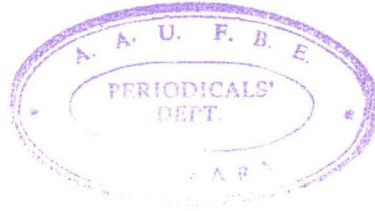


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ADDIS ABABA UNIVERSITY
FACULTY OF BUSINESS AND ECONOMICS
MBA PROGRAM



MBA Project Paper on
The Viability of Capital Market in Ethiopia
(in partial fulfillment for the Masters degree of Business Administration)



Submitted to: Dr. Ziauddin Khairoowala

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February 2002

Addis Ababa

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Certificate

This is to certify that Ato Assefa Worede has carried out his research work on the topic entitled Viability of Capital Market in Ethiopia under my supervision.

This work is original in nature and it is suitable for submission for the award of the degree of Masters of Business Administration.



Dr. Ziauddin Khairoowala

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MBA
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Declaration

I, Assefa Worede declare that this study entitled viability of capital market in Ethiopia is my own effort and study. I have carried it out independently except for the guidance and suggestions of the research supervisor. This study has not been submitted for any degree/diploma in this or any other university. It is offered here in partial fulfillment of the requirement for the degree of Masters of Business Administration.


Assefa Worede

Abstract

The study considers market size, liquidity, information, legal and regulatory framework as the basic components for the viable development of stock exchange market in Ethiopia. As a package of the structural adjustment program, the IMF and World Bank prescribe the SSA to establish capital market to serve the purpose of their economic development. However trends show that the markets in the SSA are small in size, illiquid, volatile and not preferred to direct foreign investment but slowly developing overtime.

Consequently capital market development is viable in Ethiopia holding the fact that it will be very small and illiquid. But there has to exist investment banks, brokers, dealers, adequate accounting, auditing and legal firms rating agencies supportive professional associations etc. The existence of government regulatory mechanism will further enhance its development. To further have a well functioning capital market the primary efficiency of the other financial institutions very vital.

Acronyms

- F.B.E - Faculty of Business and Economics
- IFC - International Financial Corporation
- IMF - International Monetary Fund
- SAP - Structural adjustment Program
- SSA - Sub Saharan Africa Countries
- TGE - Transitional Government of Ethiopia

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1. Introduction:

Financial liberalization has been high on the agenda of developing countries following the McKinnon (1973) and Shaw's (1973) paradigm. This paradigm- that is the financial repression school- as it sometimes referred to argues that the government intervention in the sector not only distorts the financial market but also depresses savings and leads to inefficient investment. The policy prescription that follows is liberalization. In order to promote liberalization and privatization, the financial sector should be free from state interference so as the financial resources could be allocated on profitable sector and based on the rules of the market forces.

The International Financial Institutions suggest that stock market exchanges, as a major component of the liberalization and structural adjustment program (SAP) in the financial sector, be established in developing countries in order to bring economic development and efficient allocation of resources. To what extent it has done so is another issue, but the IFC states that it is heavily involved in developing capital markets in developing countries through technical assistance, direct investments (equity and loans) in financial market institutions, and its activities to stimulate portfolio investments. In recent years stock markets have started emerging in a number of developing countries.

However, there is no general agreement among researchers and policy makers on the capital markets of developing countries. Joseph Stiglitz (1994) has criticized financial liberalization on different grounds. His argument focuses on the prevalence of market failures in financial markets. He suggests that government intervention will not only make these markets function better but will also improve performance of the economy.

The other critics of the McKinnon and Shaw school employ a variety of models to demonstrate that financial liberalization may have negative effects on saving, investment, output, or economic growth. They argue that stock markets in developing countries may do more harm than good, leading to adverse real effects for capital formation and resource allocation. They claim that developing country stock markets are largely speculative, and

their volatility cannot be explained by market fundamentals because of information asymmetry problem, costly monitoring and enforcement mechanisms, and lack of sufficient number of informed investors. Furthermore, stock markets provide a vehicle for rapid inflows and outflows of capital, which may do more harm than good, leading to adverse real effects for capital formation and resource allocation.

Nevertheless, the proponents of stock markets emphasize the importance of having a 'developed' stock market in enhancing the efficiency of investment. A well functioning stock market is expected to lead to a lower cost of equity capital for firms. Continuous adjustment of share prices imposes control on the investment behavior of companies. Finally, stock markets can attract foreign portfolio capital and increase domestic resource mobilization, expanding the resource available for investment in developing countries.

1.1 Statement of the Problem

The liberalization of government policies, the greater freedom of the private sector in the economy, the policies of increasing deregulation of the economy and privatization are more than any thing else pushing the question of the establishment of a stock exchange market as a major instrument towards mobilizing "Capital" for the productive development of trade and industry.

The market size, liquidity, volatility, investors risk attitude, and infrastructural framework are the factors that affect the viable development of a stock exchange market. In addition information flows, disclosure requirements, auditing and accounting standards, and the existence of credit institutions have and important bearing on the development and operations of these markets. Besides, even healthy capital markets are not self sufficient and they heavily rely on a well functioning bank to process payments and act as custodians and money markets. Consequently absence or low level of infrastructural development, the low level of the market size, liquidity and professionals and volatility of the market are among the constraints for the viable development of the market. No doubt, these problems have not and will not deter the limited development of primary markets through the various techniques of floating a security issue.

The need for an organized and a well-developed stock exchange market is not questionable but how realizable it could be is that which requires critical examination. Currently there are some arguments among the public concerned as to when and how the stock exchange market in Ethiopia should be developed. Some are of the opinion that there is an urgent need for such a market and argue that it is conducive to facilitate the market now with the available infrastructure while others are skeptical over the timing and efficiency in the establishment of the market. Then, what are the justifications and the prerequisites for the development of viable stock market in Ethiopia?

1.2. Significance of the study:

The idea of stock exchange market is presently a pressing issue in Ethiopia. Some interested groups are even making their own "preliminary" preparations to peruse with the activities. Some are supporting it while others are arguing over the timing of the establishment of stock market in Ethiopia. By looking at the factors that are necessary for the development of stock exchange market in general and taking the lessons from sub-Saharan Africa countries, the paper envisages the viability of stock exchange development in Ethiopia. The study will make some contribution to the prevailing issue of national interest.

1.3. Scope of the study:

Currently the issue of stock exchange market in Ethiopia has reached at a peak, yet no agreement has so far been attained among the public concerned as to when and how the stock exchange market should be established.

This paper is devoted to the examination of the trends and lessons in the stock exchanges in emerging markets in general and the SSA in particular and seeks to make inferences about the viability of the market in Ethiopia. To address this issue it will be necessary to evaluate the role played by stock markets in promoting efficient investments. To this end the stock markets development of 22 sample countries from developed and emerging markets are measured and compared based on analysis of market capitalization, amount of

new capital raised through stock exchanges, the number of listed companies, turnover, regulatory framework, information disclosure, and the like.

1.4. Objectives of the Study:

The main objectives of the study are as follows:

1. To review the concept of capital market
2. To Examine the factors affecting capital market development
3. To look at the SSA Capital market and draw lessons for the development of stock exchange market in Ethiopia.
4. To evaluate the capital market development in Ethiopia
5. To assess the position of the National bank of Ethiopia on the establishment of capital market in Ethiopia
6. To identify the limiting factors to the development of Capital market
7. To identify the possibilities of tackling the constraints
8. To identify the need for securities laws

1.5. Hypothesis

Although the size of the market may be small and face a problem of liquidity, it is possible to start a Capital market in Ethiopia.

1.6. Methodology

The present study is a descriptive in nature and used secondary data produced by the IFC fact books and the various issues of IMF and World Bank. The source of the study is based on the periods 1990-1998. The following stock markets have been selected as a sample for study.

- a) 10 sub-Saharan and 3 North Africa countries
- b) 5 Emerging markets of other Regions and
- c) 2 advanced country markets to obtain global perspective

The sample markets are taken on the basis of simple random sampling technique. The classes of samples are based on their uniformity in their level of socio economic development and the SSA markets are used to make inferences to the viable development of stock market in Ethiopia. The Variables include measures of size (market capitalization and number of listed domestic companies) and liquidity (value traded as a percentage of GDP and turnover ratio) and draw lessons from the samples taken in relation to the subject under discussion.

1.7. Limitation

Due to absence of stock exchange market in Ethiopia at this stage, the study is based on the experiences of sub-Saharan African countries. With this respect the analysis made in the International Financial Corporation fact books and various issues of the IMF and World Bank are used as a basis.

1.8. Scheme of chapterization:

The entire study as been divided into six chapters. The first chapter deals with the Introduction where in statements of the problem, Significant of the study, Objectives of the study, Hypothesis and the Methodology used have been discussed. The second Chapter deals with the concept of capital market. In the third chapter Factors affecting capital market have been discussed. The fourth Chapter has been devoted to study the trend of capital market in SSA. The fifth chapter examines the possibility of capital market development in Ethiopian and finally the last Chapter deals with summaries, conclusions, and recommendations.

Chapter II Capital Market: A Conceptual Approach:

A financial system channels funds from lenders to borrowers; create liquidity and money; provide a payment mechanism; provide financial services like insurance and pensions; and offer portfolio adjustment facilities. Financial System consists of a set markets, individuals, and organizations who trade in those markets and the supervisory bodies responsible for their regulation. The participants in the financial system are savers (ultimate lenders); investors (ultimate borrowers); financial intermediaries; regulators (supervisory bodies for their regulation); brokers, dealers, and agents¹

Financial markets refer to organizational framework within which financial instruments or claims (treasury bills, government and corporate bonds, equities and the like) can be bought and sold. In these markets, lenders buy and sell existing liability from another lender. More frequently, however, a lender will buy an existing liability from another lender. In effect, this refinances the original loan, though the borrower is completely unaware of this 'secondary' transaction. The best-known markets are the stock exchanges in major financial centers such as London, New York and Tokyo.²

2.1. Why do financial instruments exist?

The need for financial instruments arise basically due to the presence of saving surplus and saving deficit units where both have an incentive to lend (get income) and borrow (fill the gap). Usually households or individuals tend to be on the saving surplus unit. Firms basically tend to be saving deficit units as they undertake investments. However to get a loan one has to be credit worthy and a saving deficit unit must find a saving surplus unit willing to lend. The following are the main reasons for the existence of different kinds of financial instruments.

1. Uncertainty - Given uncertainty, maturity becomes important. Borrowers and lenders have incentive to prefer different maturity. A borrower needs sufficient

¹ Howells, Peter and Bain, Keith, 'Financial Markets and Institutions', Pearson Education Limited, London, 2000, Pp: 1-3

² Ibid pp: 1-16

time to pay back to the lender but that has to be at a cost (high interest payment). A lender generally prefers short maturity. In order to meet maturity preferences of borrowers and lenders different types financial instruments exist with varying terms of maturity.

2. Existence of financial intermediaries - which function by lending in a form that meets preferences of borrowers and by creating a new type of financial instrument that suits the needs and preferences of surplus units.

2.1.1. Characteristics of financial instruments:

The features to be considered in financial instruments are:

1. Term to maturity - short term (bills), medium term, and long term (bonds and equities). The longer the term the higher the risk;
2. Marketability/ liquidity of the instrument- this is to indicate how quickly the financial instrument is convertible into cash. The presence of secondary market increases the liquidity of financial instrument;
3. Riskness-Government issued instruments are less risky.
4. Level and type of yield - that be may in the form of fixed interest (bank deposit), return (bonds), and dividend (shares);
5. The kind of issuer - which may be government, corporate bodies, and others;
6. Rights of the issuer to ask for early repayment of the loan;
7. Recourse available to the lender for demanding premature repayment;
8. Taxability and the level of tax; Dividends as opposed to interest are tax deductible.
9. Type of market - whether it is deposit market, bond market or equity market; and
10. Whether the financial instrument is traded in a primary or secondary market.³

2.2. The concept of capital market:

In literature, the terms capital market; stock market; financial market and securities market are interchangeably used. In the context of this paper financial instruments refer to those which are bought and sold in organized markets without their original issuers being

³ Gebre Hiwot Ageba, 'Financial Markets and Institutions, presented' in the F.B.E., Addis Ababa University (unpublished research work), 2002

involved again and capital (securities, stock or financial) markets refer to those markets for long term claims. What are then capital markets?

Capital markets are places where financial instruments are traded. The markets may include primary markets, and secondary markets. A capital market exists whenever financial securities change hands, whether on formal securities exchange or informally between buyer and any seller.

The International Encyclopedia of Social Sciences defines Securities markets as organizations of security holders and brokers whose operations reduce the cost of transferring ownership of government and corporate bonds and stocks and increases the liquidity of these assets.⁴

According to Brigham and Houston Capital markets are markets for long-term debt and corporate stock. They are markets where financial instruments of longer terms to maturity are traded or they are markets that provide funds for long-term use.⁵ Although there is no strict definition of 'long term' but the original maturity of the debts will usually be more than five years. The main instruments that are traded in these markets are bonds and equities or company shares.

Bonds:

A bond is a promise to pay a stated rate of interest for a defined period and then to repay the principal at the specific date of maturity. Many bonds are issued with a projected life or more than twenty years. Bonds differ according to their terms concerning provisions for repayment, security pledged, and other technical aspects. They represent the formal legal evidence of debt and are the senior securities of the firm.

⁴ 'International Encyclopedia of Social Sciences', Vol. 14, The Macmillan Company & The Free Press, New York, 1968, p: 136.

⁵ Brigham, Eugene F. and Houston, Joel F., 'Fundamentals of Financial Management', the Dryden press, Philadelphia, 1998, P: 111

Common Stock:

Common stock represents a share in the ownership of the firm. It has the last claim on earnings and assets of all other securities issued, but also has unlimited potential for dividend payment and capital gains through rising prices. Shares have no specified maturity but continue for, as long as the firm exists.

Preferred stock:

Preferred stock is a hybrid. It is similar to bonds in some respects and to common stock in others. Like bonds, preferred stock has a par value and a fixed amount of preferred stock. Preferred stockholders have preference over common stock holders (but not bond holders) as to after tax earnings in the form of dividends and assets in the event of liquidation. Therefore, in terms of risk, the preferred stockholder is in a less risky position than the common stock holder but in a more risky position than the bondholder. Preferred stockholders generally receive a greater rate of return on their investment than bondholders in compensation for the slightly greater risk they assume.⁶

2.3. Types of capital markets:

Before dealing into the discussion about the viability of stock exchange market, it is necessary to have an overall picture of the structure of capital markets. Capital markets consist of (1) primary markets and (2) secondary markets.

2.3.1. Primary Market: is a market in which corporations raise capital by issuing new securities to purchasers of (investors in) stock. The development of primary markets brings together those who want to make real investments with those who have real savings. Corporations can issue their stock of shares directly or through financial intermediaries.

2.3.2. Secondary Market: is a market in which outstanding securities are bought and sold by owners other than the issuers. Secondary markets involve brokers, dealers, and financial

⁶ Francis, Jack Clark, 'Investments: analysis And Management' McGraw-Hill, Inc., New York, 1980, pp: 9-19

intermediaries¹. Secondary markets lower the costs of issue and increases the liquidity of stocks, bonds, and other financial instruments. To enhance the liquidity offered by services of brokers and dealers, the regulators strictly regulate brokers and dealers to ensure disclosure of information, prevent fraud, and restrict trading based on insider information.

In the absence of secondary market, the primary markets would probably not exist or would be much smaller than they are. Added to this, secondary markets produce an extremely valuable commodity: information. Information and liquidity are really the products of secondary markets. Thus, the social function of secondary securities markets lies in their generation of tremendous amounts of information on the value of government debts, on the value of corporate bond and stock issues, and the like that are extremely important for efficiently allocating capital resources.

2.3.3. Capital Markets Institutions:

Brokers and dealers facilitate the exchange of securities in financial markets by matching buyers and sellers and improving the liquidity in the secondary markets. They are capital market institutions and facilitate the exchange of securities in financial markets by matching buyers and sellers and improving the liquidity in the secondary markets.

Capital market institutions are not financial intermediaries, because they do not acquire funds from savers to invest in borrowers; but simply make it easier in matching savers and borrowers in the financial system. Capital market institutions, in particular investment banks, brokers and dealers, and organized exchanges contribute to the efficiency of financial markets. These institutions reduce the costs of matching savers and borrowers and provide risk sharing, liquidity, and information services that enable capital market to function smoothly.

Investment Banking

An investment banker facilitates the issuance of stocks and bonds in the primary security market. An investment banker undertakes what is called an underwriting of new issue.

¹ Ibid. 21

Underwriting means that the investment banker normally guarantees to the issuing corporations at a fixed price and a fixed yield. The underwriting investment banker publicly announces the upcoming new issue in financial publication and else where. They earn income (spread) by underwriting a firm's new stock or bond issue at a higher price. In exchange for this spread, the underwriter assumes the risk of not being able to resell the securities to investors.⁸

Underwriting lowers information costs between lenders and borrowers because investment banks put their reputations behind the firms they underwrite. Investors are given confidence about a new issue. In addition regulations require issuers of securities to disclose information about the stocks or bonds to inform investors of risks and to prevent fraud.

Dealers:

Dealers are individuals or firms that act as market makers by quoting bids and offers on securities. Dealers trade between ultimate buyers and sellers - hold inventories of securities and sell them for higher price than they paid, earning the spread between the bid price and the asked price.⁹

Brokers:

When trading becomes sufficiently heavy, brokers begin to offer specialized search services to market participants. For a fee, brokers undertake to find acceptable trading partners and to negotiate acceptable transaction prices for their clients. Brokers are most likely to appear when there are economies of scale in searching. Since a broker is frequently in contact with many market participants on a continuing basis, he is likely to know what constitutes a " fair" price for a transaction. Brokers not only provide search services at a cheaper price than an investor's own cost of search, they also arrange

⁸ Miller, Roger Le Ray, 'Modern Money and Banking', McGraw - Hill, Inc., U.S.A., 1993, P. 101.

⁹ Kohn, Mier, 'Money, Banking, And Financial Markets', The Dryden Press, Chicago, 1991, p:152

transactions closer to the best available than is possible in a direct search market. Their extensive contacts provide them with a pool of information, which individual transactions could not economically duplicate. By charging a commission less than the cost of direct search, they give transistors an incentive to make use of that information.¹⁰

Clearing Banks:

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

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

EXCHANGES: Securities in a secondary market may be traded on one of the two ways; that is through:

1. Organized stock exchanges
2. Over the counter markets (OTC).

Organized exchanges or stock exchanges:

Securities trading have been traditionally conducted by a gathering of traders at a specific location, to quote buy and sell prices and to strike a deal when prices are matched. Thus

¹⁰Garbade, Kenneth, 'Securities Markets', McGraw-Hill Inc., New York, 1982, pp: 423-424

¹¹Pardy, Robert, 'Regulatory and institutional impacts on securities markets computerization', The World Bank, 1992, p: 27.

¹² Kohn, Meir, 'Money, Banking, And Financial Markets', The Dryden Press. Chicago, 1991,p: 157

exchanges do not set prices but provide a way for buyers and sellers of financial assets to trade by lowering information costs to savers. Early forums for such gathering were coffee houses and the like but these gradually gave way to the stock exchange floors around which traders gathered to trade the stocks listed on each post. Stock exchanges began as associations of such traders who wished to gather together to trade because of shared interests and mutual trust. Overtime, the exchanges came to provide a range of related services to their members such as clearance and settlement of transactions executed on the floor.¹³

Exchanges may be incorporated, or voluntary association of members. Details of the organization include a constitution, bylaws, and rules and regulations governing their members and their trading in issues listed pursuant to the listing policy of the exchange. Income of the stock exchange is derived from membership dues (initial fees and annual dues) listing fees (initial and annual), and charges for certain services.

Required investment includes that needed for real estate and the plant and equipment necessary to provide the facilities for members and other assets include the investment of surplus earning assets (government and other securities), which provide investment income and a cushion to absorb capital expenditures and any operating deficits pending adjustment.¹⁴

The reduction in the transaction costs is achieved by the specialization of (capital markets) these organizations in transmitting information relevant for the decision of potential buyers and sellers, by provision of standardized contracts with respect to their purchases, sales,

¹³ Woelfel, Charles J., 'Encyclopedia of Banking and Finance' 10th ed., IRWIN Professional Publishing, Chicago, 1994, P: 1087.

¹⁴ 'International Encyclopedia of Social Sciences', Vol.14, The Macmillan Company & The Free Press, New York, 1968. p:136.

and financing, and frequently by furnishing specialized facilities for execution of security transactions.¹⁵

Over the counter markets: Unlike the organized exchanges, OTC market is informal, and permits unlimited right of entry by securities and virtually free access of persons into the business of dealing in unlisted securities. The OTC differs from organized exchanges in that:

- It includes trading in all stocks not listed on one of the exchanges;
- There is no fixed schedule of fees for buying and selling securities; and
- Dealers more frequently buy and sell firm inventories and derive their profit from markups on this inventory.

2.4. The Rationale of capital markets:

Like all financial markets, capital markets link 'deficit units' with 'surplus units'. They provide a meeting place for investors who save and lend in view of financial returns and borrowers who want to invest money in business. The users of capital are the issuers of securities, whereas the providers of capital are the buyers of securities. Banks, of course, provide another meeting place for borrowers and lenders. Historically, in countries that witnessed the rise of securities markets, a division of labor in finance emerged with banks dealing in relatively short-term funds and the securities markets providing long-term funds.¹⁶

Capital markets contribute to development in that they increase savings and investment flows and make the allocation of these flows more efficient. In doing so, they reduce the cost of funds to borrowers and investors in real productive assets while increasing the returns to savers, lenders, and financial investors. They accomplish this by creating

¹⁵ Sylla, Richard, 'The Rise of Securities Markets' World Bank, 1995, pp: 2-3.

¹⁶ Sylla, Richard, "The Rise of Securities Markets', World Bank, 1995. p:2-3

liquidity and generating information, thereby encouraging people to save and invest more.¹⁷

They are also considered to improve corporate governance by monitoring managers and trading shares actively; they allow cash strapped governments to issue bonds, and they provide both investors and firms opportunities for pooling, financial resources and sharing risks.

The importance of capital markets in a country can be looked at from points of the economy and the society in general that is those who wish to invest funds through the market, and those who wish to obtain funds from the market.

The gains to the economy come from:

- An improved utilization of existing domestic saving and encouraging new savings
- Channeling these savings to where they can hopefully be used most efficiently
- Assisting in the privatization process
- Providing a market for corporate control; i.e. an opportunity for efficient firms to be taken over and run by more efficient managers

To savers who wish to invest the advantages include:

- Enabling them to spread their risk over a number of investments, the market allows portfolio preferences to be established
- An opportunity to earn higher rates of return from equity investment than available on alternative investment opportunities
- Providing a liquid investment opportunity, with stocks that can easily be traded in the market should cash be urgently needed
- An opportunity to invest in imaginative types of financial securities

For companies and others seeking funds, the advantages include:

- Access to investment capital
- An opportunity to expand the size of the business through acquisition without losing control of the business

¹⁷ Ibid p: 4

- An opportunity for fast-growing and young companies to obtain finance
- An opportunity to improve company finance gearing, and to be less dependent on bank finance
- An opportunity to become known to national and world investors.

With in a long-term perspective; Mansoor and Atkin also stated the following as the key roles expected to be played by stock markets in a given country.

1. By spreading the risks of long-term investment projects, the growth of stock markets can lead to a lower cost of equity capital and thereby stimulate investment and growth;
2. By imposing a degree of control over the investment behavior of companies through continuous monitoring of their share prices and thereby of the implied possibility of merger and takeover, stock markets can contribute to efficient investment;
3. By attracting foreign portfolio capital the expansion of stock markets can serve to enhance the supply of investable resources.¹⁸

However, an alternative Keynesian view is that since we live in an uncertain world where it is difficult to ascertain what the long-term prospects of investment projects are, price formation on the stock market is inevitably subject to speculation and may actually be dominated by it. Besides Keynes (1936) legitimized these concerns by likening the stock market to a gambling casino where price information is often dominated by speculators. He thought that if a nation left its investment activities to the vagaries of a casino, 'the job is likely to be ill-done'.¹⁹

Besides there are wide spread argument among economists or in the broader policy making community about the effectiveness and desirability of capital markets. The risk sharing and efficiency enhancing functions of capital market involve cost. The first is the agency cost

¹⁸ Dailami, Mansoor and Michael, Atkin, 'Stock Markets in Developing Countries', World Bank, 1990

¹⁹ Singh, Ajit, 'Journal of International Development', John Willey & Sons, Ltd., 1999. P: 350.

inherent in the separation of management and ownership. This arises from the institutional arrangement under which the shareholders bear the risk; management has control over investment and financial decision-making process. The possibility that managers may pursue goals of the capital market involves cost.

2.5. Efficient Market Theory

Markets in general are efficient when: (1) prices adjust rapidly to new information; (2) there is a continuous market in which each successive trade is made at a price close to the previous price (the faster that the price responds to new information and the smaller the differences in price changes, the more efficient the market); and (3) the market can absorb larger currency amounts without destabilizing the price.²⁰ An efficient capital market channels liquid capital quickly and accurately out of the stock of inferior terms to the better manufacturers. This reallocation of capital funds will materialize only if (1) the better manufacturing plant is able to obtain a fair appraisal of its product's value in the market so as to raise capital funds, and if (2) the market makers play fairly. Essentially a business requires two types of market efficiencies – external or pricing efficiency and internal or operational efficiency. External efficiency means that new information is widely, quickly and cheaply available to investors, and this information includes what is knowable and relevant for judging securities and is rapidly reflected in their prices. As a result of externally efficiency, the prices of a security should fully reflect available information. Efficient security markets are obviously very desirable because they provide capital when and where able business executives need it and reward the investors who provide the needed capital with capital gains. Internal efficiency becomes relevant when the cost and speed required to trade securities are reasonable so as eternally efficient markets would possibly allocate resources efficiently.²¹

Good information is needed to make choices among investment alternatives to be funded on the basis of expected return and risk, to monitor firms' behavior after funding, and to take appropriate corrective action if things are not going as planned. For all these reasons,

²⁰ Block, Stanley B., 'Foundations of Financial Management', Richard D. Irwin Inc., U.S.A., 1992. p:430

²¹ Francis, Jack Clark, 'Investments: Analysis And Management', McGraw-Hill, New York, 1980. pp: 60-61

financial markets require reliable company data, which in turn depends upon better accounting, auditing, and information disclosure rules.²² Full disclosure of information material to investors' decisions is the most important means for ensuring investor protection. Investors are thereby better able to assess the potential risks and rewards of their investments. Disclosure requirements, accounting and auditing standards should be in place and they should be of a high and internationally acceptable quality. There must also be adequate legal protection for both debtors and creditors.²³

2.6. Pre-requisites of sound Capital market:

There are two preconditions, which are basic building blocks of sound capital market.

1. Macro-economic situation which is conducive to the supply of good quality securities and sufficient demand for them; and
2. Infrastructure capable of supporting efficient operation of securities market.

In view of the first precondition, Robert Pardy points that where the macro-economy is conducive to profitable business operation, a sufficient number of sound businesses can develop to a stage where access to capital markets is useful for their continued growth, that can then offer their securities to the public, thus creating the capital market.

The second precondition is market infrastructure, which in essence provides:

- Certainty as to property rights and contracts;
- Transparency of trading and other procedures; and public disclosure by companies of all information relevant to the value of their securities;
- Protection against unfair practices by intermediaries; and
- Protection against the financial failure of intermediaries and market institutions such as clearing houses.

There are three types of market infrastructure, which attempt to directly enable the capital market to operate in an efficient, fair and stable manner.

²² Vittas, Dimitri, 'Financial Regulation Changing the Rules of the Game', EDI Development Studies, WORLD Bank, 1992:p:23

²³ Ibid: 31

1. **Institutional infrastructure-** which provides the operational basis for the market which involves intermediaries to provide trading, investment management and financial advisory services; market and market-related service providers for stock exchanges, over-the counter markets, market information services, transaction clearance and settlement systems, and securities transfer, registration and custody; and providers of ancillary services such as accounting and auditing, legal advice, and financial valuation and debt rating services.

2. **Regulatory infrastructure-** centers on the government body, which has the power and responsibility to supervise the market, but also includes self-regulatory organizations such as stock exchanges, accounting standards boards, and accounting and auditing professional associations and similar organizations. It also includes their rules and regulatory procedures and facilities such as stock exchange listing, and trading rules or accounting and auditing standards. Plus the monitoring and enforcement of these rules.

3. **Legal infrastructure-** provides the underpinning to the operational and regulatory infrastructure. It establishes the framework of property rights, contractual relationships, forms of incorporation, and rights and responsibilities of participants in the market. It also specifies the powers and responsibilities of government supervisory authority and self- regulatory organizations.²⁴

In the forgoing pages the concept of capital markets has been discussed. In this context, the next chapter deals with factors affecting capital market development.

²⁴ Pardy, Robert, 'Regulatory and Institutional Impacts of securities market computerization', World Bank 1991. pp. 2-6

Chapter III: Factors affecting the performance and growth of capital markets:

There are important factors that affect significantly the performance and growth of stock markets. These include mainly size, liquidity, volatility, agency cost, information and regulation.

3.1. Size:

Making a market for an individual security is costly. The costs include the time a market maker must invest in learning about the company and the time he has to devote to dealing in the stock; they also include the cost of financing the trading inventory.

Many of the costs of making a market are indivisible. Hence, it will not be worthwhile making a market unless there is going to be quite a lot of business. This requires the amount of the security outstanding to be large. As a result, small and short-term borrowers are again at a disadvantage. Because the potential volume of trading in their issues is small, a secondary market will not be made, and their debt will therefore be relatively illiquid. To compensate investors, the return will have to be higher, making direct borrowing an expensive way to raise money.

Thus the size of a stock market is important if it is to play a meaningful role in the economy. There are different measures that indicate how big a stock market is. Market size is positively correlated with the ability to mobilize capital and diversify risk. The membership size of a stock exchange or the number of brokers and dealers operating on an exchange is an important indicator of size. The number of domestic companies listed on the exchange is another measure. In addition market Capitalization or the number of outstanding shares quoted at current price is used as a measure of size.

3.2. Liquidity:

Unlike borrowers lenders obviously like to get their money back quickly and easily. These conflicting needs can be reconciled by selling the securities at the secondary market. Even then, there is no guarantee that the securities will get a good price at the time a lender wants to sell. It all depends on what potential buyers are willing to pay and as a result you may make capital loss (selling at less than the amount invested) or capital gain (selling at more than the amount invested).

The relatively long term of the typical direct loan makes liquidity a particularly serious problem. However, secondary market alleviates the liquidity problem of long-term securities. The existence of a secondary market for a particular security makes that security more liquid and therefore more attractive to lenders (of course the risk associated with the uncertain resale price remains). The greater the liquidity, the lower the return the issuer will have on the loan.

An active share market is characterized by "liquidity". In an active market buyers and sellers can often be matched and transfers may be made easily and rapidly. This reduces the shareowner's uncertainty regarding the transferability of his shares, because it creates an opportunity to convert his share investment into cash by selling it to one of the numerous bidders in the market.

Besides, prices are determined at the market on the basis of frequent interaction of supply and demand of securities. This allows the owner of securities to know the approximate market value of his investment. This established (though fluctuating) value and liquidity of the securities provides a "loan value" in which lending institutions such as Commercial banks may accept these active securities as collateral for loans at a lower margin of safety (lower risk).

Thus by reducing uncertainty and increasing liquidity, an active market increases the attractiveness of corporate shares as assets for individual and institutions having resources available for investment. However, illiquid securities may have no value as a collateral

against loans. Even if they are acceptable, banks may require a higher margin of safety. Thus the existence of an active market will influence the amount of new investment that will occur at any given time period.

3.3. Volatility:

There exists volatility in the capital market as a result of fluctuation of prices, which may be due to internal and external factors such as new product development and political uncertainties and the like respectively.

3.4. Agency Costs

Agency costs refer to costs created due to conflicts of interest. Conflicts between shareholders and managers arise because managers do not capture the full return of their profit activities. Thus they may be able to transfer firm's resources to themselves by indulging in personal benefits (corporate cars jets, representation allowances, residences etc) relative to the level that would maximize the firm value. This tendency of inefficiencies resulting from the conflict of interest between the manager and shareholders is reduced when the manager owns a certain proportion of the firm's equity. In addition with more debt the firm commits to making larger cash payments, decreasing the amount of idle or "free" cash available for wasteful expenditures by the managers. Thus, debt financing has also the cost of decreasing conflicts between managers and shareholder.²⁵

3.5. Information Asymmetry:

The key to dealing with risk is information. If the risk is too great, one may not at all want to make the loan. But some risk may be tolerable if the potential reward is sufficient. Gathering such information is costly in terms of time, energy, and money. It may also be hard to get all the information. There are some private information which borrower may not want to reveal.

a) **Adverse selection** - is a lenders problem arising from the hidden information the borrower or agent may have and as a result fails to distinguish the good risk applicants

²⁵ Demergu -Kunt, 'Developing Country Capital Structures and emerging Stock Markets' World Bank, 1992, pp: 9-11.

from the bad risk applicants before making an investment. In stock market, for example, if both x and y offer securities and y is in poor investment, the uninformed public wants to pay equal for both and as a result in lower price offer to x and good price to y which normally has lower cost to pay in the future. In bond markets, when y offers bonds at higher interest rate than x, the uninformed lenders about the high risk with the project will take the offer. Customers with risky investments may be willing to borrow at high interest rates - thus; the lenders may find it unprofitable to raise their interest rate to take advantage of excess demand.²⁶

b) Moral Hazard:

When those with critical information have interests different from those of decision makers, they may fail to report completely and accurately the information needed to make decisions. Moral hazard refers to the tendency of people to change their behavior in a way that leads to large claims /benefits and arises when lenders can not easily monitor (being costly) that funds received by borrowers are used as intended. In equity financing what if a company from whom a lender bought stocks declares that the investment does not make returns by investing the funds raised into something to benefit executives or the like.²⁷

Transaction Costs:

Brokerage Commissions, minimum investments requirement and lawyers' fees are all examples of transactions costs. There is obviously a need for a channel to match small savers and borrowers, and financial intermediaries have satisfied a need that financial markets are not filling. For example mutual funds sell shares to many individual savers and, in turn, invest in a diversified portfolio of bonds or stocks.

Reducing Transaction and Information Costs:

Financial intermediaries reduce transaction costs by exploiting economies of scale, the reduction of costs per unit that accompanies an increase in volume. Transaction costs, in terms of lawyers' fees, time and energy (trouble), per unit of investment decline as the size

²⁶ Gebre Hiwot Ageba, 'Financial Markets and Institutions', presented in the F.B.E., Addis Ababa University (unpublished research work), Addis Ababa, 2002 pp: 253-255.

²⁷ Ibid. Pp: 257-258.

of transactions increase, spreading legal costs among many individual savers so that each saver who wants to invest does not have to seek costly, customized legal advice, and use of computer services that financial services such as automatic teller machine networks.²⁸ Monitoring the behavior of the borrower is vital so as to assure the terms of the contract are honored. Thus external auditor should certify regular financial statements and this makes monitoring costly. Besides there is also a free-rider problem because if a lender pays the cost of getting the information about the borrower, negotiating and writing a loan contract and monitoring his behavior, then someone else can come along and lend that borrower quite safely without incurring all these costs. Thus when costs are born by the individual, the benefits are shared by others. As a result each potential lender will wait for some one else to go first, and the loan may never be made.²⁹

The costs of adverse selection to savers and borrowers make it difficult for good borrowers to raise money in financial markets and lower returns obtained by savers. Information costs can be reduced by government regulatory requirement for direct information disclosure for firms that desire to sell securities in financial markets, and by focusing on borrowers collateral and net worth which makes it more costly for borrowers to take advantage of their asymmetric information.³⁰

The Moral hazard problem in equity financing could be reduced through audits using standard accounting principles and enacting laws against misreporting. Debt financing has lower monitoring cost than equity financing because monitoring can be made through regularity of repayments of the principle and interest. Yet this does not eliminate moral hazard and it can be reduced through restrictive covenants in the debt contract, minimum level of collateral and net worth of the borrower.³¹

²⁸ Gebre Hiwot Ageba, 'Financial Markets and Institutions', presented in the F.B.E., Addis Ababa University (unpublished research work). 2002 p.252

²⁹ Kohn, Mier, 'Money, Banking, And Financial Markets', The Dryden Press, Chicago, 1991, PP: 36-37

³⁰ Ibid. p: 256.

³¹ Ibid. P:260

In addition, the securities must be sold through a dealer (underwriter), and investment firm charged with providing full and unbiased information about the securities it sells. The underwriter takes every action to carry out its responsibilities seriously.³²

Rating agencies being specialists help in investigating the creditworthiness of corporate borrowers and in investigating and monitoring their performance. The agency arrangements greatly reduce the information, negotiation, and monitoring costs for the individual lender, but only at substantial cost to the borrower. The borrower must prepare the financial statements, pay the rating fees, and the underwriting costs, and eliminates the free-rider problem. The cost of a public issue includes underwriter's fees, legal fees, accounting fees, printing costs, debt rating. The costs are also indivisible. They depend little on the total amount to be borrowed. As a result, this sort of direct borrowing by public issue will be unattractive unless the amount to be borrowed is large and the term of the loan long.³³

3.6. Regulation:

Stiglitz (1994) argues that there is an important role for government intervention and even financial repression in financial markets due to pervasive market failures. An essential function of financial markets is collecting, processing, and conveying information for allocating funds and monitoring their use.³⁴ The general trend for regulation is based upon the existence of various types of market failure, notably the existence of asymmetric information. Arguments against regulation are centered on the ideas of moral hazard, agency captures and compliance costs. Regulation is assumed to increase the costs of entry and exit for new firms and thus inhibit competition.³⁵

³² Kohn, Mier, 'Money, Banking, And Financial Markets', The Dryden Press, Chicago, 1991, PP: 36-37

³³ Ibid., pp: 38

³⁴ Stiglitz, Joseph, 'The Role of the State in Financial Markets', Proceedings of the World Bank, 1993.

³⁵ Howells, Peter and Bain, Keith, Financial Markets and Institutions, Pearson Education Limited, London, 2000, P: 361

However, none of the criticisms of regulation provide sufficient reason by themselves to reject regulation, though they point to matters and decisions over the amount and form of regulation. With respect to the form of regulation, it is over who should carry out the regulation- the government or self-regulation. Proponents of self-regulation state that the self-regulator has a commercial incentive to protect own reputation and members are prepared to pay to achieve this. Added to this, practitioners understand the needs of the self-regulator and are likely to interfere less with its efficient functioning. However self-regulation should be supported by government regulation.

An appropriate regulatory framework for a capital market is needed to increase investor confidence. Regulation is unlikely to be satisfactory if left internal to the market. The experiences of many countries show that some government guidance is necessary. The regulatory regime should focus on three main areas: the new issues market and related disclosure, accounting and listing standards; secondary market trading activities, including market surveillance and enforcement; and supervision of market practitioners, through registration and prudential standards.³⁶

3.7. The Role of Governments:

To maintain and augment capital markets, governments have to take various legal steps to ensure that the markets are fair and honest places where small savers and big investors alike can put their funds. Laws forbidding fraud and price manipulation should be passed and enforced. Even in societies that are highly market oriented, only governments can provide two sorts of public goods: Rules to make markets work efficiently and corrective interventions where there are market failures.³⁷ Without the institutions and supportive framework of the state it will be difficult to create and enforce law and order, ensure property rights as a result production and investment will be deterred. This is due to the high 'transaction costs' (cost of arranging, monitoring and enforcing contracts), which will inhibit such activities.³⁸

³⁶ Chuppe, Terry M., Atkin, Michael, 'Regulation and Securities Markets', World Bank, Washington, 1992.

³⁷ The World Development Report', World Bank, 1992, p: 6

³⁸ Vittas, Dimitri, 'The Impact of Regulation on Financial Intermediation', World Bank, 199, p: 31

The two kinds of government intervention in securities capital markets are supervisory and developmental. Government may supervise market through laws, regulations and supervisory authority with the goal of ensuring that it operates in a fair, efficient and stable manner. However poor governance will create hostile environment for development and this will be reflected in the form of excessive rule, regulations, licensing requirements, non transparent decision making and so forth, which impede the functioning of the market. Government may also implement policies designed to develop the securities market through both incentives and compulsion with the goal of ensuring that capital raisers have access to a range of capital instruments and trading and trade related facilities adequate for their needs.³⁹

Most of the worst abuses in the securities markets in the U. S occurred before any Federal Security Regulation existed. A number of states had passed the so-called blue-sky laws, but they were deficient in many respects. Often by the time a state got around to prosecuting for sales of worthless or fraudulent securities, the promoter had long since left the state and was not, therefore, subject to its jurisdiction. Mainly because of a lack of effective Federal controls, scandalous activities using 'wash sales', 'corners on the market', 'churning', 'pools', and 'excessive pyramiding of debt', preceded the great crash of the stock market, which lasted from 1929 to 1933. The U.S. securities Act of 1933 and 1934 issues a regulation for the registration of new issues with the objective of providing the potential investor or public issues in primary market with full information needed to make disclosure of the information about new securities. To achieve this objective, the Securities Act specifies that the issuing firm and the investment banker must register the issue. Registration involves filing audited financial statements, other information about the firm, and information about underwriting agreement with the SEC. Information in the registration includes:

1. A statement as to the nature of the issuer's business, its organization, and its financial structure (prospectus).

³⁹ Pardy, Robert, 'Institutional Reform in Emerging Markets', World Bank, 1992, p:22

2. A list of directors and officers of the issuer.
3. Details about the issuer's arrangements for bonuses, stock options, and profit sharing.
4. Contracts the issuer may have with subcontractors, consultants and others.
5. Audited balance sheets and income statements of the issuing firm for several preceding year.
6. Copies of issuer's articles of incorporation, bylaws, and agreements with investment banker.
7. A statement about other securities the issuer has outstanding and their rights
8. A statement about the terms on which the issuer offers its shares to the public, and
9. Any other information that SEC may require and may materially affects the value of the securities.⁴⁰

Similarly taking the case of the Nairobi Stock Exchange the regulatory requirements for eligibility conditions are stated as follows.

1. Company to be listed must be limited by shares and registered;
2. Company must have minimum authorized, issued and fully paid up share capital of a minimum level;
3. Securities to be issued must be freely transferable and not subject to any restrictions or marketability or pre-emption rights;
4. Company must have published audited financial statements for an accounting period ending not more than 3 months prior to the proposed date of offer or un-audited interim financial statements if more than 3 months but not more than 6 months have elapsed;
5. Audited reports must not contain emphasis of matter or qualification in this regard;
6. Company must not be in breach of its loan covenants particularly in regard to the minimum debt capacity;
7. Should have made profits in at least 3 of the last 5 years preceding the issue;
8. Should not be insolvent;

⁴⁰ Francis, Jack Clark, 'Investments: Analysis And Management', McGraw-Hill, Inc., New York, 1980, pp: 78-79

9. Total indebtedness, including the new issue, shall not exceed 400% of the company's net worth's at the date of latest balance sheet;
10. Ratio of funds generated from operation to total debt for the three trading periods preceding the issue shall be maintained at a weighted average of 40% or more (requirements of solvency and adequacy of working capital);
11. Directors and senior management must have collectively appropriate expertise and experience for the management of the business;
12. Must ensure that each director is free of any conflict of interest between his duties to the company and his private interest;
13. If a bank or insurance guarantee by a bank or insurance company, the consent of the central bank or commissioner of insurance;
14. When there is guarantee by a bank or insurance company, the consent of the central bank or commissioner of insurance;
15. When there is a guarantor, a financial capacity statement duly certified; and
16. Information memorandum or prospectuses approved by the capital market authority.⁴¹

Thus on view of establishing a viable capital market in Ethiopia, firms that will be legible to participate in the market should be screened by setting regulatory institutions and regulations.

3.8. Stock Market Development Indicators

There are various indicators of stock market development but for the purpose of this paper the measures taken include: (a) market size, (b) market liquidity, (c) market volatility, and (d) regulatory and institutional development.. For analysis of the samples under considerations I have used the IFC's Emerging Markets Data Base and the International Financial Statistics of the IMF.

⁴¹ Gebre Giwot Ageba, 'Financial Markets and Institutions', presented in the F.B.E., Addis Ababa University (unpublished research work), 2002

A) Market size:

- 1) Market Capitalization (Market Value) = Share Price x number of shares outstanding
- 2) Listed domestic companies = The number of domestically incorporated companies listed on the countries stock exchanges at the end of the year. However, this indicator does not include investment companies, mutual funds, and other collective investment vehicles.

The market capitalization ratio is the value of listed shares divided by GDP and this ration is used by anlysisits to measure the market size. In terms of economic significance, the assumption behind market capitalization is that market size positively correlated with the ability to mobilize capital and diversify risk.

B) Liquidity:

This refers to the ability to easily buy and sell securities. Liquidity has three dimensions: 'Time'- the speed with which as asset can be exchanged for money; 'risk'- the possibility that the asset may have depreciated in value or that the issuer may have defaulted in some way in on its terms; and 'cost'- the pecuniary and other sacrifices that have to be made in carrying out exchange.

Liquidity indicator is meant to measure across countries and since data is very limited the ratio of total value traded to GDP and turnover ratio are used as a measure. The total value traded ratio measures the organized trading of equities as a share of national output and therefore should positively reflect liquidity on an economy as a whole. The second measure of liquidity is turnover ratio where high turnover indicates low transaction costs and the vice versa.

- 1) Value Traded = The total value of shares traded during a period.
- 2) Turnover ratio = The total value of shares traded during the period divided by the average market capitalization for the period.

This is meant to measure liquidity across countries and since data is very limited the ratio of total value traded to GDP and turnover

3) Average market capitalization

$$= \frac{\text{Begin. Value of current period} + \text{Ending value current period}}{2}$$

2

C) Volatility;

This indicator is a twelve-month rolling standard deviation estimate based on market returns. Although greater volatility is not necessarily a sign of more or less stock market development, it is sometimes referred "less volatility" as reflecting "greater stock market development."⁴²

D) Regulatory and Institutional Indicators:

Seven regulatory-institutional indicators are given. The first indicator shows whether the firm listed in a stock market publishes price-earning information. The IFC gives P, C, and NP, which indicate the information is published, comprehensive and published internationally and not published. . The second measures accounting standards. The IFC assigns values of G, A and P for countries with good, adequate and poor accounting standards. The third indicator measures the quality of investor protection laws as judged by the IFC, where G, A, and are used to indicate good adequate and poor investor protection laws. The fourth indicator shows whether the country has a securities and exchange commission or not. The fifth, sixth, and seventh indicator measure restrictions on dividend repatriation by foreign investors, capital repatriation by foreign investor, and domestic investments by foreigners. The IFC assigns values 0, 1, and 2 indicating whether capitals flows are restricted, have some restrictions, or are free, respectively.

After dealing with the factors affecting capital market development and the indicators of measures of level of the market development, the next chapter deals with the trend development in the Sub Saharan African countries.

⁴² Demergu-Kunt and Levin, Ross, ' Stock Market Development and Financial Intermediaries', World Bank, 1995, p: 5

Chapter IV: Capital Market Development In Sub-Saharan countries - A Trend Analysis:

Many African countries began to reform their financial sectors as a part of the IMF/World Bank Structural adjustment programs in the 1980s and 1990s and as part of this process; some countries established or expanded existing ones. Ducker (1996) noting several African countries establishing stock exchanges despite their weak private sectors, observed stock exchanges had become the 1990s equivalent of National Anthems and Flags in Africa.⁴³ Countries with markets in the early stage of development consist of few quoted companies, small capitalization, high concentration, low liquidity, high volatility, and comparatively rudimentary institutional settings, which include among others several African countries (Cote d'Ivoire, Kenya, and Zimbabwe).⁴⁴

Further, Yishak quoting Jefferis (Yishak: 2000) stated that stock market development in Africa is incomparably low and exists only in few SSA countries. The markets also tend to be narrow limited both geographically and in terms of customers.⁴⁵

Stock Markets in Sub-Saharan countries and in selected developing and advanced countries:

The tables 1, 2, 3, and 4 provide information on the stock market development in (a) African countries in the 1990s; (b) for comparative purposes on some leading emerging markets from other regions; (c) to obtain a global perspective two advanced country markets, Italy and the UK. Data is provided on the following variables: market capitalization in absolute terms, as well as relative to GDP; trading value and the turnover ratio, i.e. trading value expressed as a proportion of market capitalization; and number of listed companies.

⁴³ Singh, Agit, 'Journal of International Development', John Wiley & Sons Ltd., 1999, p.345.

⁴⁴ Papaioann and Lawrence, 'The Internationalization of emerging Equity markets', Finance and Development 1993, P.30

⁴⁵ Yishak Mengesha, 'Prospects of Securities market in Ethiopia' Mekelle University, Mekell, 2000, p: 2

4.1. Size

The table No 1 shows that the South African stock market size as measured in terms of market capitalization is ranked 17th in the world of the total market capitalization of emerging markets in 1998. However, market capitalization of the total sub-Saharan countries ranked least of the other emerging capital markets' capitalization. It is important to note that although there is an increasing trend in the number of listed companies, market capitalization and turnover in the periods 1990-1998 relative to all emerging countries has decreased from 29.9% in 1990 to 13.7% in 1998. And relative to developed markets and to all markets it has decreased from 1.6% to 1.1% and from 1.5% to 1% in 1990-1998 respectively.

The size of SSA markets is measured in terms of market capitalization as a percentage of GDP in the periods 1990-1997. This indicator assumes that the stock market size is positively correlated with the ability to mobilize capital and diversify risk. On this basis, countries like South Africa, Mauritius, Morocco, Egypt, Zimbabwe and Namibia are considered to have relatively good market size which have registered in 1997 179.8%, 37.8% 36.3%, 27.6% 22.1% and 21% of GDP respectively

In terms of number of listed companies, the size of African Stock Exchange ranges from the smallest to one of the largest in the world. Based on the end of 1998 levels Egypt and South Africa ranked 9th and 17th in the world, in number of listed companies. Thus in the same year Egypt and South Africa had 861 and 668 listed companies. Generally this number has been increasing over the continent and it primarily comprises banking, insurance, mining companies, cement industries and plantations.⁴⁶

There are, however, many examples of failed efforts to develop stock markets. In the early-to-mid 1990 attempts to develop stock markets in the Gambia and Zambia did not prove successful. These countries built stock exchanges and provided people to staff them. There

⁴⁶ Emerging Stock markets Fact book, International Finance cooperation, Washington, D.C., 1998

were, however, so few listed companies and so little market exchanges that these stock exchanges could not generate the fees to be self-sustaining.⁴⁷

4.2. Liquidity

To look at liquidity of African stock exchange markets, the value-traded ratio is used as a measure. Value traded as a percentage of GDP indicates that with the exception of South Africa and Egypt (30.4% and 22.3% respectively), the other markets do not have satisfactory liquidity.

The other measure of liquidity is the turn over ratio. The turnover ratio is computed by dividing the total value of trades by GDP and is used to measure liquidity, volatility and transaction costs in a particular stock exchange market). From the point of African markets, this parameter indicates that South Africa, Egypt and Morocco stock exchanges have trading size of 34%, 31.6% and 17.6% respectively which can reasonably lower transaction costs, and increase liquidity while others are characterized with thin and volatile markets.

4.3. Volatility:

High price volatility in emerging markets may stem from small-market effects and informational imperfections. With few traders occurring, information about stock value and therefore stock prices tends to be noisy. Moreover, limited reporting requirements in many markets mean that investors typically have less information about firms and receive less frequent updates than do investors in industrial markets.⁴⁸

The risk-rating index used by institutional investors places Africa as the most risky region in the world. Economic transactions in the regions are conducted in highly uncertain and risky environments, which engender eminently more volatile returns to investment and income streams than in other parts of the world.⁴⁹ Consequently most of African exchanges are relatively illiquid (In 1995, 8 out of the 12 most illiquid exchanges in the

⁴⁷ World Development Report, 'Financial Systems', World Bank, 2002. P: 78.

⁴⁸ Buckberg, Elaine, 'Emerging Stock markets and International Asset pricing', the World Economic Review, Vol. 9. No1. , World Bank, 1995 (January). P.52.

⁴⁹ Nissanke, Machik K., 'Financing Enterprise Development And Export Diversification in SSA', UNCTAD, U.N., Geneva, 1998.

world were in Africa). Sales turnover relative to market capitalization of most African markets was less than 10%.⁵⁰ However, trading volume and liquidity for the continent has been increasing over the periods 1990-1998.

4.4. Regulatory and Institutional Framework:

Table 6 summarizes the institutional and regulatory indicators of the samples undertaken. The indicators are available on an annual basis and for the purpose of this paper information at the end of 1994 for sixteen countries is considered. There are of course differences among countries and indicators. For example, Brazil like the other countries allows foreign capital inflows and outflows but P/E yield is not published. All countries meet the annual disclosure requirements while there are variations on the issue of interim financial statements. Indonesia has poor accounting standards; South Africa, Brazil, Chile, Korea, and Malaysia maintain quality accounting standard leaving the rest with adequate standard. Lastly, all countries maintain investor protection mechanism with majority having a functioning Securities Commission or similar government agency on regulating market activity.⁵¹

Generally both self - regulation and government regulation are exercised in Africa stock exchanges. Botswana, Morocco and Swaziland rely entirely on self - regulation. Namibia and Kenya are largely based on self - regulation with some oversight supervision from government bodies.⁵² While most other African countries stock exchanges have a regulatory authority. Other than South Africa, the most significant markets in Africa are those of Nigeria, Zimbabwe, Egypt, and Mauritius.

Low income, inadequate laws and regulations, information problems, corruption and lack of enforcement are the factors that deter the development of capital market in Africa.

⁵⁰ Tadeos Hargework, 'Conditions for fostering Stock market Development in Ethiopia', proceedings of a Seminar 21-22 July 2000, Mekelle University, Mekelle, 2000, p: 47.

⁵¹ IFC Fact Books, 1993 - 1997

⁵² Tadeos Hargework, conditions for fostering Stock market Development in Ethiopia, proceedings of a Seminar 21-22 July 2000, Mekelle University, Mekelle, 2000, p: 48

Then what lessons can be drawn from the stock markets in SSA? In Terms of size and liquidity the SSA stock exchange markets are at the stage of low level of development overwhelmingly dominated by South Africa and Egypt (number of listed companies). However, trend analysis of the periods under study indicates that there is an improvement in both aspects in all the SSA markets.

Ethiopia is a country with similar level of social, economic and infrastructural development with SSA. It is understood that the banking industry cannot fully meet the long-term financial demand for investment. If well-developed stock exchange market emerges it will fill the gap left by the banking industry. Experiences of SSA stock exchange show us that it is viable to develop stock exchange market in Ethiopia, but the market is expected to be small in size, illiquid and volatile and the banking industry should develop so as it could more accessible to the financial needs of the investing public.

2.5. Foreign Capital Inflow:

Although factors such as policies, institutional weaknesses, and political instability are stated as the shortcomings developing countries in terms of foreign capital attractiveness, yet policies and institutions in industrialized countries have a bearing on FDI flows.⁵³

Developing countries can reduce the level of risk attached to external capital inflows and secure the benefit of technology and expertise transfers in expanding the amount of direct investment (equity for of investment) in total external financing.⁵⁴ Besides foreign direct investment has the advantage of providing employment opportunity and tax revenue to a given country. Given that equity investment is desirable there is a question how developing countries might attract it and use it effectively. Countries with stable economic and political environments are the most successful in this regard. To attract direct investment it may be appropriate to offer inducements of various kinds.

⁵³ Bachmann, Heinz B. , *Industrialized Countries Policies Affecting Foreign Direct Investment in Developing Countries*, Vol. I, The World Bank, Washington, D.C. , 1991.

⁵⁴ World Development Report, World Bank, 1985, p: 134

Policies in industrial countries are also important for encouraging equity flows; liberal trade and industrial policies are most conducive to direct investment in developing countries. Foreign portfolio investment might be stimulating by removal of restrictions, restrictions, regulations and tax barriers that impede investors' access to domestic stock markets. Further more, major indigenous corporations might be also permitted to list their shares on international stock exchanges.

Table 5 provides information on private capital flows to individual African countries during the 1990s. Since only a small number of African countries have stock markets, the table shows that most African countries did not attract significant portfolio capital flows. Further, South Africa received most of the region's portfolio flows followed by Egypt, Morocco, and Ghana. Sub-Saharan Africa's record as regards the foreign direct investment inflows is relatively much better, both in terms of aggregate investment, as well as its distribution among countries. Nevertheless, it has been estimated that between 1990 and 1997 the sub Saharan countries received a cumulative foreign direct investment of \$ 23 billion, less than 5% of this total for all developing countries. Moreover 70% of the region's foreign direct investment went to oil producers (Angola and Nigeria) and to Egypt, Morocco, Ghana, Uganda and South Africa.⁵⁵

According to Getachew since the issuance of private investment code in July 1992 and up to January 1999 a total 5076 investment projects with an estimated capital of 47.6 billion Birr have been licensed where 3.5% belongs to foreign investment.⁵⁶ Experiences of SSA countries foreign capital flows are mainly dominated by foreign direct investment and Ethiopia should create an environment that is favorable for foreign direct investment and the policies adopted should not negatively discriminate them. Besides the National Bank of Ethiopia's regulatory and supervisory capacity should be developed so as it could be able to carry out its responsibility of possible financial crisis.

⁵⁵ Financial Times, June 1998

⁵⁶ Getachew Belay, Private Sector in Ethiopia vis-à-vis the Need ..., proceedings of a seminar 21-22 July, Mekelle University, Mekelle, 2000, p: 69

In the foregoing pages a trend of capital market development in sub-Saharan countries has been discussed. In this context the next chapter has been devoted to study the possibilities of capital market development in Ethiopia.

Chapter V:

Capital Market Development In Ethiopia - A Survey Analysis

A proper stock exchange has never been developed so far in Ethiopia. However, prior to the 1974 revolution there were investments in stock of shares and the first institutional arrangement for share dealing was established in May 1960 when the then State Bank of Ethiopia formed share exchange department in order to stimulate trading and holding of shares. The formation of the department helped to facilitate share trading and build public confidence as well as market stability. The bank used to invite depositors to participate in the ownership of several listed companies. The bank also used to offer loans against shares pledged as collateral by suitable borrowers.

An organized share-market can be traced back to the public offering of shares in HVA-Ethiopian (Previous Producer of Wonji sugar) which occurred between January and March 1959 and which resulted in the raising a capital of Eth \$2.5 million. For the first time in its history the bank acted as a subscription agent, providing HVA with facilities through which the public could obtain its shares and thus participate in its capitalization. The size and success of the HVA brought a significant public interest in shareholding.

On 9 Feb 1965 a share dealing group was established and the role of the State Bank of Ethiopia was taken over by the Commercial Bank of Ethiopia Share Co., which used to serve as share registrar and subscription agent for the companies. The Ethiopian Investment Authority on the other hand used to provide an underwriting service.

The group adopted its own rules and regulations pertaining to listing requirements, disclosure and group behavior in general. The rules on disclosure require listed companies to adhere to the release of information pertaining to the operation of their companies. Moreover establishment of a company in accordance to the Commercial Code 1960 was a

pre-requisite that listed companies were required to abide by.⁵⁷ The share-dealing group continued its operations until the popular revolution of 1974.

With the emergence of the Dergue Regime to power in 1974 and its adoption of socialist system (central planning), all privately owned major economic units including all financial institutions were nationalized in 1975. This led to the deteriorating performance of the Ethiopian economy for years. After the downfall of the Dergue Regime (1991), the TGE launched a new market economic policy in 1992. In order to develop a new economic management intended to stabilize reform and restructure public enterprises, proclamation No 25/1992 was issued. This provides the legislative basis for the implementation of public sector reforms, divestiture and privatization.

The financial reforms and liberalization undertaken include elimination of priority access to credit; interest rate liberalization; restructuring and introduction of profitability criteria; reduced direct governance control of financial intermediaries and limits on central bank and banks loan to the government; enhancement of the supervisory, regulatory and legal infrastructure and power of the central bank allowing private financial intermediaries; and introduction of treasury bills auction markets.⁵⁸

Given the prevailing shortcomings, the bank base finance could not fully satisfy the requirements of investors. This raises the issue of capital market, which facilitates resource allocation and governance and control. The allocation function includes mobilization; pooling and sharing risk; and facilitating capital inflow. The governance function includes gathering, processing and aggregation of information; monitoring and control; and contractual efficiency.⁵⁹

⁵⁷ Von Pischke, J.D., Shares and Share Trading in Addis Ababa, College of Business Administration, H.S.I University, Addis Ababa, 1968.

⁵⁸ Gebre Hiwot Ageba, An Analysis of Financial Sector and credit policies during the derg period and post derg period, Ethiopian Journal of Economics, Volume no.1, April, 1997.

⁵⁹ Gebre Hiwot Ageba, The Case of Capital Market in Ethiopia, Proceeding of a seminar , Makalle University, Makalle,21-22, July 2000. p:56

However, in the absence of well-functioning capital markets there will be three types of imperfections: (a) opportunity for risk diversification will be limited; (b) firms will be unable to achieve optimal capital/financing structure (internal finance, equity finance, debt finance, etc.) in view of conflict of interest between managers and customers and suppliers, and between different classes of investors of the firm; and (c) information available about firms to creditors and investors will be less.⁶⁰

Then how can a viable capital market be developed in Ethiopia at this moment? And who should be responsible initially to take care of it? There is a group which reiterates that stock exchange market can be established in Ethiopia now and among others would contribute towards the efficient allocation of the country's invisible resources; help domestic savings; enable enterprises raise capital readily for expanding their operations; expand the ownership base in the economy, encourage transparency among commercial organizations; encourage foreign investment, speed up privatization process; and facilitate share trading by providing an organized market.

As opposed, the other group argues that it will not serve the interest of the large investing public, because of the absence of professionals to serve the organized market, legal and regulatory framework, developed accounting and auditing standards and practices and the like.

However, a number of enterprises are presently emerging in Ethiopia by raising external financial resources (equity etc.). Then it can be believed that capital market prevails at its rudimentary stage but the question lies whether the legal, institutional and regulatory framework are conducive for the viable development of a well functioning capital market. Even if the infrastructural framework were there would the market accommodate sufficient participants and be liquid? Then the market size and liquidity, and infrastructure are

⁶⁰ Gebre Hiwot Ageba, The Case of Capital Market in Ethiopia, Proceeding of a seminar, Makalle University, Makalle, 21-22, July 2000. p:51

considered as the features for evaluating the viable development of stock exchange market in Ethiopia.

5.1. Size and Liquidity:

The size and liquidity of the market is influenced by the supply and demand of shares. On the supply side, bond markets have tended to develop because of the government's needs to raise non-inflationary finance. However government bonds are inaccessible to the large inviting public but to institutional investors like the pension authority because of their size.

The privatization process through issuance of stock of shares which is underway, the existing share companies, the establishment of new investments through issuance of stock of shares and the issuance of government securities are the potential supply for securities in the market.

The demand for shares may come from various sources, which may be individuals and/or institution. Boosting domestic demand for securities and boosting securities trading will require stable economic policies to raise savings as well as the emergence of institutional investors. However, individuals demand for long-term investment may be very low as a result of being risk averse, low income and information asymmetry. The demand from the public enterprises such as banks, insurance companies, and the Pension Fund Authority is so far reflected in the government securities but their investment on private securities will require further development management capacity and autonomy in their respective enterprises. However, the trend of SSA stock exchanges shows that the market is small in size and less liquid but improving through time. Then, even if the size of the market may be small and less liquid, a stock exchange market can be developed in Ethiopia.

5.2. Regulation:

The Ethiopian financial intermediaries and markets like any financial intermediaries in the world have to be subject to extensive regulation. The main rationale for regulation is the existence of market failure in financial systems arising from externalities, market power and information problems.

Externalities include the risk of systematic failure (that is, the risk of failure of one or more institutions as a result of the actual or threatened failure of another), the infection effect (that is, the general lowering of standards and prices caused by excessive competition). The basic problem may arise from informational asymmetries between the suppliers and users of financial services.

Further, perfect competition is not self-sustaining. If entirely left alone, the traders would find it to their advantage - certainly in the short run - to form coalitions with a view to exercising market power. Public interest would be hampered if businessmen get together without rules to preserve competition. These laws derive their economic justification from inherent vulnerability of competition. Thus self-regulation by exchanges cannot be a complete answer, no matter how competitive the activity on their trading floors. The exchanges themselves are monopolistic institutions, which restrict membership and deny floor access to non-members. The merchants may be persons of integrity, but in the final analysis their responsibility is towards their fellow members not towards the public at large. Hence self-regulation by exchange should be supplemented by government regulation.⁶¹

The Ethiopian Commercial Code that is issued 40 years back requires to be updated so as it could cope up with the prevailing economy of the country and the globalization of the world economy. Thus in line with the increasing liberalization and the increasing participation of the private sector, the government has noted that capital market is prevalent and the Research Institute of Law and Justice is undertaking studies to make further refinement of the Commercial Code so as to facilitate the viable development of capital market of Ethiopia.⁶² But it is not only the revision of the law that is needed but also the capacity and commitment of enforcement.

⁶¹ Houthakker, Hendrik S., *The Regulation of Financial Markets, Principles and Applications*, P: 481 Journal of Finance, Vol. 37 1982

⁶² Abiotawi Dimocraci, quoting Dr. Fasil Nahom director of the institute: Hidar 5-11/1994 No. 404 12th. Year.

The self regulatory regime proposed by the Steering Committee for the formation of the Addis Ababa stock exchange has already set draft rules and regulations that include among others for adequate disclosure, accounting and auditing standards, listing requirements, membership requirements, code of conduct for membership and measures for controlling price manipulation and fraudulent practices. The National Bank of Ethiopia this time has also developed a proposal through its task force for the development of stock exchange and accordingly a tentative draft regulation, listed requirements, lists of proposed companies to be listed, and the like is made ready where by the office is initially stipulated to be financed by the NBE. After all the public sector has public interest. Therefore, as the private sector should not alone regulate the market, the NBE's regulatory power should be tightened in order to implement the government regulatory system.

5.3. Supervision:

There are four basic forms of regulatory activities in securities markets: prudential, Protective, organizational, and structural.⁶³ These four forms of regulatory activities translate in practice to the performance of a diverse range of functions: That is making market monitoring and investigation; prosecution of breaches of law; examination and approval of prospectuses and other corporate documents; auditing of financial statements and other documents of intermediaries, and supervision of the operational and financial stability of stock exchanges; clearing houses and other types of services.⁶⁴

Prudential controls-aim to overcome market externalities such as possible systematic contagion from failure of an intermediary (reduce the risk of systematic failure and avoid disruptions caused by financial crisis). They require intermediaries to be adequately capitalized, professionally managed, diversify their risks, and adopt proper accounting policies as per the licensing requirement issued by the National Bank of Ethiopia.

⁶³ Pardy, Robert, International Reform in Emerging Securities Market, World Bank, 1992. p: 22,

⁶⁴ Vittas, Dimitiri, The Impact of Regulation on Financial Intermediaries, World Bank, 1991, p: 7

Protective control- deals with the information problems that affect the relations of intermediaries with their customers, and between large and small investors. These arise from the existence of informational asymmetries between suppliers and users of financial securities services and from poor price information (they emphasize information disclosure, clarity of contractual relationship, and strict fiduciary responsibility.⁶⁵ With the need to improve the protection of creditors and investors in a capital market disclosure provisions of companies require to be enhanced.

Organizational control- provides for the establishment of such organizations as stock exchanges, clearing houses, and market information systems¹¹ that aim to cope with the externalities caused by the existence of networks such as stock exchanges, payment-clearing systems, and information networks. By setting out the rights and obligations of market participants on objective criteria such as technical competence, and financial standing, they promote the efficiency and networks' integrity.

Structural control- allows government to manage the overall balance and shape of the securities market through such mechanism as restrictions on foreign ownership of intermediaries, on the type of activity in which an intermediary may engage, and on the specifications of the instruments, which may be traded.

However, establishing such a mechanism requires a supervisory agency structured either as part of the central bank or as an independent body and issue laws and regulations envisaged to ameliorate the functioning/development of capital market. Nevertheless, much less progress has been made in transforming effective regulation and supervision.

A Supervision Department is established in the bank to carry out its prudential regulation and supervision role. The National Bank of Ethiopia in its endeavor to play its role in the creation of an organized stock exchange set up a task force to look into the potential for the establishment of the market. Accordingly the Governor gave directives to the task force it

⁶⁵ Ibid P:8

has come with the rationale for its establishment and among others linking to the history of the share dealing group, the responsibility vested upon it to regulate and supervise the country's financial sector including securities trading and the like. The task force made its report for legislative, organizational, and operational steps for the establishing a prototype stock exchange in Ethiopia.⁶⁶

However, the bank should enhance the capacity of the department so as to ensure the soundness of the financial sector, minimize the risks of financial market failure and enhance the viable development of stock exchange market in Ethiopia.

Yet it takes time to train bank examiners and for them to acquire adequate experience; therefore supervision is likely to remain weak for some time and may not be able to protect some future. Supervise should thus focus on the basis of their limited resources on addressing screening entrants and adopt prudent practices.

The level of professionalism; and public awareness: For capital markets to function effectively the market players must be able to properly analyze and understand market opportunities and risks and the rules of the game. Without market knowledge, market participants will not have the competence to comprehend the operations of the market and adhere to the rules and regulations.

In Ethiopia, many of the business community and individuals do not know the concept and technical operations of capital markets. There is low level of professionals and business decisions may not be taken rationally and possibly run the risk of being driven out of market. Poor record keeping and low accounting standards in the country are reflected in the usual delayed audited financial reports by many of the existing organizations in the country. The absence of adequate independent rating agencies and audit firms of high quality and reputation suggest that individual investors in stock of shares will fail to get information pertinent to the company while buying shares. These shortcomings may erode public confidence in the market and be a bottleneck for its growth.

⁶⁶National Bank of Ethiopia, A study Report on the Establishment of a Stock Exchange in Ethiopia (unpublished), Addis Ababa, 1999.

Chapter VI

SUMMARY, CONCLUSION AND SUGGESTIONS

Financial instruments arise due to the presence of saving surplus and saving deficit units where both have an incentive to lend (get income) and borrow (fill the gap). Different financial instruments exist as a result of uncertainty, which gives maturity due importance, and existence of financial intermediaries which function by lending in a form that meets preferences of borrowers and by creating a new type of financial instrument that suits the needs and preferences of surplus units. The features necessary to financial instruments are term to maturity, marketability/ liquidity of the instrument, riskiness, level and type of yield, level and type of yield; the kind of issuer, taxability and the level of tax, and whether the financial instrument is traded in a primary or secondary market.

Capital markets are markets for long-term debt and stock. They are markets where financial instruments of longer terms to maturity are traded. Like all financial markets, capital markets link 'deficit units' with 'surplus units'. Capital markets consist of (1) primary markets and (2) secondary markets. Primary market is a market in which funds are raised by issuing new securities to purchasers or investors. Secondary market is a market in which outstanding securities are bought and sold by owners other than the issuers. Secondary markets involve investment banks, brokers, dealers, and financial intermediaries. In the absence of secondary market, the primary markets would probably not exist or would be much smaller than they are. Secondary markets lower the costs of issue and increases the liquidity of stocks, bonds, and other financial instruments.

Capital markets contribute to development in that they increase savings and investment flows and make the allocation of these flows more efficient. In doing so, they reduce the cost of funds to borrowers and investors while increasing the returns to savers, lenders, and financial investors. More specifically capital markets are important in that they improve utilization of existing domestic saving and encouraging new savings, channel these savings to where they can hopefully be used most efficiently, assist in the privatization process, enable savers spread their risk over a number of investments, provide an opportunity to

earn higher rates of return from equity investment than available on alternative investment opportunities, provide a liquid investment opportunity, provide firms access to investment capital to expand the size of the business and the like.

However there are wide spread arguments over the effectiveness and desirability of capital markets. The risk sharing and efficiency enhancing functions of capital market involve cost. The costs include underwriter's fees, minimum investments requirement, legal fees, accounting fees, printing costs, and debt rating which are indivisible. Moreover information costs (to reduce adverse selection) and monitoring costs (to reduce moral hazard problem) are significant to savers and borrowers and this requires government regulatory requirement, which among others is direct information disclosure to the public. There is also the agency cost inherent in the separation of management and ownership. This arises from the institutional arrangement under which the shareholders bear the risk; management has control over investment and financial decision-making process. The possibility that managers may pursue goals of the capital market involves cost. Then important factors should be considered that affect significantly the performance and growth of stock markets. These include mainly size, liquidity, volatility, agency cost, information and regulation.

An essential function of capital markets is collecting, processing, and conveying information for allocating funds and monitoring their use. There is however an information asymmetry problem in a market which includes adverse selection problem and moral hazard problem. Thus good information is needed to make choices among investment alternatives to be funded on the basis of expected return and risk, to monitor firms' behavior after funding, and to take appropriate corrective action if things are not going as planned. For all these reasons, financial markets require reliable company data, which in turn depends upon better accounting, auditing, and information disclosure rules. Full disclosure of information material to investors' decisions is the most important means for ensuring investor protection. Investors are thereby better able to assess the potential risks and rewards of their investments. Disclosure requirements, accounting and auditing

standards should be in place and they should be of a high and internationally acceptable quality.

The need for regulation is based upon the existence of various types of market failure, mainly the existence of asymmetric information, which bring about adverse selection and moral hazard problem. An appropriate regulatory framework for a capital market is needed to increase investor confidence by providing both debtors and creditors adequate legal protection. To enhance the liquidity offered by services of brokers and dealers, the regulators strictly regulate brokers and dealers to ensure disclosure of information, prevent fraud, and restrict trading based on insider information. Generally the institutional, regulatory, and legal infrastructures should be developed to have a viable capital market.

As a major component of the liberalization and structural adjustment program (SAS) in the financial sector, the International Financial Institutions suggest that stock market exchanges be established in developing countries in order to bring economic development and efficient allocation of resources

The lessons drawn from the countries, which have developed stock exchange market in the SSA reveal that except the South African and Egypt Stock exchange market, the others are characterized mainly by low level of market size (low number of listed companies and market capitalization), liquidity, and volatility but progressing positively from time to time. Further the stock exchange markets in most African countries do not serve, as a source of foreign portfolio inflow that adds liquidity for the market. Thus capital markets in SSA are characterized as small and illiquid.

Then could capital market in Ethiopia be realized? Obviously, capital market development is a long-term process that may not be expected to be active at the out set and as a result the size of the market will obviously be small. To have a capital market which functions effectively there has to exist investment banks, brokers and dealers that properly analyze and understand market opportunities and risks and the rules of the game. The development of strong professional associations is very important to the well functioning of the market.

Managerial competence is also another impediment as decisions may not be taken rationally and possibly run the risk of being driven out of market. Poor record keeping and low accounting standards in the country are reflected in the usual delayed audited financial reports by many of the existing organizations in the country. The absence of adequate independent rating agencies and audit firms of high quality and reputation suggest that individual investors in stock of shares will fail to get information pertinent to the company while buying shares. These shortcomings may erode public confidence in the market and be a bottleneck for its growth.

The expected participants in the market such as Banks, Insurance companies, Pension Funds etc, are by in large government controlled. Thus, the management of these public enterprises should have the capacity and autonomy to involve in the market as institutional investors. Otherwise, the market capitalization is expected to be low.

The market will not accessible to the majority of the investing public because of information problem about the borrowers from the investing public. Banks have a developed information capacity and the development of a well functioning bank will give a ground to provide reputation to the newly established firms which will help them in subsequent competency to enter in the market.

The government has to take various legal steps so as the markets will be fair and honest places where savers and investors could have confidence. The institutional and supportive framework of the government is important in enforcing laws and orders. The NBE in its endeavor to carry out its supervisory responsibility should build up its capacity so as to ensure the soundness of the financial sector, minimize the risks of financial market failure and enhance the viable development of stock exchange market in Ethiopia.

In light of the above information, a stock exchange market may be realized in Ethiopia but the infrastructural shortcomings should be alleviated so as the market could contribute on its part to the economic development of the country and filling the gap to the bank based financing.

Table - 1 Stock market in Africa, in selected developing and advanced economies: market capitalization for each country relative to all emerging markets and all markets in 1990 and 1998

Country	Market Capitalization Emerging		Market Capitalization All Market	
	Capitalization	Capitalization	Capitalization	Capitalization
	1990	1998	1990	1998
Sub Saharan Africa				
Botswana	0.054	0.040	0.003	0.004
Cote d'Ivoire	0.113	0.101	0.006	0.008
Ghana	0.016	0.077	0.001	0.006
Kenya	0.093	0.1133	0.005	0.009
Mauritius	0.055	0.103	0.003	0.008
Namibia	0.004	0.038	0.000	0.003
Nigeria	0.283	0.161	0.015	0.012
South Africa	28.349	9.502	1.463	0.723
Zimbabwe	0.494	0.073	0.025	0.0056
North Africa				
Egypt, Arab Rep.	0.364	1.361	0.019	0.104
Tunisia	0.109	0.127	0.006	0.010
Morocco	0.199	0.875	0.010	0.067
Other Emerging Markets				
India	7.949	5.871	0.410	0.447
Thailand	4.925	1.948	0.254	0.148
Malaysia	10.019	5.978	0.517	0.455
Korea	22.795	6.395	1.177	0.487
Brazil	3.371	8.979	0.174	0.683
Mexico	6.745	5.121	0.348	0.389
Advanced Country Markets				
Italy	30.66	19.237	1.583	1.464
United Kingdom	174.97	111.416	9.032	8.480

	Total	1990			1998			
		Relative to emerge markets	Relative to development markets	Relative to all markets	Total	Relative to emerging markets	Relative to development markets	Relative to all ma
Sub Saharan	142,594	29,391	1.5998	1.517	245,652	13.711	1.129	1.004
All Emerging countries	485,158	-	5.443	5.162	1,791,685	-	8.238	7.111
Developed markets	8,913,233	1218.826	-	1213.887	21,749,035	92.389	-	92.389
All markets	9,398,391				23,540,740			

Adopted from IFC fact books, various issues 1990-1998

Table – 2 Stock markets in Africa in selected developing and advanced economies, trading value and turnover ratio.

Countries	Trading value US \$ millions		Turnover Ratio %	
	1990	1998	1990	1998
Sub Saharan Africa				
Botswana	15.92	65.16	6.1	0.7
Zimbabwe	69.45	120.52	2.9	12
South Africa	NA	520,971	NA	34
Mauritius	5.09	99.85	1.9	5.4
Kenya	18.67	40	2.2	0.3
Cot d'Ivoire	18.67	40	3.4	10.8
Namibia	NA	83.37	0	0.6
Ghana	NA	15.22	NA	3.3
Nigeria	12.35	150.12	0.9	5.1
North Africa				
Egypt, Arab Rep.	NA	5436,96	NA	31.6
Tunisia	17.59	154,22	3.4	13.3
Morocco	NA	1583.28	NA	17.6
Other Emerging Markets				
India	25,415,65	58,905,28	65.9	56.0
Thailand	22,127.7	24,850,90	92.6	71.2
Malaysia	19,958.31	31,381.47	24.6	29.3
Korea, Dem.Rep				
Brazil	3,859.54	114,068.88	23.6	70.9
Mexico	14,399	26,147.61	44	28.5
Advanced Country Markets				
Italy	39,869,29	150,963,27	26.8	43.8
United Kingdom	280,672,39	734,610.8	33.3	36.8

Source: adopted from IFC fact books, various issues 1990-1998

Table -3 Stock markets in Africa in selected developing and advanced economies, market capitalization in U.S \$ relative to GDP and Trading value relative to market capitalization

Country	Millions % of GDP				Value of shares Traded as % of capitalization	
	1990	1998	1990	1997	1990	1998
Sub Saharan Africa						
Botswana	261	724	6.6	12.1	6.1	9.0
Zimbabwe	2,395	1,310	27.3	22.1	2.9	9.2
South Africa	137,540	170,252	128.9	179.8	NA	30.4
Mauritius	268	1,849	10.1	37.8	1.9	5.4
Kenya	453	2,024	5.3	17.7	2.2	3.7
Cot d'Ivoire	549	1,818	5.1	12.0	3.4	2.2
Namibia	21	689	0.7	21.0	0.0	12.1
Ghana	76	1,384	1.2	16.4	NA	1.1
Nigeria	1,372	2,887	4.8	9.1	0.9	5.2
Switzerland	-	-	-	-	-	-
North Africa						
Egypt, Arab Rep.	1,765	24,381	4.1	27.6	NA	22.3
Tunisia	533	2,268	4.3	12.2	3.3	6.8
Morocco	966	15,676	3.7	36.3	NA	10.1
Other Emerging Markets						
India	38,567	105,188	12.9	33.7	65.9	56.0
Thailand	23,896	34,903	28.0	15.3	92.6	71.2
Malaysia	48,611	107,104	113.6	95.1	24.6	29.3
Korea, Dem.Rep	110,594	114,593	5.3	17.7	NA	NA
Brazil	16,354	160,887	3.5	31.1	23.6	70.9
Mexico	32,725	91,746	12.4	38.9	44	28.5
Advanced Country Markets						
Italy	148,766	344,665	13.6	30.1	26.8	43.8
United Kingdom	848,866	1,996,225	87.0	155.2	33.3	36.8

source: IFC fact books, various issues 1990-1998

Table - 4 World Number of listed Domestic Companies Emerging Markets

	1991	1992	1993	1994	1995	1996	1997	1998
Sub Saharan Africa								
Botswana	9	11	11	11	12	12	12	14
Zimbabwe	60	62	62	64	64	64	64	67
South Africa	688	683	647	640	640	626	642	668
Mauritius	20	22	30	35	28	40	40	40
Kenya	53	57	56	56	56	56	58	58
Cot d'Ivoire	25	27	24	27	31	31	35	35
Namibia	-	3	4	8	10	12	13	15
Ghana	13	15	15	17	19	21	21	21
Nigeria	142	153	174	177	181	183	182	186
Swaziland	2	4	4	4	4	6	4	5
North Africa								
Egypt	627	656	674	700	746	649	654	861
Tunisia	-	17	19	21	26	229	34	38
Morocco	67	62	65	51	44	47	49	53
Over Emerging Markets								
India	2,556	2,781	3,263	4,413	5,398	5,999	5,843	5,860
Thailand	276	305	347	389	416	454	431	418
Malaysia	321	369	410	478	529	621	708	736
Korea	686	688	693	699	721	760	776	748
Brazil	510	565	550	544	343	551	526	527
Mexico	209	195	190	206	185	193	198	194
Advanced countries								
Italy				228	250	244	235	320
U.K				2070	2078	2433	2046	2399

Source: IFC fact books various issues 1991-1998

Table - 5 Net capital flows to Individual African countries (U.S \$ million)

Group and Country	Foreign Direct measurement		Fort folio Equity		Bank and Trade hearted lending	
	Annual average		Annual average		Annual average	
	1992-96	1997	1992-96	1997	1992-96	1997
Angola	262	350	0	0	185	-374
Burkina Faso	0	0	0	0	0	0
Burundi	1	1	0	0	-1	0
Cameroon	13	45	0	0	-14	0
Central Africa Rep	-2	6	0	0	0	0
Congo Dem. Rep.	1	1	0	0	-1	0
Congo Rep.	5	9	0	0	35	0
Cote d'Ivoire	71	327	8	18	4	-436
Ethiopia	6	5	0	0	-47	23
Ghana	122	130	190	46	29	27
Guinea	10	1	0	0	-3	24
Guinea- Bissau	1	2	0	0	0	0
Liberia	14	15	0	0	0	0
Madagascar	12	14	0	0	-6	-1
Malawi	1	2	0	0	-9	-1
Mali	10	15	0	0	-1	0
Mauritania	8	3	0	0	4	-2
Mozambique	33	35	0	0	2	2
Niger	2	2	0	0	-23	-14
Nigeria	1,375	1,539	6	4	-617	-258
Rwanda	2	1	0	0	0	0
Sao Tome and Principe	0	0	0	0	0	0
Sierra Leone	-2	4	0	0	-6	0
Somalia	1	0	0	0	0	0
Sudan	0	0	0	0	0	
Tanzania	70	158	0	0	-1	-15
Uganda	78	180	0	0	-11	-1
Zambia	56	70	0	0	-36	9
Benin	5	3	0	0	0	0
Chad	15	15	0	0	0	0
Comoros	1	2	0	0	0	0
Gambia. The	9	12	0	0	-3	0
Kenya	11	20	9	12	-121	-119
Senegal	33	30	0	0	-16	14
Togo	0	0	0	0	0	-6
Zimbabwe	-36	70	17	10	-3	-18
Lesotho	18	29	0	0	1	13
Gabon	-54	-100	0	0	-35	-5
Algeria	11	7	2	8	480	-557
Equatorial Guinea	110	20	0	0	0	0
Mauritius	21	53	13	24	61	94
Morocco	413	1,200	87	243	-44	-140
Tunisia	404	316	0	0	-1	1
Botswana	-29	100	0	0	2	-5
Cape Verde	5	13	0	0	2	1
Egypt, Arab Rep.	688	891	249	1,813	-393	-109
Seychelles	26	49	0	0	1	-3
South Africa	695	1,725	2,183	1,393	-26	-131
Swaziland	50	75	0	0	-1	0
Tonga	2	3	0	0	0	-3
Sub - Saharan Africa						
All developing countries 86,694	86,694	163,423	37,024	30,191	27,350	62,748

Source: World Bank Debt Tables, Various issues 1990-1998

Table - 6 Information Disclosure Summary for Emerging Markets

Market	Regular publications of P/E, yield	repatuate free	Entry free	Annual disclosure requirements	Interims financial disclosure requirements	Actuating standards	Investor protection
<u>Latin America</u>	C			*	Q	A	AS
Argentina	NP			*	Q	G	GS
Brazil	C			*	Q	G	GS
Chile							
<u>Asia</u>							
India	C			*	S	A	AS
Indonesia	C			*	S	P	AS
Korea	C			*	S	G	GS
Malaysia	C			*	S	G	GS
<u>Europe</u>							
Greece	C			*	S	A	AS
Hungary	C			*	S	A	AS
Portugal	C			*	S	A	AS
Poland	C			*	S	A	AS
<u>Mildest</u>							
Indian	P			*	-	A	AS
Turkey	C			*	Q	A	AS
<u>Africa</u>							
Nigeria	P			*	S	A	AS
South Africa	C			*	S	G	A
Zimbabwe	C			*	S	A	AS

Key: Regular publications of P/E, yield = P = published, C = Comprehensive and Published internationally, NO = Not published

Annual disclosure requirements = consolidated audited annual accounts required.

Source: IFC Fact Books 1993-1994

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National Bank of Ethiopia Directive on Share Dealing

Article 1

Definitions

Unless the context requires otherwise, the following terms shall have the meanings ascribed below:

- 1.1. A "share" is a security entitling the owner a share in the equity and the benefits thereof of a business company. Unless otherwise explicitly stated, the term may be used interchangeably with the word "stock";
- 1.2. The "Share Dealing Group" is the group established under the authority of the NBE by its founding member for the purpose of dealing in shares and other securities and performing other activities related to share dealing;
- 1.3. A "listed company" is one which is entitled to sell its shares through the Share Dealing Group;
- 1.4. The "Primary market" is the market where the original issuers of shares sell shares to buyers;
- 1.5. The "Secondary market" is the market where shares are traded among buyers and sellers who are not the original issuers of the shares;
- 1.6. the "over-the-counter market" is the market for shares and other securities other than that represented by the centralized Share Dealing Group;

Article 2

Establishment of the Share Dealing Group

A group called the "Share Dealing Group" is hereby established to engage in the trading of shares and other countries.

Article 3

Functions of the Share Dealing Group

The functions of the Share Dealing Group shall be as follows:

- 3.1. To list, under the auspices of the NBE, eligible business companies whose shares may be publicly quoted and traded through the Share Dealing Group;
- 3.2. To publicly quote and display the current prices of shares and other securities of listed companies and institutions;
- 3.3. To deal in shares and other securities of listed companies, including government and corporate bonds and treasury bills.
- 3.4. To register or cancel, through its members, shares and other securities of listed companies and institutions in order to track down the transfer of shares and other securities through purchase or sale.
- 3.5. To promote widespread investment by the public at large and institutions in shares and other securities, including government and corporate bonds and treasury bills and to foster the development of a modern stock exchange in Ethiopia.

Article 4

Regulation and Supervision of the Share Dealing Group

Regulation and supervision of the Share Dealing Group with respect to: a) possession of appropriate legal personality; (b) financial capacity; (c) dedication to the development of the securities market in Ethiopia; d) financial performance; e) appropriate information disclosure and f) other requirements as may be required is vested in the national Bank of Ethiopia.

Article 5

Operational Procedures of the Share Dealing Group

The operational procedures of the Share Dealing Group shall be governed by the Rules and Regulations of the Share Dealing Group to be stipulated and agreed upon by the Share Dealing Group under the chairmanship and supervision of the NBE.

Article 6

Effective Date

This Directive shall enter into force as of _____.

2. Rules and Regulations of The Share Dealing Group

Article 1

Name of the Stock Exchange

The name of the prototype Stock Exchange shall be the Share Dealing Group.

Article 2

Purpose of the Share Dealing Group

The purposes of the Share Dealing Group are:

- 1.1. To list, under the auspices of the NBE, eligible business companies whose shares may be publicly quoted and traded through the Share Dealing Group.
- 1.2. To publicly quote and display the prices of shares and other securities of listed companies and institutions.
- 1.3. To deal in the shares and other securities of listed companies, including government and corporate bonds and treasury bills, for the accounts of Group members as well as for the accounts of third parties in the capacity of stockbrokers and agents;
- 1.4. To register or cancel, through its members, shares and other securities of listed companies and institutions in order to track down the transfer of shares and other securities through purchase or sale.
- 1.5. to ensure through the NBE the compliance of listed companies and institutions with the criteria for listing and share issue;
- 1.6. To promote widespread investment by the public at large and institutions in shares and other securities, including government and corporate bonds and treasury bills and to foster the development of a modern stock exchange in Ethiopia.

Article 3

Regulation and supervision

The National Bank of Ethiopia both as the Chairman of the Share Dealing Group and the central bank of the country shall be the regulatory and supervisory authority of the securities trading system in Ethiopia.

Article 4

Conditions for Membership in the Share Dealing Group

Membership in the Share Dealing Group is conditional on the following criteria:

- 4.1. Possession of public legal personality (natural or juridical);
- 4.2. Financial capacity and willingness to allocate at least Birr 500,000 to the trading of shares;
- 4.3. Willingness and capacity to act as a broker or agent for at least one company listed on the stock market;
- 4.4. Strict observance of the rules and Regulations of the Share Dealing Group and the NBE Directive on Share Dealing;
- 4.5. Regular payment of membership fees;
- 4.6. Dedication to the development of the securities market in Ethiopia and demonstration of this through participation in manpower and institution capacity building programmes;
- 4.7. A good track record on physical and financial performance in the past three years;
- 4.8. Willingness to make periodic operational and financial information disclosures as may be prescribed by the NBE and the Share Dealing Group;
- 4.9. Other reasonable conditions as may be required by the NBE and the Share Dealing Group.

Article 5

Criteria for the Listing of Companies

Companies, which wish to be listed by the Share Dealing Group, must fulfill the following eligibility criteria:

- 5.1. Be legally registered as public share companies;
- 5.2. Have a minimum paid-up share capital of 5 million Birr;
- 5.3. Have a minimum of fifty shareholders;
- 5.4. Must have shown strong financial and operational performance over at least the past three years;
- 5.5. Must be willing to disclose all relevant information on their operations and submit regular financial and operational reports to the NBE and the Share Dealing Group;
- 5.6. Must have no restrictive clauses on the transfer of their shares in their Memorandum and Articles of Association;
- 5.7. Must have their books audited by external auditors;
- 5.8. Must strictly abide by the Rules and Regulations of the Share Dealing Group.

Article 6

Share Issue by Listed Companies

Listed companies must have the prior approval of the NBE and the Share Dealing Group to make a public offering of their shares either directly or through members of the Share Dealing Group, which can act as stock brokers and agents, whether such public offerings are for subscription, offer for sale, rights issue, private placements or other forms of share issue.

Article 7

Share Dealing Sessions and General Procedures of the Share Dealing Group Meetings

- 7.1. The Share Dealing Group shall meet at least once every week under the chairmanship of the NBE or its designee to conduct a share dealing session;
- 7.2. Each member of the Share Dealing Group must be prepared to deal in at least one of the listed shares.
- 7.3. The secretary and assistant secretary of the Share Dealing Group shall be from the NBE and the Commercial Bank of Ethiopia, respectively;
- 7.4. The chairman shall open and conduct the meetings of the Share Dealing Group;
- 7.5. Agendas of the meetings shall be prepared by the secretary or assistant secretary on the basis of the regular duties of the Share Dealing Group and the suggestions of the Chairman and other Group members;

- 7.6. The secretary and assistant secretary of the group shall take minutes, record the results of share dealings and file and maintain records of contracts of share purchases and sales;
- 7.7. Share-dealing sessions are to be conducted by call-over, the essential features of which are as follows:
 - 7.7.1. Announcement by the secretary of the share being traded
 - 7.7.2. Announcement of the offer share price by the concerned member;
 - 7.7.3. Competitive bidding
 - 7.7.4. Announcement of deals on prices and volume of shares
 - 7.7.5. Recording of final deals
 - 7.7.6. Decisions of the Share Dealing Group shall be made by majority voting, with the chairman having a casting vote.

Article 8

Share Registration, Subscription and Transfer

- 8.1. Members of the Share Dealing Group, in their capacities as stockbrokers and agents for their client listed companies, may act as share registrars and share subscription and transfer agents;
- 8.2. In their foregoing capacities, group members shall register shares and other securities in an orderly manner, effect transfers of shares, communicate notices of general meetings and annual reports and undertake to calculate, check and distribute dividend warrants.

Article 9

Founding Members of the Share Dealing Group (Tentative)

- 9.1. The following shall be the founding members of the Share Dealing Group
 1. National Bank of Ethiopia ----- Chairman
 2. Commercial Bank of Ethiopia----- Member
 3. Construction and business Bank----- "
 4. Awash International Bank----- "
 5. Abyssinia Bank----- "
 6. Wegagen Bank----- "
 7. United Bank----- "
 8. Dashen Bank----- "
 9. Ethiopian Insurance Corporation----- "
 10. Awash Insurance Company----- "
 11. Nile Insurance Company----- "
 12. African Insurance Company----- "
 13. East African Securities Trading----- "
 14. MIDROC - Ethiopia----- "
- 9.2. Each Group member may authorize up to three different representatives for participation in the meeting of the Group provided, however, only one representative may be present at any one meeting of the Group.

Article 10

Accommodation and operating expenses of the Share Dealing Group

- 10.1. The national Bank of Ethiopia shall provide accommodation for the weekly meetings and secretarial and record-keeping functions of the Share Dealing Group;

- 10.2. Similarly, the operating expenses of the Group shall be borne by the NBE for at least the first year of the Group's operational existence;

Article 11

Names of Listed Companies (Tentative)

1. Ambo Mineral Water Factory
2. Addis Tyre Share Company
3. Africa Insurance company
4. Akaki Textiles Factory
5. Awash Insurance company
6. Awash International Bank
7. Bedelle Brewery
8. Berhanena Selam Printing Enterprise
9. Berta Construction S.C.
10. Commercial Bank of Ethiopia
11. Dashen Bank
12. East Africa Bottling PLC.
13. East African Securities trading Co.
14. Equatorial Business Group
15. Ethiopia Amalgamated LTD.
16. Ethiopian Insurance Corporation
17. Ethiopia Hotels Enterprises
18. Ethiopian Airlines
19. Ethiopian electric Power Corporation
20. Ethiopian Shipping Lines
21. Ethiopian Telecommunications Corporation
22. Guna Trading House S.Co.
23. Mega Distribution Enterprise
24. Meta Abo Brewery
25. MIDROC Ethiopia
26. National Insurance Co. of Ethiopia
27. National Mining Corporation
28. National Motors Corporation
29. Nefas Silk Paints Factory
30. Nile Insurance Co.
31. Nyala Insurance Co.
32. Ries Engineering S.C.
33. St. George Brewery (BGI)
34. United Insurance Co.
35. Universal Leather Articles Factory

(N.B. Members of the Share Dealing Group automatically qualify for listing).

Article 12

Dealing in Other Securities

Government bonds and bonds issued by corporate bodies authorized by the NBE as well as (government) treasury bills may be traded by members of the Share Dealing Group.

Article 13

Share Certificates and Settlement

At the initial stages of stock market development in Ethiopia, shares shall be issued in scrip or certificate form. Settlement for the purchase of shares shall be primarily in cash and by check.

Article 14

Costs of Share Issue, Commission and Service Charges

The costs of primary share issues shall be borne by the issuers. Stockbrokers, share dealers, agents and underwriters may charge a commission or service charge of a maximum of 1 percent of the total value of the deal in question.

Article 15

Arbitration of Disputes

Clarification of the spirit of the Rules and Regulations of the Share Dealing Group and jurisdiction of disputes that may arise among the members of the Group shall be handled by a special arbitration committee, chaired by the Governor of the NBE (who is also the Chairman of the Group) and two other members of the Group. Decisions by a majority vote or consensus of this committee are final and non-compliance by the concerned disputants may result in suspension from membership of the Group.