareholders, (3) the role of stakeholders in corporate governance, (4) disclosure and transparency, and (5) the responsibilities of the board.

The rights of shareholders include a set of rights including secure ownership of their shares, the right to full disclosure of information, voting rights, participation in decisions on sale or modification of corporate assets including mergers and new share issues. The guidelines go on to specify a host of other issues connected to the basic concern of protecting the value of the corporation.

In the area of equitable treatment of shareholders the OECD is concerned with protecting minority shareholders' rights by setting up systems that keep insiders, including managers and directors, from taking advantage of their roles. Insider trading, for example, is explicitly prohibited and directors should disclose any material interests regarding transactions.

The OECD also recognizes that there are other stakeholders in companies in addition to shareholders. Banks, bond holders and workers for example are important stakeholders in the way in which companies perform and make decisions. The OECD guidelines lay out several general provisions for protecting stakeholder interests.

The guidelines provide a great deal of detail about the functions of the board in protecting the company, its shareholders, and its stakeholders. These include concerns about corporate strategy, risk, executive compensation and performance, as well as accounting and reporting systems.

Finally the OECD lays out a number of provisions for the disclosure and communication of key facts about the company ranging from financial details to governance structures including the board of directors and their remuneration. The guidelines also specify that annual audits should be performed by independent auditors in accordance with high quality standards.

The major thrusts of the OECD principles are for better disclosure of important information to shareholders and vigorous protection of shareholder interests. Although the OECD Principles are a useful starting point to protect investors, they focus mainly on internal controls and are designed primarily for listed companies that function within an effective legal and regulatory environment with adequate competition. With this concept in mind let's have a look at that the investors protection regime of the Commercial Code of Ethiopia.

The Commercial Code, under Articles 398(1) and 402 provides for Voting by proxy but no voting by mail is allowed. The minimum percentage required for shareholders to call general meetings is 10% of the capital under Article 391(2). Likewise, the pre-emptive right of shareholders to buy newly issued shares in proportion to their shareholding is unequivocally provided under Article 345(4) and 470(1). Article 352 calls for proportional representation of minorities in boards though it lacks clarity. A shareholder's right to challenge decisions of the general meeting is provided under Article 416(2-5). Article 463 also gives minorities the right to withdraw from the company when fundamental changes are made to the Articles of Association, or to the company.

However, Article 401 of the Code specifically requires shares to be deposited during shareholder meetings. The other important minority protection mechanism the Commercial Code fails to set out under Article 365(1) is the derivative suit mechanism i.e., the right to initiate suits against directors or third parties on behalf of the company.

Generally, the investors' protection regime of the Commercial Code meets three of the six criteria from La Porta et al. index. Given that the protections lacking under the Code are the most important ones that can minimize minority shareholder exploitation by managers and/or block holders, it can be said that the law is inadequate in shareholder protection.

Yet a slight twist can raise the scores in these indices. For instance the cumulative voting under Article 352 can say what it is supposed to mean with a slight revision. So does the question of proxy voting by mail.

From the above discussion it is clear that the internal control mechanisms are important for protecting investors. It is also clear that the investors' protection regime of the Commercial Code is inadequate. Therefore, revision of the commercial code is a useful starting point to ensure a better investors protection. Yet effective investors' protection relies on a combination of internal and external controls. In order for these internal control mechanisms to have a meaningful effect, they must be buttressed by a variety of extra-firm institutions (referred to as external controls). As mentioned above the internal control mechanisms are designed primarily for listed companies that function within an effective legal and regulatory environment with adequate competition. Yet, Ethiopia does not have a stock market. Moreover, the set of institutions that provides the

essential legal and regulatory framework and a competitive self-enforcing environment is either absent or weak. However, without this framework, internal controls no matter how well designed will have little impact. These institutions provide a level playing field and ensure that internal corporate governance procedures adopted by firms are enforced and that management is responsible to owners and other stakeholders.

To start the discussion on how stock markets protect investors, it is appropriate to start with the stock exchange. A stock exchange may be defined as any organization set up for the purpose of providing a trading platform, where buyers and sellers can meet to transact in securities. If a company wants its securities to be traded in a stock exchange, it must be listed. Listing is a regulatory process through which the securities of a public company can become eligible to be traded in a regulated stock exchange.

In order to ensure that securities trading on the exchange meet some minimum procedural and quality requirements, the exchanges set requirements for 'listing' a security on the exchange. So, at the time of listing securities of a company on a stock exchange, the company is required to enter into a listing agreement with the exchange. Listing rules also spell out in considerable detail information which must be disclosed by companies as a condition of listing. These listing requirements often include the requirement that financial data be audited by recognized professional accountants.

In addition to any information required by the listing rules as a condition of listing, security laws also impose a general duty of disclosure in respect of listed companies. Disclosure remains a central principle of the listing regimes for companies after they have been admitted to listing. The rationale for such disclosure is that it is necessary for the proper functioning of the market as it enables investors to make informed decisions. Economic theory holds that for markets to operate efficiently, investors must be fully informed when making investment decisions²¹⁷. Disclosure obligations imposed on listed companies attempt to ensure that this is the case with regard to information concerning the business of such companies. Such disclosure obligations are referred to as 'continuing obligations' which can be categorized as periodic disclosure obligations and on-going disclosure obligations. The main example of periodic disclosure is the requirements

²¹⁷ Macneil, *supra* note 38.

relating to the publication of financial information on a regular basis. On-going disclosure requires particular types of information to be publicized whenever they occur. The most wide-ranging obligation of this type requires listed companies to disclose material developments in their business and changes in their financial position which are not public and are likely to have a significant effect on their share price.

A basic distinction can be drawn between listed and unlisted securities. The attraction of listing for shareholders is that the liquidity of their holding is improved. Listed securities generally have a higher degree of transferability and liquidity than unlisted securities, for which there may be no real market or one with only very limited liquidity. The attraction of liquidity (in essence the ability to buy or sell) for investors, in return, is that their protection is improved. At the end of the day, liquidity is all that counts for the investor and issuer, and is actually the benchmark for each stock market. All over the world, the first question of market participants, who are interested in doing some CM transactions will be the question of liquidity. It is a bit like a vicious circle: if there is no liquidity, there is no interest in the market. If there is no interest in the market, there will be no liquidity.

The link between liquidity and investors protection is created by takeovers. The relevance of takeovers to investors' protection is that the threat of takeover can act as disciplining mechanism for the board of directors/management. A poorly performing company faces the threat of takeover because the shareholders are likely to lose confidence in the existing management and may prefer to accept a takeover offer than to hope for a recovery in the share price. Although a change in control resulting from a takeover does not automatically lead to changes in the board of directors, this is likely to occur in most cases as the new shareholders will want to install new directors to give effect to their plans. The threat of removal as a result of a takeover can represent just as serious a threat to a board of directors as any other sanction for poor performance and therefore takeovers can potentially be a significant mechanism for investors' protection²¹⁸.

Takeovers can be viewed as an example of shareholders collectively exercising the 'exit' option. The rationale for a takeover offer is that the bidder believes a company is being run inefficiently and that benefits can be gained through a change of control. In order to gain control, it is likely that a bidder will have to pay a premium over the prevailing market price. The premium reflects

²¹⁸ Ibid.

the special circumstances in which the 'exit' option is being exercised and the value attached to control of a company. While the sale of a shareholding normally does not carry with it any real control over a company, a takeover offer is designed to transfer control and therefore a bidder will attach a higher value to shares that deliver control of a company²¹⁹. In principle, the size of the premium that a bidder should be prepared to pay to gain control should be less than the benefits that result from the change in control. If it were otherwise, the bidder would be over-paying for the target and while the target shareholders would benefit, shareholders of the bidder would suffer loss as a result of the transaction²²⁰.

However, several conditions must be met for takeovers to operate as an effective disciplining mechanism. First, there must be a liquid stock market. If there is not, it is unlikely that a bidder will be able to acquire sufficient shares in the target company to gain control. For this reason, takeovers are relatively rare in countries with 'bank centered' systems of corporate governance, in which share ownership is often heavily concentrated. They are more commonly associated with countries such as the UK and USA, in which share-ownership is relatively dispersed and there are large and liquid capital markets²²¹. Second, there must be rules in place that ensure fair and equal treatment of the shareholders in target companies. If there are not, it is likely that arbitrary treatment of different shareholders will lead to widespread resistance to takeovers on the part of shareholders who do not fall within the favored group²²². Third, there must be adequate disclosure to the shareholders of the target company to enable them to make a decision on the offer. This is particularly the case when the offer is a 'share-for-share'¹³¹ offer under which the shareholders in the target company are being offered shares in the bidder. Unless the target shareholders have adequate information they will be unable to judge whether the benefits claimed by the bidder as a result of the takeover can realistically be achieved²²³.

Disclosure is also designed to support efficient price formation. It is typically justified by reference to its support of the market efficiency dynamics which translate information into the

²¹⁹ Ibid.

²²⁰ Ibid.

²²¹ Ibid.

²²² Ibid.

²²³ Ibid.

price of securities. Exchanges require listed companies to make timely and accurate disclosure on all material matters regarding the companies, including the financial situation, performance, ownership, and governance of the company²²⁴. As a result, owners of a company who monitor the market price of their shares can there by infer whether the agents are acting in their best interest. Hence, the stock market can be an important mechanism for corporate control. The quality of managerial decision-making is an input in the choice of investors, whose judgment on company performance is summarized in the share price. If the managerial team is thought to be incompetent or venal, the share price will be low relative to otherwise comparable firms, which can place pressure on managers in various ways. Stock price can be linked to managerial pay and bonuses. It can get a manager fired or hired²²⁵.

3.3 Preconditions and Determinants of Stock Market Development

3.3.1 Preconditions of Stock Market Development

To understand the important role played by stock markets in protecting investors, it is important to understand how stock markets work. A well-functioning stock market creates appropriate linkages of information, incentives and governance between managers and investors. This process is supposed to be carried out through a network of intermediaries that include information analyzers such as financial analysts and ratings agencies; assurance professionals such as external auditors. These parties, who are themselves subject to incentive and governance problems, are regulated by a variety of institutions. What follows is a description of the set of some of these preconditions for stock market development.

The Accounting and Audit Infrastructure

Stock markets rely on information intermediaries for the dissemination of information to the market and to monitor performance of listed companies. Therefore, information should be prepared and disclosed in accordance with high quality standards of accounting. The application of high quality standards is expected to significantly improve the ability of investors to monitor the company by providing increased reliability and comparability of reporting, and improved insight into company performance. The quality of information substantially depends on the

²²⁴ OECD, supra note 105.

²²⁵ Estrin, supra note 22.

standards under which it is compiled and disclosed²²⁶. An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the exchange, regulator, board, shareholders and other stakeholders that the financial statements fairly represent the financial position and performance of the company in all material respects. In addition to certifying that the financial statements represent fairly the financial position of a company, the audit statement should also include an opinion on the way in which financial statements have been prepared and presented. This should contribute to an improved control environment in the company.

Information Analyzers

In addition to demanding independent and competent auditors, stock exchanges are complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice. These intermediaries, if they are operating free from conflicts and with integrity, can play an important role in providing incentives for company boards to follow good corporate governance practices²²⁷.

Regulators and Standard Setters

Regulatory institutions provide an additional set of players in the working of stock markets. The regulatory mechanisms of stock markets are divided into internal and external. Internally, Self-Regulatory Organizations (SROs) exercise some direct oversight responsibility for their respective areas of competence and to the extent appropriate to the size and complexity of the markets. Various models of self-regulation exist and the extent to which self-regulation is used varies. The common characteristic of SROs, in most jurisdictions is a separation from the government regulator (although government oversight and authorization generally exists). Accordingly, stock exchanges have the power to ensure compliance with applicable laws by their members through investigation and disciplinary measures. The regulatory framework of stock exchanges usually comprises a set of rules reflected in: 1) the companies' law, 2) the governing law of the regulatory agency, and 3) the listing rules of the stock exchange. In the typical case,

²²⁶ OECD, *supra* note 105.

²²⁷ *Ibid.*

the provision of the companies' law provides the starting Point for regulating capital markets. Regulatory agencies and stock exchanges do not reenact the provisions in the companies' law but tend to introduce additional and more detailed rules²²⁸. Regulation of the accounting profession is delegated to an SRO, a body intended to oversee the education and training of the profession, registration of accountants and auditors, establishment of standards for them, regulating their performance including investigation of possible shortcomings.

From the above discussion it is clear that the regulatory regime of stock markets makes appropriate use of Self-Regulatory Organizations. However, SROs are subject to the oversight of the external (government) regulator and must observe its standards when exercising powers and delegated responsibilities. The regulator requires any SRO to meet appropriate standards before allowing the organization to exercise its authority. Oversight of the SROs is ongoing. Moreover, once the SRO is operating, the regulator assures it self that the exercise of this power is in the public interest, and results in fair and consistent enforcement of applicable securities law, regulations and appropriate SRO rules. As a condition to authorization, the regulator should require a SRO to:

- Have the capacity to carry out the purposes of governing laws, regulations and SRO rules, a capacity to enforce compliance by its members and associated persons with those laws, regulations, and rules;
- Treat all members of the SRO and applicants for membership in a fair and consistent manner;
- Develop rules that are designed to set standards of behavior for its members and to promote investors' protection;
- Submit to the regulator its rules for review and/or approval as the regulator deems appropriate , and ensure that the rules of the SRO are consistent with the public policy directives established by the regulator ;
- Cooperate with the regulator and other SROs to investigate and enforce applicable laws and regulations;
- Enforce its own rules and impose appropriate sanctions for non- compliance;

²²⁸ Mensah, supra note 167.

- Assure a fair representation of members in selection of its directors and administration of its affairs;
- Avoid rules that may create uncompetitive situations ; and
- Avoid using the oversight role to allow any market participant unfairly to gain advantage in the market²²⁹.

Regardless of the extent to which self-regulation is used; the government regulator retains the authority to inquire into matters affecting investors or the market. Where the powers of an SRO are inadequate for inquiring into or addressing particular misconduct or where a conflict of interest necessitates it, the regulator takes over the responsibility for an inquiry from an SRO. It is important therefore, to ensure that the information provided by the SRO to the regulator allows these matters to be identified at an early stage.

The most prominent feature stock market regulation is the mandatory disclosure system. Stock exchanges require listed companies to provide them with periodic disclosure, at a minimum, on an annual basis though some require periodic disclosure on a semi-annual or quarterly basis, or even more frequently in the case of material developments affecting the company. Information must be prepared and disclosed in accordance with high quality International Accounting Standards rather than the more opaque accounting rules. An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects. A number of countries are tightening audit oversight through an independent entity. Indeed, the *Principles of Auditor Oversight* issued by IOSCO in 2002 states that effective auditor oversight generally includes, inter alia, mechanisms: "...to provide that a body, acting in the public interest, provides oversight over the quality and implementation, and ethical standards used in the jurisdiction, as well as audit quality control environments"; and "...to require auditors to be subject to the discipline of an auditor oversight body that is independent of the audit profession, or, if a professional body

²²⁹ IOSCO. (2007), *Objective and Principles of Securities Regulation*. IOSCO. www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf, p.26.

acts as the oversight body, is overseen by an independent body”²³⁰. It is desirable for such an auditor oversight body to operate in the public interest, and have an appropriate membership, an adequate charter of responsibilities and powers, and adequate funding that is not under the control of the auditing profession, to carry out those responsibilities.

One of the major purposes of stock market regulation (be it internal or external) is the protection of investors. Full disclosure of information material to investors’ decision is the most important means for ensuring investor protection. A strong disclosure regime that promotes real transparency is central to investors’ ability to exercise their ownership rights on an informed basis. Disclosure, with its ‘self-help’ connotations, is strongly associated with the empowerment model. It forms a central element of current retail market policy internationally, reflecting the ingrained assumption that disclosure can support better decision-making and stronger market-based saving²³¹. Investors are better able to assess the potential risks and rewards of their investment and, thus, to protect their own interests. Disclosure can empower investors to achieve their investment objectives²³². Experience in countries with large and active equity markets shows that disclosure can be a powerful tool for influencing the behavior of companies and for protecting investors. By contrast, weak disclosure and non-transparent practices can contribute to unethical behavior and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy as a whole²³³.

As key components of disclosure requirements, accounting and auditing standards must be in place and they should be of a high and internationally acceptable quality. An important point I would like to emphasize here is that the development of stock markets is usually accompanied by increased reporting standards and requirements which is a strong incentive for the improvement of accounting and auditing. The reason is that stock exchanges have strong incentives to require listed companies to comply with improved accounting and auditing standards. Because exchanges incomes rise as the volume of transaction rises, they create stock markets that attract

²³⁰ OECD, supra note 105.

²³¹ Moloney, supra note 7.

²³² Tafara, E., & Peterson, R. (2007), A Blueprint for Cross-Border Access to US Investors: A New International Framework. *Harvard International Law Journal*, 48 (31).

²³³ OECD, supra note 105.

investors by adopting rules that benefit the later. It is only natural for stock exchanges to act like this because this is the same reason that applies to the incentive of any producer to supply goods or services that consumer's desire²³⁴. An exchange will survive only if a sufficient number of investors find it worthwhile to use the exchange's facilities to purchase the securities listed on the exchange²³⁵. Whether an exchange is attractive or not to investors depends on its capacity to seek and enforce contractual commitments and legal obligations to disclose from a broad cross-section of firms. The necessity of attracting investors who have ample alternatives should lead exchanges to choose rules and listing standards that produce adequate, reliable and timely information²³⁶. Therefore, the need for disclosure of financial information is a strong incentive for the improvement of accounting and auditing standards.

3.3.2 Assessment of the Preconditions of Stock Market Development in Ethiopia

Implicit throughout this discussion is that developing stock markets is a means to ensure investors protection. As already discussed above, the development of stock markets is usually accompanied by increased reporting standards and requirements, which contribute to the efficiency of the markets and their mobilizing and allocating functions. The development of widely accepted accounting procedures, checked by independent external auditors is also assumed to be an important benefit derived from the development of stock markets. However, there is a strong argument that claims the key infrastructures mentioned above are the necessary preconditions for the development of stock markets. According to this line of argument, the institutions such as the accounting and audit must come first before the actual establishment of

²³⁴ Mahoney, P. G. (1997), "The Exchange As A Regulator" (*Virginia Law Review*, No. 83), 1453-1500.

²³⁵ The discussion above shows that many of the stock markets of the sampled countries are illiquid. Some attribute the illiquidity of the markets to lack of confidence in the operation of the exchanges by the general public because of weak institutional infrastructure to support the operation of the stock markets. So, if an exchange will survive only if a sufficient number of investors find it worthwhile to use the exchange's facilities to purchase the securities listed on the exchange and if many of the said stock exchanges do not enjoy sufficient public confidence, what explains their survival? According to IMF, 2006, all SSA stock markets remain dependent on regional government subsidies for their operation.

²³⁶ Ibid.

stock exchanges. This argument reminds us the classic ‘‘chicken and egg story’’. Although this argument might seem relevant, it cannot be fully endorsed because unless there is a stock market, the related institutional infrastructures may not develop. Institutions such as , stock brokers and rating agencies need a stock market before they appear to exist.

Having said this, the argument that institutions such as the accounting and audit are the necessary preconditions for the development of stock markets can’t be totally ignored. It is possible that these two causal processes may not be mutually exclusive and may very well be a natural feature of the links between the development of stock markets and, for instance, the development of accounting and auditing standards. It is true that the development of stock markets positively contributes to the improvement of accounting and auditing standards. It may equally be true that well developed accounting and auditing standards are critical inputs for the proper functioning of stock markets. Stock market is not a closed system, it is an open system whereby it affects and is also affected by what is happening in the overall environment. Hence, it is appropriate to assess the level of development of the key institutional, regulatory, and legal infrastructures which are essential for proper functioning of stock markets.

Financial Intermediaries

Currently, Ethiopia has no independent financial intermediaries that can effectively satisfy the operational needs of a stock market. However, it is possible to use existing banks to set up independent, fully capitalized subsidiaries as brokers, investment dealers and underwriters.

Information Intermediaries

As critical information intermediaries, the roles of accounting and audit to the well functioning of stock market are paramount. Stock markets rely on information intermediaries to disseminate information to the market and to monitor performance of listed companies. Hence, it is appropriate to review Ethiopia’s accounting and audit infrastructure from this input side study of stock market development. Table 19 below summarizes the institutional framework for stock market development in Ethiopia. As can be seen from the table below, Ethiopia lacks any properly legislated regulatory standards governing the presentation of financial statements and the auditing of such statements. As a result, the credibility of financial information is diminished by the variability of its quality. This includes financial statements provided to:

- ✓ Banks for providing finance to the private sector
- ✓ The tax authorities for the determination of tax liabilities
- ✓ Trading partners for the extension of credit and support of relationships
- ✓ Stockholders for the evaluation of the business in which they have invested²³⁷.

²³⁷ Martin, *supra* note 162, p.12.

Table 19 Institutional Framework for stock market development in Ethiopia

Assurance Professionals (External auditors)	Regulator of the Profession	Accounting/Auditing Standards	Standard Setters	Information Analyzers (Financial analysts, Rating agencies)
The private sector audit profession is relatively small. By 2005, there were around 50 registered Auditing Firms ²³⁸ .	Currently, the Office of the Federal Auditor General [OFAG] regulates the private sector accounting and auditing profession. It is also responsible for licensing auditors. However, it is not conducting a monitoring and investigation function. There is no such function operating in Ethiopia ²³⁹ .	Ethiopia lacks any properly legislated regulatory standards governing the presentation of financial statements and the auditing of such statements. Currently, there is no single accepted and documented set of accounting or auditing standards. However, in 2003, the then Board of Ethiopian Professional Association of Auditors and Accountants [EPAAA] lobbied the OFAG to adopt the International Standards on Auditing [ISA's] and the later responded in August 2003 by instructing all auditors to adopt the ISA's for all audit reports while "customizing them for use in Ethiopia". Unfortunately, it quickly became clear that these moves were premature. The profession was unprepared for such a major move. As a result, the OFAG instruction to auditors has not been implemented, while EPAA and OFAG work out realistic next steps towards proper regulatory standards, particularly a financial reporting framework that is officially recognized for adoption in Ethiopia. ²⁴⁰	The Office of the Federal Auditor General [OFAG] is supposed to set the accounting/auditing standards. However, there are no such standards currently. But, there is a plan for a National Accounting and Auditing Board (NAAB) or a Standard Setting Body (SSB) under OFAG.	none.

Because of the fact that financial information prepared by companies in Ethiopia is not credible, banks and the tax authorities do not rely on audited financial statements in granting loans, and upon filing of tax returns by companies respectively (Martin, 2005). I have repeatedly stated that the value of adequate, reliable and timely information for investors is extremely important. Investors pay enormous amount of money to strangers for completely intangible rights, whose value depends entirely on the quality of the information that the investors receive. However, the integrity of financial information is seriously questioned and therefore, investors are expected to be less protected. Therefore, in order to protect investors, there is an urgent need to introduce stock markets. In the absence of organized stock markets there can be no meaningful protection of investors. Indeed, this is the most fundamental question that the growth of dispersed ownership in Ethiopia is posing.

Regulatory and Legal Framework

Currently, Ethiopia doesn't have an adequate legal and regulatory framework that can serve as a foundation for a secondary trading market. Ethiopia's existing laws are inadequate for the secondary trading market for securities. There is no independent securities commission responsible and properly empowered for the regulation and supervision of the secondary trading market. Table 20 below summarizes the legal and regulatory framework for the secondary trading market for securities.

The Draft Proclamations for the Regulation of the Purchase and Sale of Securities in the Secondary Trading Market and for the Regulation of the Offer, Sale, and Issuance of Securities in the Primary Securities Market

Section 4 of The Draft Proclamation for the establishment of the Ethiopia Securities Commission establishes the Ethiopia Securities Commission. Under the Draft Proclamations, rules relating to stock exchanges; stock market institutions, participants and licenses; Securities transactions and registers; market misconduct; Administrative and civil actions; Disclosure of information; and Other provisions are developed. The legal and regulatory framework as stipulated by the Draft Proclamations seems adequate to enable the Commission to fulfil its tasks of regulating the securities market. As the Commission is empowered by the Draft Proclamations to make its own rules and regulations as and when necessary, it has all the means on hand to enforce an efficient market supervision to safeguard the interests of investors. Under the Draft Proclamation for the regulation of the offer, sale, and issuance of securities in the primary securities market and for the establishment of the Ethiopia Securities Commission Prospectus Requirements, the Commission can ensure from the very beginning that full and reliable information for all securities issues is being given to the public to foster the confidence of investors in the securities market.

3.3.3 Determinants of Stock Market Development

The experience of the sampled countries and the literature suggest that the existence or creation of certain political, economic, and policy environments can smooth the process of stock markets development.

1. **Political environment.** Political uncertainty is detrimental to any investment. Investors' projection of future political conditions, both domestic and international, directly affects their willingness to invest in such risky financial assets as stocks. Government stability and consistency in applying financial and economic policies tends to increase investors' confidence and to increase the flows of capital from savers to productive investments.
2. **Economic environment.** The key determinants for the success of securities markets include sufficient demand for and supply of securities. Demand for securities depends on the amount of capital available for investment in the hands of individuals and institutions. In very low per capita income nations and where corporate investment funds are in short supply, demand for securities cannot be expected to be high. Garcia and Liu, (1999) find

that sound macroeconomic environments and sufficiently high income levels—GDP per capita, domestic savings, and domestic investments—are important determinants of stock market development in emerging markets²⁴¹.

The degree of familiarity of potential investors with the securities markets operation affects demand. The existence of investment alternatives affects both the demand for and the supply of securities. Thus, bank deposit interest rates, tax policies, and the capitalization of securities markets are all considered by owners of capital when they make investment decisions. Investors must be convinced that the risks of securities ownership are likely to be offset by returns that sufficiently adjust for those risks as compared with more secure investments.

The supply of securities is as important to the smooth operation of a market as the presence of demand for them. When too few securities are available for purchase and trading, it may be difficult to attract investors, who may doubt that a large enough market exists to ensure the liquidity of their investments. The result will be a shallow, sluggish market that does not perform its function. In cases where demand for securities is high but few issues are available, securities prices may rise to unrealistic levels. Experts believe that a minimum number of issues required for the successful institution of a stock market is 20 profitable companies²⁴².

3. Policy environment. To encourage development of healthy securities markets, legal inducements that affect the supply and demand for securities are helpful. Such incentives include tax exemptions or reductions for income derived from capital gains and/or dividends from securities issued by publicly traded companies; tax credits for owners of publicly traded shares; tax deferral for dividends, interest and capital gains from securities purchased for retirement funds; and tax breaks for companies that list their shares on exchanges. While governments have important policy roles in the early stage of securities market development, their future involvement should be primarily catalytic and supervisory to create a sense of confidence in the public about the market.

3.3.4 Assessment of the Determinants of Stock Market Development in Ethiopia

The previous sections have provided empirical evidence and theoretical justification for the introduction of regulated stock markets in Ethiopia in terms of their relevance to the financial intermediation of the country and the role they may play in protecting investors. A portion of this

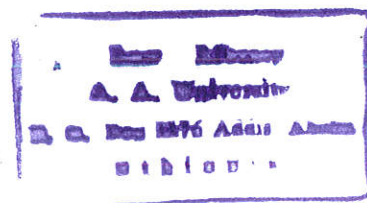
section has also assessed the key infrastructures for stock market development in Ethiopia. The next question, therefore, is what determines stock market development in Ethiopia?

Based on the above observations and the previous discussions, developing stock markets in Ethiopia face several direct challenges:

- High level of poverty. As the average household income is very low²⁴³, people do not have a lot of assets to save or even to invest. This is seen as impediment for setting up a liquid stock market.
- Low level of public awareness about securities markets. The degree of awareness by potential investors of investments in stocks affects demand for stocks.
- Lack of institutional capacity to facilitate stock trading. Stock markets work most efficiently when such intermediaries as brokers, dealers, underwriters and the like are knowledgeable, professional, skillful, honest, and have sufficient resources to perform their functions.
- Inadequate Legal, regulatory, accounting, tax²⁴⁴, and supervisory systems influence stock market liquidity.
- Low implementation capacity on the part of the government regulator as a result of insufficient resources and lack of knowledge and skill to enforce security laws.
- Absence of a strong judiciary system. There is no system of civil courts where securities cases can be prosecuted by a dedicated governmental authority. There are no specific training programs to educate prosecutors and judges on CM regulation, including corporate governance. There are commercial courts that specialize in hearing commercial cases, but there are no courts that specialize in hearing only securities law and company law cases.
- The underdeveloped state of the bond market. The Government Bond (Treasury Bill) Market is the only active primary money market in the country. Tenders are offered periodically by the Central Bank. The Government Offers 28 day, 91 day and 182-day bills. As of recently, there is a new development where the corporate bond market has started operating in the country. It is believed that the establishment of a corporate bond market which involves less risk, both to participants of the market and the stability of the business environment, should come first. It helps create some of the necessary preconditions for the establishment of a CM. The sales of bonds in the market create the need for a supervisory authority as well as a formally established and regulated secondary market in order to facilitate transfers, fair and transparent pricing and investor protection.

On the other hand, many prospects (opportunities) for developing stock markets exist in Ethiopia including:

- Existence of many share companies such as financial institutions with a large number of shareholders. The Trade Registry at the Ministry of Trade and Industry (MoTI) shows that there are 110 share companies formed in only 6 years. It is also easy to estimate that many more share companies are under formation since then. As stated above, the minimum number of issues required for the successful institution of a stock market is 20 profitable companies. Ethiopia definitely has more than 20 profitable firms that can pay more in dividends than what banks currently pay in interest²⁴⁵;
- Limited capacity of the banks in the country to finance big and risky projects;
- Existence of promising investment opportunities that require significant risk capital and wider public participation. Ethiopia has considerable unexploited resources including unexploited fertile land.
- High inflation rate and negative bank deposit interest rates. As the inflation rate is much higher than the return of the savings account and the government bonds, local investors do not have an adequate investment possibility to achieve returns higher than the current inflation, there is a need to provide them with alternative investment opportunities;
- The emerging dispersed ownership structure. In contrast to the concentrated ownership structure, dispersed ownership structure tends to foster liquid stock markets.
- The privatization efforts going on²⁴⁶ would help with the supply problems, particularly if a public offering of shares is used as the method of privatization. Unfortunately, Privatization Public Enterprises Proclamation 146/98 fails to state this mode of privatization²⁴⁷. As a result, the PPESA is privatizing companies only via tenders to selected investors and not to the general public.
- The existence of institutions like the country's Pension Fund, insurance companies, credit unions, etc., with large sums of money. If allowed to invest, they would boost the demand for securities.
- The gradual improvements of the incentive packages in the successive investment proclamations help attract new investors including Ethiopians with foreign passports.



CHAPTER FOUR

Summary, Conclusion and Recommendations

4.1 Summary and Conclusion

This study has set out to consider information which relates to the following basic research questions: (1) what is the relevance of introducing stock market in Ethiopia to the banking sector development (2) How will the introduction of stock market solve or minimize the 'agency costs' that are supposed to exist in the publicly held share companies in Ethiopia as a result of the emerging separation of ownership and control and the diffused nature of share ownership (3) What is the relevance of introducing stock market in Ethiopia in light of the existing institutional, regulatory, and legal framework for investors' protection in the primary offering market (4) What are the necessary institutional, regulatory, and legal frameworks for stock market development and other determinants of stock market development. To answer the first question financial intermediation patterns of 9 countries where there are already established stock markets has been investigated and the level of development of the stock markets in each of these countries using standard models of stock market development indicators has been assessed. To answer the second question, a comprehensive literature review has been undertaken. With regard to the third question, review and analysis of the relevant laws that relate to the offer and sale of securities by issuers in the primary market has been undertaken. Finally, to answer the last question, review and analysis of the relevant laws that relate to the secondary trading of securities in the secondary market has been undertaken. In addition, review and analysis of relevant legislations, policy, and programs of the Government to support a liquid stock market has been undertaken. The findings are given below.

Investigation of financial intermediation patterns of the sampled countries on the basis of standard models of stock market development indicators reveal that the positive influence of stock market development on financial intermediation (private sector credit as a ratio of GDP) is significant for countries with relatively developed stock markets. For Cote d'Ivoire, Ghana, Kenya, and Zimbabwe the ratio of bank credit to private and NFPEs to GDP in 2003, was in the range of 15 to 20 percent, but Malawi, Tanzania, Uganda, and Zambia have a ratio below 10 percent. These countries also record an M2 to GDP ratio in the lower range for the group. The

only notable exception is South Africa which has a ratio of 82.7 percent. Better financial intermediation (higher ratio of bank credit to the private sector) in South Africa may be explained by the fact that the country has a well developed stock market. On the other hand, the ratio was 24.3 % for Ethiopia during the same period. This appears to be comparable to the sampled eight countries. However, taking many relevant factors into consideration, financial intermediation is weaker in Ethiopia than even in those eight countries with less developed stock markets. This suggests that the absence of regulated stock markets has adversely affected financial intermediation of the country.

In addition to low ratio of bank credit to the private sector, another major feature of Ethiopia's banking sector is the accumulation of large excess liquidity. Bank liquidity ratio in Ethiopia is the highest for the group of countries sampled. Furthermore, banks have also been burdened by the accumulation of non- performing loans which has aggravated the situation. NPLs were by far the highest in Ethiopia in comparison with the sampled countries. South Africa suffered the least from NPLs. Banks and microfinance institutions tend to require at least 200% collateral. Recently, the amount of collateral banks request has increased and become the highest in the developing world.

On the basis of the traditional indicators of stock market development, South Africa had 403 listed companies with a market capitalization that constituted 214.1% of GDP. Zimbabwe with 79 listed companies had a market capitalization that is 87.9 % of GDP. The remaining capital markets are relatively small. Kenya, with 47 listed companies had a market capitalization that is 24.9% of GDP. Ghana, also with only 29 listed companies has a market capitalization that is 30.7% of GDP. Zambia, Tanzania, Uganda, and Malawi had even fewer listings and market capitalizations that are insignificant relative to GDP. Those countries also have a ratio of bank credit to private sector below 10 percent.

Most stock markets of the sampled countries also suffer from the problem of low liquidity. Liquidity as measured by the turnover ratio is as low as 0.2 percent in Ghana compared with 45 percent in South Africa. Although various macro-economic factors can cause illiquidity in the stock markets it appears that institutional factors partly contributed to the exchanges illiquidity. Poor liquidity of stock markets in many of the countries may be the result of inefficient legal,

regulatory and supervisory framework as well as low level of development of the accounting and auditing framework.

Review of the legal, regulatory and institutional framework for stock markets regulation indicates that in all the sampled countries, reasonable regulations have been put in place to achieve the key objectives of transparency and disclosure. However, many stock markets face gaps and insufficiencies of legal framework. There are also serious informational and disclosure deficiencies. Further, supervision by regulatory authorities is often far from adequate. The less developed of the stock markets, [on the basis of traditional indicators]; suffer from a far wider range of such deficits. Most importantly, enforcement of rules and regulations is increasingly challenged by weak judiciary systems making it difficult to obtain convictions when rules are violated. The infrastructural indicators also show that many stock markets of the sampled countries use slow manual systems. Even though markets are gradually adopting electronic systems there are substantial stock markets which trade manually and use manual clearing and settlement. Similarly, most markets do not have central depository systems.

South Africa is the exception to the above general trend. With the most developed stock market based on the traditional indicators, South Africa has also better legal, regulatory and supervisory framework for stock market regulation. In South Africa, the King I & II Report helped improve the legal, regulatory, and supervisory framework. The King II Report was designed to elaborate on the practices of good governance as defined by the law. Therefore, where legal deficiencies were identified, the Report made recommendations to the relevant authorities. The South African securities market has also been reformed. The original Johannesburg Stock Exchange merged with the South African Futures Exchange and the Bond Exchange of South Africa. Most importantly, the listing requirements of the Securities Exchange South Africa (JSE) have been extensively revised. JSE has formed technical alliance with the London Stock Exchange, whereby SA companies can have primary listings in both Johannesburg and London. The JSE has adopted the London Stock Exchange's SETS System, and the JSE now uses the FTSE rules to classify its companies.

After the reforms, the South African financial system has emerged as a sophisticated and well developed sector of the economy. The increased importance of financial services to the economy

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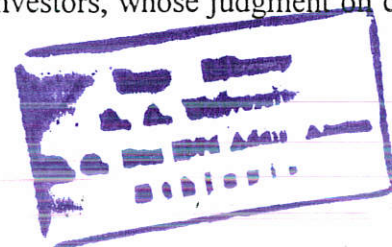
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After the reforms, the South African financial system has emerged as a sophisticated and well developed sector of the economy. The increased importance of financial services to the economy

has resulted in increased investor activity on the local stock market by local and international investors. Foreign investors have played a catalytic role by applying pressure for market reform and for higher corporate governance standards. Furthermore, South Africa has been admitted to the World Trade Organization (WTO), giving further impetus to domestic regulatory reforms towards a market-oriented corporate culture. As a result, the JSE has become the leading exchange in Africa not only on the basis of the traditional indicators of stock market development but also on the basis of the institutional indicators of stock market development including disclosure and accounting standards indicators which improved transparency and the quality of information available for banks. This seems the reason why South Africa has the highest ratio of bank private sector credit to GDP.

On the other hand, Ethiopia lacks any properly legislated regulatory standards governing the presentation of financial statements and the auditing of such statements. It also lacks any mandatory disclosure system. As a result, the credibility of financial information is diminished by the variability of its quality. This includes financial statements provided to banks for providing finance to the private sector. Because of the fact that financial information prepared by companies in Ethiopia is not credible, banks do not rely on audited financial statements in granting loans. This has negatively affected the development of the financial system of the country.

The relevant literature on the role of stock markets in protecting investors state that a well-functioning stock market creates appropriate linkages of information, incentives and governance between managers and investors. This process is supposed to be carried out through a network of intermediaries that include information analyzers such as financial analysts and ratings agencies; assurance professionals such as external auditors. These parties, who are themselves subject to incentive and governance problems, are regulated by a variety of institutions such as regulators and standard setters. Exchanges require listed companies to make timely and accurate disclosure on all material matters regarding the companies, including the financial situation, performance, ownership, and governance of the company. As a result, owners of a company who monitor the market price of their shares can there by infer whether the agents are acting in their best interest. Hence, the stock market can be an important mechanism for corporate control. The quality of managerial decision-making is an input in the choice of investors, whose judgment on company



performance is summarized in the share price. If the managerial team is thought to be incompetent or venal, the share price will be low relative to otherwise comparable firms, which can place pressure on managers in various ways. Stock price can be linked to managerial pay and bonuses. It can get a manager fired or hired.

Review and analysis of Ethiopia's legal, regulatory, and institutional framework reveals that there is no adequate protection for investors in the primary offering market. The literature implies that the introduction of regulated stock markets in Ethiopia naturally creates the need for a set of stock market institutions, regulations, and laws that needs to be in place in order to protect investors in the primary offering market. Economic theory holds that for markets to operate efficiently, investors must be fully informed when making investment decisions. Disclosure obligations imposed on listed companies attempt to ensure that this is the case with regard to information concerning the business of such companies.

Review and analysis of the relevant laws that relate to the secondary trading of securities in the secondary market as well as relevant legislations, policy, and programs of the government to support a liquid stock market reveal that the overall institutional, legal and regulatory framework for any stock market activity in the country is missing at the moment. On the basis of the experience of the sampled countries and the relevant literature, developing regulated stock markets in Ethiopia is likely to face the following major challenges: high level of poverty, low level of public awareness about securities markets, inadequate legal, regulatory, accounting, tax, and supervisory systems, low implementation capacity on the part of the government regulator as a result of insufficient resources and lack of knowledge and skill to enforce security laws, absence of a strong judiciary system. On the other hand, many prospects (opportunities) for developing stock markets exist in Ethiopia including: existence of many share companies such as financial institutions with a large number of shareholders, limited capacity of the banks in the country to finance big and risky projects; existence of promising investment opportunities that require significant risk capital and wider public participation, high inflation rate and negative bank deposit interest rates, the emerging dispersed ownership structure, the existence of institutions like the country's pension fund, insurance companies, credit unions, etc., with large sums of money.

4.2 Recommendations

Assessments of stock market development levels show that Stock markets in the sampled countries remain immature. Market capitalization is very low for many of the countries. It is as low as 1.4 percent of GDP in Uganda. This contrasts with Zimbabwe and South Africa, which have capitalization ratios of 87.9 and 214.1 percent respectively. Market liquidity is also very low: turnover ratios are as little as 0.2 percent in Uganda compared with 45.0 percent in South Africa. In most stock markets, informational and disclosure deficiencies prevent trading in most listed stocks. Further, supervision by regulatory authorities is often inadequate. Low liquidity implies low investors protection. Empirical evidence shows that the quality of shareholder protection is correlated with the capitalization and liquidity of stock markets. The most remarkable result of illiquidity is an unfair market price. Therefore, illiquid securities carry higher risks than liquid ones; this becomes especially true during times of market turmoil, when the ratio of buyers to sellers may be thrown out of balance. During these times, holders of illiquid securities may find themselves unable to unload them at all, or unable to do so without losing a lot of money.

For a sustainable stock market development in Ethiopia liquidity is even more important because of the limited investor and issuer base. As Ethiopian investors only have a small portion of their household income to invest, a fair priced – liquid – market is imperative in order to avoid creating systematic losses for the general public. Illiquid stock markets cannot also be a destination for inward capital inflows. The recent study by Centre for Global Development finds that African Stock Markets with the exception of South Africa do not get foreign equity investments because of their low level of liquidity . Therefore, Ethiopia should be able to create suitable conditions for the development liquid stock markets. To that end, the following recommendations are suggested.

4.2.1 Law on the Creation of Stock Market Regulatory and Supervisory Institutions

Regulation and supervision of a stock market play a great role in determining its development. Regulation and supervision should typically aim at the protection of investors from the potentially opportunistic behavior of insiders. Investor protection helps solve agency problems and information asymmetry arising from inside information. This helps in making optimal

decisions, increasing access to external finance and resulting in productive investment and eventually liquid stock market. Therefore, there is the need for a law that mandates the foundation of a securities market regulatory and supervisory body; without this law a stock market regulator and supervisor cannot be established. Hence, it is recommended that the law should stipulate that the regulatory and supervisory body should be established as an independent body. The law should also provide for a creation of a powerful regulatory body with significant enforcement powers that did not require reliance on courts. Regular disclosure, transparency and enforcement should form an integral part of regulation and supervision. The law should place much of the responsibility for accurate corporate accounting and disclosure on intermediaries, and focus the regulatory oversight by the government regulator on these intermediaries. The law should also cover topics relating to Market misconduct (e.g. insider trading); Takeover and merger regulation; establishment and licensing of appropriate stock market institutions (such as , Stock Exchanges, Depository Institutions, Stockbrokers, Investment Banks, and Investment Advisors) that are necessary for the proper functioning of stock market.

4.2.2 Improving the Investors' Protection Regime of the Commercial Code

Another key determinant of stock market development is the level of shareholder protection in publicly traded companies, as stipulated in company laws. Stock market development is more likely in countries with strong shareholder protection because investors do not fear expropriation as much. In addition, ownership in such markets can be relatively dispersed, which provides liquidity to the market. Unfortunately, the investors' protection regime of the Commercial Code is inadequate. The commercial Code does not allow voting by mail. Article 401 of the Code specifically requires shares to be deposited during shareholder meetings. Article 365(1) fails to set out the derivative suit mechanism which is an important minority protection mechanism. The code does not require that issuers of securities prepare and file a Registration Statement and Prospectus with an independent government agency for review and approval prior to offering and selling securities to investors; There is no requirement that the Registration Statement and Prospectus contain full, fair, accurate, and timely disclosure of material facts and information regarding the issuer, the securities, and the offering prior to offering and selling securities to investors; There is no requirement that the Registration Statement and Prospectus contain Audited Financial Statements and be prepared in accordance with defined internationally

accepted accounting principles and auditing standards. There are no adequate anti-fraud provisions in the event of material misrepresentations and omissions of material facts and other fraudulent conduct etc.... Hence, it is recommended that either the commercial code should be revised to rectify such gaps or insufficiencies or a new securities law should incorporate such topics or both.

4.2.3 Actively Encouraging Listings

Successful development of stock markets requires the existence of sufficient supply of stocks. The supply of stocks depends on the number of companies willing to list their company to trade shares publicly. To encourage companies for listing, government should develop appropriate incentive schemes. Tax incentives can be used to encourage companies to go public. Concessionary tax rates or temporary tax exemptions for companies with serious intentions of listing may lead to short-run distortions and yet could also provide the necessary push for gathering a critical mass of listed firms. In addition, as the companies to be listed in the stock exchanges will be more transparent than other companies, giving an incentive to such companies will ultimately benefit the government through increased tax revenues.

4.2.4 Actively Encouraging Shareholding

Successful development of stock markets also requires the existence of sufficient demand for stocks. Demand for stocks depends on the amount of capital available for investment in the hands of individuals. It also depends on incentive schemes available for investors. Therefore, it is recommended that the government should provide tax incentives for individuals willing to invest in shares. Tax rates on dividends and capital gains can be restructured to encourage investors to hold shares.

4.2.5 Public Education and Awareness Campaign

Another important task in increasing the demand for stocks is to educate the public about the benefits and costs of investing in shares. Increasing public knowledge about the functioning of the stock market could promote the development of the stock market in Ethiopia. Educating the public about the role of the stock market can help increase the investor base and improve the liquidity of the stock market. Stock markets can tap into potentially large amounts of financial

wealth which exists outside of the financial system, by pursuing vigorous and consistent educational campaigns about stock markets at various levels of society. Currently the majority of the population doesn't seem to be adequately informed about the investment options available. Therefore, the would be stock market regulator and stock exchanges should strive to implement far-reaching and carefully designed public sensitization campaigns and make it their institutional mission to educate the general public about investing in shares using the public media. They can also organize forums where the business community and the general public can learn about the working of stock markets.

4.2.6 Promoting Institutional Investors

Another way of creating demand for securities is Promoting Institutional Investors. The involvement of institutional investors in the would be stock exchanges must be pursued vigorously. Institutional investors often are at the forefront in promoting efficient market practices and financial innovation. They typically favor greater transparency and market integrity in both primary and secondary markets, seek lower transaction cost, and encourage efficient trading and settlement facilities. Pension Funds, insurance companies and other institutional investors can therefore act as a countervailing force to commercial and investment banks as well as other market intermediaries, forcing them to be more competitive and efficient. Indeed stock exchanges and individual investors stand to gain from increasing the involvement of institutional investors on stock exchanges. One way to promoting institutional investors is lifting all the legal restrictions from institutional investors like the largest government pension fund, public and private insurance companies and credit unions so that they can fully participate in the securities markets.

4.2.7 Using Public Offering of shares as a Method of Privatization

As far as the supply side is concerned, the most valuable measure to boost the supply of stocks is to use public offering of shares as a method of privatization. According to the Ethiopian Privatization and Public Enterprises Supervision Authority about 70 companies will be privatized through the next five years generating an estimated minimum income of 500 m ETB per year. However, Privatization of Public Enterprises Proclamation No.146/98 fails to state this mode of privatization. As a result, the PPESA is privatizing companies only via tenders to selected

investors and not to the general public. Therefore, it is recommended that this proclamation should be amended to the effect that it provides for the use of public offering of shares in future privatizations of the said and other companies. Public offering of shares as a modality of privatization would result in broad ownership of firms. Broad ownership of firms would give citizens a stake in the country's economy, thus reducing the resistance generated by the discomfort of the layoffs due to privatization. Most importantly, this could jump start the stock market and could create the required liquidity from the very beginning.

4.2.8 Listing of Government Owned Enterprises

Review of the various Regulations establishing various types of public enterprises in various sectors reveals that such enterprises operate under three distinct names: corporations, enterprises, and share companies. Examples of corporations include the Ethiopian Telecommunication Corporation,²⁴⁸ and the Ethiopian Electric Power Corporation²⁴⁹. Examples of enterprises include the Ethiopian Airlines Enterprise²⁵⁰. As regards state owned share companies, these are forms of share companies that are 'transitory' in nature as they are in the process of transformation and are waiting for sale to the private sector.²⁵¹ The capital of these share companies are divided into shares and totally held as government shares²⁵². With regard to these companies, it has been recommended that public offering of shares be used as a method of privatization (see 4.2.7). However, large share companies like CBE, are not subject to privatization at all. Other enterprises and corporations like the Ethiopian Air Lines Enterprise, Ethiopian Electric Power Corporation, Ethiopian Telecommunications Corporation, Ethiopian Insurance Corporation etc are not subject to 'corporatization' currently. Corporatization refers to the legal process of converting an entity [enterprise/corporation] into a share company although initially the State is the sole 'shareholder'. In this regard Article 1(2) of the Privatization of Public Enterprises (amendment) Proclamation No.182/1999 provides that an enterprise converted into a share company shall cease to exist upon registration as Share Company and be replaced by the company.²⁵³

The power to convert a public enterprise into a share company form of business organization resides in the Council of Ministers by virtue of Article 47(2)(a) of Proclamation No.25/1992. In order To create a liquid stock market, large share companies like CBE and enterprises and corporations like the Ethiopian Air Lines Enterprise, Ethiopian Electric Power Corporation,

Ethiopian Telecommunications Corporation, Ethiopian Insurance Corporation are crucial as these enterprises have the critical size to create liquidity and they are well known by the general public.

Therefore, it is recommended that these public enterprises be part privatized through Public Offer Of shares. To that end it is recommended that the Council of Ministers should consider converting public enterprises into share company form of business organization. Part privatization should allow the government to keep full control over the part privatized companies. Listing must be mandatory for such part privatized companies.

4.2.9 Creation and Capacity Building of Stock Market Institutions.

A well-functioning stock market creates appropriate linkages of information, incentives and governance between managers and investors. This process is supposed to be carried out through a network of financial and information intermediaries that include information analyzers such as financial analysts and ratings agencies; assurance professionals such as external auditors. These parties, who are themselves subject to incentive and governance problems, are regulated by a variety of institutions. Currently, Ethiopia doesn't have enough number of independent financial intermediaries that can effectively satisfy the operational needs of a stock market. Therefore, it is recommended that the government, among other things, should permit private and state banks to act as financial intermediaries.

Stock markets also work most efficiently when brokers, dealers and the like are knowledgeable, professional, skillful, honest, and have sufficient training and resources to perform their functions. It is also important to have a vigorous and independent regulatory body. Through its regulatory power, it can do much to reduce uncertainty by increasing information flows, by punishing those who engage in forbidden activities, and by taking measures to enhance investor confidence. However, trained human resources are also supposed to be lacking and would be a serious obstacle for running and managing stock markets. Therefore, the human resources required for the well-functioning stock markets need to be selected, oriented and trained in advance. The experience of ECX could be followed in this regard. The government should enlist the services of the International Finance Corporation (IFC) for operational and technical advice in training government staff and staff of financial institutions (e.g. accountants, financial analysts

and lawyers) responsible for the operational, supervisory and regulatory aspects of securities markets activities. This would help in upgrading the quality in terms of technical skills and analytical capacity of the personnel in the securities markets business.

4.2.10 Automation

Automation²⁵⁴ is also expected to help reduce the costs and inefficiencies in stock markets and increase trading activity and liquidity²⁵⁵. Automation helps to speed up operations and activities of exchanges and reduces cost associated with manual systems. In addition, automation makes it easier to extend trading days and hours due to less cumbersome procedures. Automated trading also eliminates the need for trade intermediation since investors can log onto systems to monitor markets and also trade on markets, thus bypassing the use of brokers.

Automation of the trading system usually either precedes or is preceded by the adoption of a central depository system (CDS). Under the CDS system, there is total elimination of risks such as the loss, mutilation and theft of certificates associated with holding and trading of paper-based securities of investors.

4.2.11 Attract Capital Flows and Encourage Foreign Participation

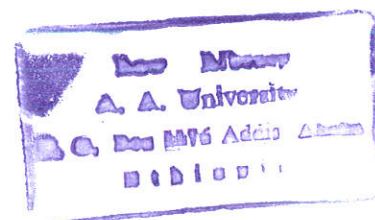
Private capitals flows especially portfolio flows are important for stock market development. Capital account restrictions limit the capabilities of stock markets to explore cross-border investments. To attract foreign portfolio and foreign direct investments, the government may consider liberalizing the capital account. The dissemination of market information is another integral part of securities markets development. Since the competition among developing countries to attract foreign capital is very intense, there is a need to make concerted efforts to disseminate market information to potential investors abroad. A coherent and integrated strategy to market the country based on providing pertinent and timely information to the international investors would help attract direct and indirect (portfolio) investments and invigorate the stock markets.

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