Addis Ababa University
College of Business and Economics
Department of Accounting and Finance

Benefits and Challenges of the Upcoming Capital Markets in Ethiopia

By: Bizuneh Minda

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Approved by Board of Examiners

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Statement of Declaration

I, Bizuneh Minda declare that this research titled "Benefits and Challenges of the Upcoming Capital Markets in Ethiopia" is done with my own effort. I have conducted it independently with the guidance and suggestions of my research advisor. I assure anyone that this study has not been submitted for any scholarly award in this or any other university.

Bizuneh Minda Demissie	________________	________________
	Signature	Date

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Abstract

Ethiopia is one of the few countries in Africa that does not have a stock market. Currently, the government has a plan to establish a secondary capital market by 2020. There are controversial issues among researchers regarding the relevance of the capital market in developing countries. Thus, this research is aimed to clear these issues by analyzing the country's current economic situation. The researcher is used the country's current prevailing secondary data from the web pages of NBE, World Bank and other sources and try to persuade some of the benefits and challenges of the country regarding the upcoming implementation of the capital markets. Based on the data sources, I have found out that the capital markets help to complement the development of the financial sector, highly efficient mechanism for channeling local savings to investments, reduce cost of capital and unemployment, offer liquidity to investments, reduce investment risks, help for government financing and contribute for unification of the country. However, capital markets are not free from challenges. Some of the challenges that the emerging market in Ethiopia faces are lack of experience of expertise, effective regulation and supervision, financial infrastructure and investors' financial literacy. Finally, ways to alleviate these challenges are forwarded to the respective bodies.

Contents

Chapter 1

Introduction

1.1 Background of the Study

As pointed out by Easterly and LWFE(2000)(as cited in Mebrahtu, 2014) that poverty remains a major challenge of sustainable development and stability in Ethiopia, the second populous country in Africa. According to them this is the reason for poverty reduction has become the top agenda of the Ethiopian government by redirecting the economy into market-oriented, implementing different policies and initiating poverty alleviating plans at different periods. They also added that the dreadful nature of poverty, in the country, is declining due to progressive economic growth and positive policy directions.

Bekaert and et al(2005) states that efficient financial sector is one of the factors for economic growth in order to pool domestic savings and mobilizes foreign capital for productive investments. Thus, it seems difficult for the government to achieve the government's accelerated, sustained and transformative economic growth without a vibrant, efficient and enabling financial system. According to Fabozzi and Peterson (2009) financial system is a system that allows the exchange of funds between lenders, investors, and borrowers.

As Jetu (2014) noted that during the Imperial regime, there was a small share trading activity in Ethiopia carried out under the regulatory auspicious of National Bank of Ethiopia (NBE), department of Share Exchange.

Kaleyesus (2017) reported that at the second annual finance summit held from 19-20 December 2017 at the UNECA, it has been recalled that in 1897 Emperor Menelic II sold shares in France to raise part of the 40 million francs needed to build the Ethio-Djibouti railway line. According to him in 1906 the first bank in Ethiopia, Abyssinia Bank, floated its shares in Addis Ababa, New York, Paris, London and Vienna. As Von Pischke(1968)(as cited in Jetu, 2014) noted that Ethiopian stock market during the Imperial regime was moderately successful to provide an organized market in its pioneering efforts. He also stated that even though market capitalization remained small and did not have much impact on the economy, workable share trading environment has been developed.

As Asrat (2003) noted that with the coming of the Dergu regime to power, the introduction of a centrally planned economy resulted in the nationalization private industries and dissolution of share dealing groups.

Since the abolition of the Addis Ababa Share Dealing Group in 1974 by the military government ruling Ethiopia at that time, no capital market has been in place in Ethiopia (Tiruneh, 2012). Even though Ethiopia has not been succeeded to have its own financial market for more than forty five years, its need in the ongoing financial liberalization is gaining consensus among various stakeholders in the country.

Mohammed (2010) and Petros(2009) (as cited in Tiruneh, 2012) have confirmed that in Ethiopian economy there is a wide-ranging prevalence of share illiquidity which signifies the need for secondary financial markets. The persistence of this illiquidity will frustrate existing shareholders and discourage the market for new offerings.

As Kaleyesus (2017, 2018) reported that Ethiopia is one of the few countries in Africa that does not have a stock market. He also said that out of 192 countries in world, 150 have stock market and in Africa out of 54, 29 countries have stock market. He also said that two components of money market, viz., treasury bills market and inter-bank loan market are operating in Ethiopia on a limited scale. Moreover, on the capital market side the primary market does exist but not in modern form and there is no secondary market (Kannan & Ejigu, 2013).

The effort to establish a capital market is as old as the existence of the free market in Ethiopia. Fitsum (2015) reported that,in early 1995 few years after the introduction of free market economy the National Bank of Ethiopia reportedly undertook a study on the Feasibility of Establishing Securities Exchange Market in Ethiopia and also prepared a draft Securities and exchange proclamation. He also reported that the study failed to get approval from the government.

As Ruecker(2011) said, in 2008, the NBE launched a capital market infrastructural development study by international consultants under the Financial Sector Capacity Building Project which was financed by the World Bank based on the potential interest of the government of Ethiopia which is under review by the concerned government body.

On 2013, NBE representatives had revealed that the central bank finalized its study to establish secondary market during a discussion held at the Hilton hotel that was attended by experts from the financial sector. "But, we have gone back to our study and focus on a stock exchange that will include both the primary and secondary market, " an expert from NBE explained at the time. Recent announcements only mention the establishment of a secondary market stock exchange indicating a likely move by the government to delay or shelve the primary market stock exchange plan. Whether effective supervisory and regulatory institutions are there, the critical preconditions for the creation of capital market can be fulfilled in a year or so is yet to be seen (Fitsum, 2015).

Upon the transition from the central economic policy to the new economic policy the need for stock market development has been discussed and being studied by various groups/ stakeholders and academics to initiate the establishment of stock market in Ethiopia. Finally, all studies stressed the importance and the rationale behind the need for the establishment of a stock market and cite several advantages for the development of the country (Getachew, 2016).

Legesse(2012) noted that Ethiopian Commodity Exchange (ECX) was introduced in 2008 as a structured market facility designed to provide fair and transparent pricing of major agricultural products. Moreover, in the absence of officially structured market place for trading shares, investors and companies are forced to sell their share through bidding process or through brokers. As Fitsum (2015) said, the successful ECX is also mulling to broaden its operations into stock and bond trading.

Kaleyesus(2017) reported that at the second annual finance summit, Zemedeneh, one of the finance experts, said that due to the absence of stock market some people do not know where to invest their money. He also reported, Ato Zemedeneh's saying that "Many people construct buildings and shopping malls in Addis Ababa and it is not easy to find tenants. According to Zemedeneh we see half empty buildings and that is a capital tied up. He also said that on one side, there are many people who have a lot of money but do not know where to invest their money. As Ato Zemedeneh said, on the other side there are individuals who have innovative business ideas and do not have the required seed capital".

Kaleyesus (2017) reported the research conducted by Fairfax Africa Fund that if a stock market is established in Ethiopia today an initial public offering of 200 billion birr could be generated in four years' time. He also reported Ato Zemedeneh's saying as he has feasible and innovative business proposals drafted by entrepreneurs in the manufacturing sector, health and infrastructure sectors that require 20 billion birr capital injection. Ato Zemedeneh also said that "It would have been easy to raise the required investment capital to fund these useful investment projects if there was a capital market".

According to Zemedeneh, Global Chairman of Fairfax Africa Fund, in the summit held in 2018 said that there are 50 to 70 local companies which can be listed in the stock exchange. Moreover, "All the banks and insurance companies, which are well regulated, can offer an initial Public Offering the day the Addis Ababa stock market is ready for launch " (Kaleyesus, 2018).

So far, Ethiopia's private companies have sold hundreds of thousands of share under close scrutiny of the National Bank. The large state-owned enterprises to be fully or partially privatized, private companies, and the 16 banks and insurance companies are the major ones expected to take part in Ethiopia's capital market. In the last 15 years. Ethiopian banks have only managed to sell share worth of 30 billion Birr (Ethiopian Press Agency, April 4, 2019).

On the third East Africa Finance Summit which was held in 2018 in Addis Ababa and reported by Kaleyesus(2017), the Ethiopian government is poised to set up the country's first stock market by 2020. As Kaleyesus reported for more than 20 years Ethiopian scholars, business leaders, consultants and government officials have been debating on the need to establish a stock exchange. He also reported it is now the time is for the establishment of the first Addis Ababa Stock Exchange. Kaleyesus write their saying that a one page template issued by the office of the prime minister recently indicated that the government was planning to establish a capital market by 2020. He also reported that the targets set to be accomplished by 2020 are enhancing the use of modern financial technology, establish a system enabling e-commerce and digital financing and introduce capital market.

Some financial experts doubt if the planned Addis Ababa Stock Exchange (AASE) can be realized by 2020. Abdelmenan, a financial analyst, questions if the required financial and technological infrastructure can be built within two years.

It has been said in the third East Africa Finance Summit as we Ethiopian's are going to have a stock market this time. It was said by Zemedeneh, Global Chairman of Fairfax Africa Fund, as we have been on this path for 18 years and he concluded for no more academic discussion. We do need a capital market. We are part of the global economy (Kaleyesus, 2018).

As Zemedeneh said and many studies agree,capital market has several benefits in advanced economy. Charles and Erik, for example said that strong and modern capital markets benefit every corner of the U.S. economy, from Main Street to Wall Street. On the other hand, Singh(1999) explained that establishing a capital market, for African economies particularly those in Sub-Saharan Africa, is likely to do more harm than good at the current state of their development. From this fact what Zemedeneh said "now it is no more an academic discussion" is not correct under the dynamic economic and political world. So, we need to conduct many researches again and again in our different economic, cultural, and political environment for the betterment of the implementation. Hence this research takes its part.

Even though the technical studies for the establishment of the AASE were done by Ernst and Yound twenty years ago (as reported by Kaleyesus, 2018) and Kannan and Ejigu wrote an article in 2013 titled "Establishing Secondary Market in Ethiopia: Benefits and Costs Study", there are many reforms in the past six years including the financial secor.

The new economic and political reforms made by the new Prime Minister Abiy Ahmed may create many other opportunities and challenges related to the financial system. Thus a research has to be conducted based on the current situation, and make aware of the actors (government, investors, financial intermediaries and the like) about the benefits and costs of the upcoming capital market in Ethiopia. This study is going to analyze some of the benefits and challenges of any economy with the current prevailing secondary data of the country and look for any other benefits and challenges particular to Ethiopia, if any.

1.2 Statement of the Problem

Mebrahtu (2014) noted that studies conducted to analyze the impact of establishing capital market on economic growth of countries have substantiated its significance in advanced economies. However, investigations in developing countries have varied results. As Stiglitz and Singh (as cited in Mebrahtu, 2014) reveal that establishment of capital market in developing countries has little relevance in economic growth. As Singh(1999) also said, African countries would do better to use their human, material, and institutional resources to improve their banking systems than to promote capital market. On the other hand, Murinde(2006) noted that capital market development is important in developing countries to complement and facilitate reforms in the banking sector. It has also been said by Ouandlous (2010) that for emerging economies to imitate the achievements of the advanced economies, they have to establish and develop capital markets.

As Benn (2001) confirmed that facilitating the growth of securitized financing in poor countries, particularly those which already have an effective commercial banking sector, have long been considered an important component of the economic development process. From this we understand that development of capital market for developing countries has benefits with different level of economic development. So, here in this research the researcher is going to investigate and analyze the benefits that Ethiopia in particular enjoy from the upcoming capital market development, and on the other side, the challenges that the country face during implementation under the current financial system, which enable anyone whether support either of the two controversial issues.

1.3 Objective of the Study

1.3.1 General Objectives

The general objectives of this study are to enable the stakeholders of the capital market (investors, government, and financial intermediaries)

- judge the need for establishment of the secondary capital market at the current stage of development; and
- fell free to participate, with due care, in the market development by explaining the benefits and challenges of the country pertaining to

the implementation of the capital market here in Ethiopia with the help of the prevailing secondary sources.

1.3.2 Specific Objectives

The specific objectives of this research are listed below.

- It orients some of the benefits of the capital markets in any economy and some of the peculiar benefits of the country Ethiopia to the market participants.

- It makes the stakeholders of the capital market orient and ready to face the challenges for effective implementation of the market.

- It contributes for the government decision making regarding the implementation of the capital market.

- It uses as a base for other researchs, which need to discuss other variables and want to look for additional benefits and challenges.

1.4 Significance of the Study

The proper circulation of funds in an economy is crucial for the economic development of the country. Effective circulation and utilization of funds leads to the industrial development of the country thereby supporting the economic growth. On the other hand, securities market help in transfer of resources from those with idle resources to others who have a productive need for them. Without the involvement of the participants of the capital market, it will not be effective. Investors, for instance, have to involve in the market by critically analyzing the benefits and costs related to the upcoming capital market in Ethiopia. Unless the investors are very clear about the benefits they gain from the market, they do not participate in the market so that the market will not function effectively. Moreover, the research will inform the government about some of the challenges of the market and make them ready to alleviate the worse cases. So, this research is important in showing the benefits of the capital market to the stakeholders of the market and challenges of the country in implementing the upcoming capital market in the current situation of Ethiopia so that enable them participate with due care.

1.5 Delimitation of the Study

This study analyzed only three of the requirements of capital market[1]. These are: (1) the familiarization of the system to the local private sector; (2) the formation of competitive information technology infrastructure; and (3) enabling digital payment systems. Moreover, the research didn't consider the financial institutions other than banks.

1.6 Limitations of the Study

Because of the partial lockdown due to COVID-19, the researcher was unable to obtain the required data to support the discussed benefits and chanllenges further, and include any other benefits and challenges of the market. In addition, this research needs time to discuss in detail about some of the other requirements of capital market and decide the readiness of the country Ethiopia.

1.7 Organization of the Study

This research is organized into five chapters. The first chapter introduces about the previous studies and the need for this research. Chapter two shows the results obtained from many researches about benefits and challenges of the capital market in any economy and the scholars controversial issues regarding capital markets. Chapter three explains about the source of data and the way that the study analyses the data to reach at a conclusion. Chapter four analyzes and interpret the data obtained from the secondary sources. Chapter five concludes about the benefits and challenges of the upcoming capital markets in Ethiopia, and recommeneds the respective bodies to alliviate the challenges of the country to the upcoming implementation of the capital market.

[1]Subsection 2.4.2. Requirement of capital market.

Chapter 2

Literature Review

2.1 Theoretical Review

2.1.1 Roles and Functions of Financial System

A financial system provides a more efficient transfer of funds by overcoming the information asymmetry problem between those with funds to invest and those needing funds. Information asymmetry, in general, means that one party has more information than the other party to a transaction, which results in an imbalance of power in a transaction. In terms of a financial system, information asymmetry can lead to an inefficient allocation of financial resources (Frank and Pamela, 2009).

Abdullah F. (2018) noted that the role of the financial system in the economic system is to facilitate production, employment and consumption. Moreover, the financial system exists to facilitate the design, sale and exchange of funds and financial investments. He classified this exchange as direct and indirect. As Kiflework (2018) also said that the financial system plays the key role in the economy by stimulating economic growth, influencing economic performance of the actors, affecting economic welfare.

As Caprio and Honohan (as cited in Per Jacobsson, 2011) argue that a well-functioning financial system plays an essential role in generating promoting the efficient allocation of investment, high levels of saving, and smoothing economic fluctuations stemming from non-financial causes. They also confirmed that by facilitating informed risk-taking, it is a key element in achieving optimal levels of productivity growth, and rising living standards. According to them the importance of this contribution can be seen in the divergence of economic performance between countries with open and those with repressed financial systems.

The study made by Mebrahtu (2014) pointed out that the role of financial institutions and media is significant by increasing awareness on public increase financial access, propagate information to savers, mobilize financial resource from excess areas and channel it to shortage areas where investment opportunities are ample. Economists like Stein et al (as cited in Mebrahtu, 2014) describe institutions enable to reduce transactional and information costs and make markets operate with efficiency and liquidity. Yartey and Akjasi(2007) also noted that the existence of well-developed financial intermediary institutions, particularly the banking sector, is important for stock market development.

As Guiso & Jappelli(2005) said each of the three components of the financial system of an economy (financial markets, financial intermediaries (institutions) and financial regulators plays a specific role in the economy. Moreover, according to the functional approach financial markets facilitate the flow of funds in order to finance investments by corporations, governments and individuals. They also argue that financial institutions are the key players in the financial markets as they perform the function of intermediation and thus determine the flow of funds. According to them the financial regulators perform the role of regulating and monitoring the participants in the financial system.

2.1.2 Functions of Financial Assets

According to Fabozzi and Peterson (2009) an asset is any resource that is expected to provide future benefits and, hence, has economic value. Two categories of assets are: tangible assets and intangible assets. They said that an intangible asset represents a legal claim to some future economic benefits. The value of a tangible asset depends on its physical properties whereas the value of an intangible asset has no relation to the form; physical or otherwise, in which the claims are recorded. They noted that financial assets(or financial instruments) are intangible assets where, typically, the future benefits come in the form of a claim to future cash. According to them certain types of financial instruments are referred to as securities and generally include stocks and bonds.

As Fabozzi and Peterson (2009) noted that financial assets serve two principal economic functions. They added that financial assets allow the transference of funds from those entities that have surplus funds to invest to those who need funds to invest in tangible assets. They also noted that financial assets permit the transference of funds in such a way as to redistribute the unavoidable risk associated with the cash flow.

2.1.3 Roles and Functions of Financial Markets

According to Frank and Pamela (2009) a financial market is a market where financial instruments are exchanged. As they described financial markets provide the following three major economic functions: Price discovery, Liquidity and Reduced transaction costs. They added that price discovery means that the price of the traded asset is determined by the interactions of buyers and sellers in a financial market. Moreover, financial markets provide a forum for investors to sell a financial instrument and is said to offer investors liquidity. Frank and Pamela (2009) also said that all financial markets provide some form of liquidity. However, they pointed out that the degree of liquidity is one of the factors that characterize different financial markets.

As Norman et al(2000) said the role of financial markets in economic development continues to attract increasing attention both in academia and among policy-makers. They also pointed out that evidence from recent empirical studies suggests that deeper, broader, and better functioning financial markets can stimulate higher economic growth. The study made by Ndikumana(2001) (as cited in Kiflework, 2018) also argue that even though evidence on Africa is still limited, the results from existing empirical work supports the view that financial development has a positive effect on economic growth in African countries. Financial markets provide a vehicle for allocation of savings to investment. It, as he explained, can be grouped as money market and capital market.

2.1.4 Capital Markets

As Abdullah (2012) stated that the capital market is that segment of the market in which long term financial assets (securities with more than one year to maturity such as government and corporate bonds, stocks, etc.) are traded.

As Abdullah (2012) explained the capital markets can be subdivided the primary market and the secondary market. According to him the primary market is that part of the market in which issue of new securities is carried out, often referred to as the new issues market. Moreover, in the primary market firms and other organizations raise the funds they need by issuing (selling) long-term securities such as stocks and bonds to potential investors. Abdullah(2012) also added that the secondary market is where the purchase and sale of already-issued securities takes place among investors. As he explained these transactions do not change the total amount of securities outstanding; it simply transfers ownership from one investor to another. According to New Times Publications LTD (2016) secondary market must exist for the primary market to thrive because holders of securities are able to sell them for cash on the secondary market to other investors. For this reason,as it explained, investing in securities comes with organized and licensed exchanges to maintain and run both primary and secondary markets smoothly.

As Abdullah (2012) explained that in a secondary market, securities are usually traded on a stock exchange or over-the-counter (OTC). He added that in an exchange trading structure, the exchange sets the various rules and regulations that govern how and when trading takes place and will also provide the infrastructure to monitor and settle all trades. Abdullah (2012) also described that transactions that take place outside the exchanges are said to occur in the OTC market. He noted that these transactions take place at no specific single location, often occurring through communication networks, comprising telephone lines, computer terminals, and other electronic facilities, which connect brokers, dealers and investors. He further described that dealers quote the prices at which they are willing to buy and sell various securities on the network whereas investors interested in trading can either execute trades directly or through a broker contacting a dealer on their behalf.

Abdullah (2012) explained that the OTC market, however, has no mechanism to stop sharp increases or declines in security prices, which may occur due to the temporary imbalance between supply and demand. He also said that in the organized exchange markets, such imbalances can be tackled by the exchange halting trading in a certain security, to allow additional buyers or sellers to restore equilibrium to the market.

2.1.5 Participants of Capital Markets

According to AP Faure (2015) the secondary equity market participants are members of share exchanges (broker-dealers), issuers of equity, investors, and speculators (or arbitrageurs). He added that speculators (or arbitrageurs) may be members of exchanges (the members that only deal for themselves) or non-members. AP Faure(2015) also argues that their usefulness lies in increasing the turnover in the equity market, thereby contributing to efficient price discovery.

According to Bib. 31 several important functions of Broker-dealers in the financial industry include providing investment advice to customers, supplying liquidity through market making activities, facilitating trading activities, publishing investment research and raising capital for companies.

According to Bib. 30, an issuer is a legal entity that develops registers and sells securities to finance its operations. It also explained that issuers may be corporations, investment trusts, or domestic or foreign governments. Moreover, issuers make securities available such as equity shares, bonds, and warrants.

As Bib. 31 explained that there are mainly three categories of investors in markets, viz. retail investors, institutional investors, and non-institutional investors. It also explained that investors play a major and vital role in the success and growth of a company. According to Bib. 31 the main goals of an investor relation professional are: to enable the company to achieve the optimum share price that reflects the fundamental value. Moreover, representing the company to investors and representing investors to the company. Bib.31 stated that the largest institutional investors in the bond market are primarily commercial banks, pension funds and insurance companies. This, as Bib.31 added, is also true for Ethiopia institutional investors tend to buy and hold bonds for long term, to minimize asset liability mismatch.

2.1.6 Requirements of Capital market

The four pillars for capital markets development are: macroeconomic stability, sound banking systems, solid institutional frameworks, and adequate regulation and supervision (Center for Global Development, 2014).

Metassebia H. (2019) stated that it is important to have attention by the Ethiopian policy makers to the following main enabling minimum standards to operate a stock exchange market: the establishment of institutional framework, the creation of regulatory laws, the familiarization of the system to the local private sector, the formation of competitive information technology infrastructure, enabling digital payment systems, creating reliable and consistent financial system, and the development of capable manpower.

It is planned by the country Ethiopia to start the Addis Ababa Stock Exchange after a year in 2020. However, Metassebia H. (2019) asks whether it is possible to achieve the required institutional, manpower, financial and technological infrastructures within a year.

Well-functioning capital markets require incentive structures to "crowd in" commercial investors, an enabling policy and regulatory framework, and synchronization of robust regulatory framework with institutional capacity (World Bank, 2019).

Ethiopian Herald (August 8, 2019) reported Ato Zemedeneh's saying as there are a number of new institutions required for running a successful capital market. As he also said we first need to set up a regulatory institution. According to Ato Zemedeneh, as reported in Ethiopian Herald (2019), the stock exchange can be incorporated by the private sector but the regulation has to be done by the government. Moreover, we need to have stock brokerage firms and investment banks. Ato Zemedeneh said that stock traders have to be trained and the local accounting and auditing firms have to build their capacity. He also said that the financial media has to be established or the existing ones should extend their financial news coverage.

2.1.7 Benefits of Capital Markets

Asrat T. (2003) noted that review of the literature indicates that well-functioning securities markets have the following benefits: 1. Enhanced savings mobilization, 2. Help in resource allocation, 3. Promote efficient financial system: securities markets break the oligopoly that would be enjoyed by the banks in the absence of securities markets, 4. Help term transformation and improve capital structure, 5. Allow de-concentration of ownership, 6. Improve accounting and auditing standards, 7. Provide effective tools for monetary and fiscal policy: when an economy has well-developed securities markets, it can conduct monetary and fiscal policies through these markets, and 8. Help privatization efforts. According to him Economists widely believe that privatization of state enterprises will reduce losses and create efficiency. Asrat (2003) also noted that the lack of well-developed domestic equity markets is one of the most notable problems associated with privatization of state enterprises.

As Samuel S. (2009) pointed out that the development of a dynamic market automatically increases the level and sophistication of financial intermediation in an economy. According to him such markets promote economic growth through increased access to savings and risk diversification. He said that a typical market comprises of several institutions including banks, insurance companies, mutual funds, mortgage firms and finance companies which all contribute to resource mobilization. He also confirmed that governments can also finance their deficits while reducing fiscal pressure on the banking system, which can help bring down the cost of capital by reducing the risk faced by the financial system.

As noted by Levine (as cited in Gregory, 2012) stock markets enhance economic activity by producing information, monitoring investments, facilitating risk management, mobilizing savings, and easing exchange of goods and services.

According to Benn S. (2001) the most salient benefits of capital markets are: they increase the economy-wide mobility of productive resources, represent a highly efficient mechanism for channeling local savings to investments, allow efficient reallocation of financial risks, dramatically increase the scope for foreign financing, and complement, rather than substitute for, the development of the banking sector. Moreover, empirically, equity investments in developing countries appear to offer more attractive risk-return profile than debt. According to Benn S. (2001) countries with more liquid stock markets enjoy faster growth rates of real per capita GDP over subsequent decades. He also added that stock markets are critical to the development of venture equity financing as they provide an essential exit mechanism for venture capitalists, who are therefore able continuously to reallocate their capital towards new promising enterprises.

Many researches confirmed on the benefits that come from strong modern capital markets in any economy. Anokye (as cited in Kiflework, 2018), for example, noted that countries will benefit by establishing stock market through promotion of savings by providing an alternative financial vehicle for individuals to meet their risk preferences and liquidity needs, thereby increasing the saving in the market. The salient benefits of having capital markets are reviewed as follows.

A. Enhance saving mobilization and risk management:

As Tessema (as cited in Kannan and Ejigu, 2013) pointed out that stock and bond issues serve to increase the national savings rate by creating incentives to invest. According to him securities generally earn higher returns than more secure instruments such as bank savings deposits, because they are risky investments. He also noted that securities also offer investors the option to diversify across industries, thus improving their risk/return tradeoff.

Stock market has an advantage due to the discipline imposed on corporate managers since movements of share prices reflect managers' performance, existence of mechanisms for appropriate pricing and hedging against risk and increased inflows of funds to the thriving domestic stock market (Demirguc-Kunt and Levine,1999).

As Getachew (2016) argues that the presences of stock markets which provide for various vehicles for transferring risk through which investors can confidently invest. He showed that investors had the opportunity of switching from low risk to high risk investments. He also added that stock market provides a number of benefits to borrowers and investors, including governments for risk sharing and efficient allocation of capital sake.

Stock markets offer an alternative channel for savings mobilization and resource allocation (N'Zue, 2006). Stock markets enable savings mobilization for financing "immense works" (Hicks, 1969, and Greenwood and Smith (1996), as cited in Getachew, 2016).

International risk sharing through internationally integrated stock markets improved resource allocation and can accelerate growth (Obstfeld,1994, as cited in Getachew, 2016).

Market liquidity is seminal to create ready and willing investors all the time since such market makes investment less risky and more attractive (Mebrahtu, 2014).

As Ruecker(2011) described, the system of financial markets provides a conduit for more public's savings. He noted that bonds, stocks, and other financial claims sold in the money and capital markets provide a profitable, relatively low-risk outlet for the public's savings. He added that an increase in domestic investor interest originates from the availability of profitable options for saving within the local economy.

Stock markets arise to improve liquidity and facilitate investment in multiple risky projects, thereby spreading out the risk from any one project (Levine,1991, as cited in Evans, 2012).

As Ezana (2012) stated that the privatization process in Ethiopia has been conducted in the form of ”private placement” to the highest bidder, with limited information being available to the public. He recommended that the lack of available information in ”private placement” can be addressed by the creation of a stock market, giving transparency to the deal process, empowering local individual investors, and spreading ownership by lessening the political impact.

Capital markets provide one means to raise capital, as capital markets mobilize savings for investment (Anokye,2008).

B. Lower cost of Capital

According to Demirguc-Kunt and Levine(1999) stock market has an advantage due to lower cost of equity. Getachew (2016) also explained that stock market encourage savings by providing individuals with an additional financial instrument that may better meet the risk preferences and liquidity needs and further provide an avenue for growing companies to raise capital at lower cost. He also noted that efficient stock markets may also reduce the costs of information to reveal efficient stock prices.

Facilitating the emergence of commercial rather than mutualized trading operations in developing markets should mainly result in lower capital costs to domestic listed companies. Domowitz and Steil (as cited in Benn, 2001) argue that dis-intermediating trading reduced trading costs, and those trading cost reductions, in turn, reduced the cost of raising equity capital.

Charles and Erik (2010) pointed out that liquid capital markets reduce the cost of investing. Moreover it lowers trading costs and provides opportunity for retirement savings. They also noted that strong capital markets are characterized by low trading costs and efficient share markets. According to Charles and Erick (2010) investors are willing to pay more for a firm’s shares, and the cost of capital falls because of low trading costs. They added that the lower cost of capital, in turn, leads to more investment, growth, and jobs.

As Getachew (2016) noted that efficient stock markets may reduce the costs of information to reveal efficient stock prices. Singh(1999) reported that researchers argued that the stock market might not perform efficiently in developing countries and may not be feasible for all African markets given the huge costs and poor financial structures.

According to Sergio and Frank (2004) secondary markets bring together many interested parties and so can reduce the costs of searching for likely buyers and sellers of assets. Moreover, by accommodating many trades, secondary markets keep the cost of transactions low. They also added that by keeping the costs of both searching and transacting low, secondary markets encourage investors to purchase financial assets.

C. Offer Liquidity to Investments

As explained by Yakov and Haim (1991) an asset is liquid if it can be bought or sold at the current market price quickly and at low cost. According to them illiquidity is thus related to the costs of executing a transaction in the capital markets. They added that in addition to direct transaction costs, which are relatively easy to measure, the costs of illiquidity include the difference between the actual execution price and the price that would have prevailed in the absence of the transaction, which is virtually impossible to measure. They also pointed out that illiquidity costs can be separated into a number of distinct components: (1) Bid-ask spread: Dealers and market-makers quote bid and ask prices, and public traders enter orders with limit prices at which they are willing to buy or sell securities. (2) Market-impact costs: are incurred when an investor trading a large quantity drives the market price up when buying or down when selling beyond the best bid and ask prices. (3) Delay and search costs: are incurred when a trader delays the execution of a transaction in an attempt to accomplish better trading term. (4) Direct transaction costs: include brokerage commissions, exchange fees and transaction taxes.

Stock markets improve liquidity by reducing the cost of transacting on equity shares, reducing the cost of acquiring financial information and enforcing financial contracts (Gregory, 2012).

According to Zsofia and Geoffrey (2008) as secondary markets develop, transaction costs are lowered and liquidity increases, so investors gain the confidence needed to invest in long-term government securities. They also added that the lengthening of the maturity of the government debt stock reduces the frequency of new issuance and assists in the budget planning process.

Market liquidity is firmly associated with the availability of smooth and sophisticated exchange markets coupled with public awareness, investors' protection and skillful and able intermediaries (Mebrahtu, 2014).

Ibid (as cited in Jetu, 2014) pointed out that introducing stock markets enhances the liquidity of assets as it provides high level of buying and selling stocks without affecting its market price. He also argues that in the absence of stock market facility, the ability to convert stocks into cash quickly could be hampered. He also added that liquidity will initiate the individuals to invest in stocks and hence has a positive effect on economic growth. Yartey and Adjasi(2007), on the other hand, argue that increased stock market liquidity may have an adverse effect on the rate of economic growth by reducing the need for precautionary savings.

Ruecker(2011) argue that absence of stock market in Ethiopia may cause illiquidity of assets as holders of stocks may find it difficult to sell same at a fair market price. As he pointed out that Ethiopian investors only have a small portion of their household income to invest, a fair priced stock trading is significant in order to avoid creating systematic losses for the general public. He also confirmed that in order to ensure the liquidity of assets in Ethiopia, it is vital to introduce stock market because of the limited investor and issuer base.

According to Sergio and Frank (2004) investors in financial assets receive several benefits from a secondary market. They noted that such a market obviously offers them liquidity for their assets as well as information about the assets' fair or consensus values.

As Tiruneh (2012) noted that financial markets enable security holders to easily convert their investment in securities into cash at the prevailing market price. He also added that increased number of players, number and amount of financial transactions, generates liquidity and promotes active trading.

As Kiflework (2008) said critics argue that financial market liquidity may negatively influence corporate governance because very liquid financial market may encourage investor myopia. He added that investors commitment and incentive to exert corporate control may be weaken because they can easily sell their securities holdings in more liquid financial markets. He briefly explained that instant financial market liquidity may discourage investors from having long-term commitment with firms whose securities they own and therefore create potential corporate governance problem with serious ramifications for economic growth.

D. Help in Resource Allocation:

Kannan and Ejigu (2013) noted that without securities markets, companies must rely on internal resources (retained earnings) for investment funds, on bank financing or on government grants or subsidies. According to them such forced reliance on self-finance penalizes young companies whose products may have greater future demand. These new and growing enterprises often have little in the way of retained earnings. Asrat (2003) also said that banks extend loans to priority sectors in response to government directives without due regard to quality, since they in emerging economies are mostly owned and run by governments. He noted that this leads to inefficient resource allocation and widespread loan delinquencies. He argues that the prevalence of these problems reduces the level of private investments, productivity of capital and the volume of savings.

According to Asrat (2003) excessive dependence on bank loan limits the growth of private investment which is considered as "the engine of economic growth". He added that if securities markets are established, they promote economic efficiency by channeling money from those who do not have an immediate productive use for it to those who do.

As Gunnvald (2006) noted that smoothly functioning financial markets have a positive effect on long-term economic growth: they encourage division of labor and specialization because transaction costs are lower. He explained as this reduces information costs and promotes appropriate allocation of resources, since projects are evaluated in connection with the provision of equity and loan capital.

Getachew M.(2016) pointed out that reducing the costs of acquiring information is expected to facilitate and improve the acquisition of information on investment opportunities; and thereby improves resource allocation.

Securities markets create better opportunities for small emerging companies to raise funds in the venture capital market because venture capitalists would be more comfortable investing in new ventures with the knowledge that possible future divestment can take place through a public offering at a potentially substantial profit (Asrat, 2003).

One of the most pressing issues for developing countries is to channel existing scarce resources into productive investment so that they can stimulate productivity, create employment, provide individuals and enterprises with basic utilities, contribute to efficient natural resource management and ultimately maximize overall health of the economy (Dahou et al, 2009, as cited in Tiruneh, 2012).

Stock exchanges improve efficiency in resource allocation through a competitive mechanism. They increase liquidity and provide risk capital for trail blazing ventures (Wang and Ang. , as cited in Samuel S., 2009).

E. Promote Economic Growth

The establishment of stock market in Ethiopia could contribute to economic growth, since it encourages investment by helping traders buy and sell stocks quickly and efficiently(Abebe Y. 2006, as cited in Jetu, 2014).

Liquidity in turn affects economic growth positively by increasing incentive to invest and save. Levine (as cited in Kannan and Ejigu, 2013) found out that countries with well-developed financial sector and a liquid capital market experience faster rates of capital accumulation and greater productivity gains. According to him as liquidity increases, firms gain increased assurance that they will be able to exit from long term investments. He also added that firms therefore become more willing to make the permanent investments critical to development. However, Yartey and Adjasi(2007) argue that increased stock market liquidity may have an adverse effect on the rate of economic growth by reducing the need for precautionary savings.

Now a day, there is a growing consensus that financial market development reduces the costs of financing, increases savings and thereby investment, while boosting economic growth. As Gunnvald G. (2006) also noted that smoothly functioning financial markets, including securities markets, promote long-term economic growth (Zsofia and Geoffrey, 2008).

Many researchers support that there is a close relationship between capital markets and economic growth. Researchers such as Bencivenga et al. (1996), Levine (1991), and Obstfeld (1994)(as cited in Kannan and

Ejigu, 2013) argued that stock markets provide services that boost economic growth.

As noted by Charles and Erik (2010) stocks, bonds, and mutual funds channel the discrete savings of millions of individuals to fund everything from large corporations to young startups. They explained further that higher stock prices and lower bond yields, which allows for more investment, higher growth, and greater job creation.

As Dudley and Habbard (as cited in Mebrahtu, 2014) noted that capital markets in the UK and US dominate these countries financial system and are the main reasons for higher productivity growth, greater employment opportunities, advanced technology and economy. However, as they argue, investigations in developing countries have varied results. Demirguc-Kunt and Levine(1999), for example, pointed out that increased liquidity can deter growth by increasing returns to investments, greater stock market liquidity may reduce saving rates through income and substitution effects. Adjasi and Biekpe (as cited in Getachew, 2006) also noted that in case of the African subcontinent, liquidity has been a significant factor in hampering stock market development and consequently retards economic growth. Getachew (2006) said that stock markets had more information than financial intermediaries and usually translate in more efficient allocation and better growth.

A well-functioning financial market, coupled with a developed financial sector, is the main asset for every national economy since it promotes economic growth and supports the eradication of poverty (Elias, 1995, as cited in Asrat, 2003).

As Applegarth (as cited in Tiruneh, 2012) pointed out that establishing financial markets cultivates channels for firms to issue various debt instruments and raise equity. Moreover, simultaneously providing more long-term options for saving and asset management for investors that will benefit enlarging economies by increasing market efficiency. He argues that financial markets are presumed to stimulate competition and speed up economic growth. Tiruneh (2012), on the other hand, noted that the higher degree of price volatility on stock markets in developing countries reduces the efficiency of the price signals in allocating investment resources. He also pointed out that these serious limitations of the stock market have led many analysts to question the importance of the system in promoting economic growth in African countries.

Wagacha (cited in Samuel S. 2009) argue that stock exchanges help release idle funds for investment because they generally provide higher rates of return than alternative investments. He added that when the stock exchange is successful, activity in the market provides a strong impetus for economic growth.

Aggarwal R. (2003) pointed out that strong security markets are necessary for the economic growth and development of any country. He also point out that efficient raising of capital and allocation of financial resources is an integral part of economic development.

F. Government Financing

As Zsofia and Geoffrey (2008) noted that deep and liquid Government securities market (DLGSM) help ensure stable government financing and budgeting by providing for a broad range of government security maturities. Moreover, market financing of government deficits usually begins with the issuance of short-term government bills. They added that frequent rollover of government securities creates uncertainties regarding the cost of deficit financing, which in turn makes formulation of the government budget more uncertain. They also said that the ability of government to quickly finance large deficits in response to unexpected developments is enhanced by DLGSMs. According to Zsofia and Geoffrey (2008) unexpected events that quickly require large government expenditures, such as banking crises or natural disasters, necessitate the rapid issuance of government paper to the private sector if the government wants to avoid inflationary monetization. Moreover, rapid financing is facilitated by government security markets sufficiently liquid to absorb large new issues at relatively low cost.

According to World Bank (September 23, 2019) an estimated $4 trillion annual investment is required for developing countries to achieve the sustainable development goals by 2030. it added that in light of the investment requirement and the maximizing financing for development strategy-helping countries maximize their development resources by drawing on private sector financing-there is a greater need to develop and strengthen capital markets in order to mobilize commercial financing.

2.1.8 Challenges of countries related to Capital Markets

Usually there are struggles to entertain the benefits of something in our day to day activities. Thus to enjoy the benefits of the securities markets, we have to be aware of the possible challenges that come across and face with them. All the benefits listed above will be enjoyed from the strong and modern capital market. Moreover, some of them will benefit the economy under great regulation and control; otherwise they will become costs for the economy. To make the market strong and modern we need to reduce the threats that will result from inability of reducing the challenges. Some of the significant challenges of operating capital markets are as follows.

A. Speculations:

As binswanger (as cited in Kannan and Ejigu, 2013) argues that stock market prices do not accurately reflect the underlying fundamentals when speculative bubbles emerge in the market. In such situations, as he noted that prices on the stock market are not simply determined by discounting the expected future cash flows, which should reflect all currently available information about fundamentals. Moreover, under this condition, the stock market develops its own speculative growth dynamics, which may be guided by irrational behavior. As he confirmed that this irrationality is expected to adversely affect the real sector of the economy as it is in danger of becoming the by-product of a casino.

B. Market cycles:

According to Asrat (2003) during the early stages of securities markets development the supply of stocks and bonds is limited, manipulation is relatively easy, investors are unsophisticated, underwriters and brokers are inexperienced, and securities legislation often has loopholes. He consequently concluded that economic cycles are more difficult to predict. He is also confirmed that the job of a financial analyst would be very difficult during the early years of development.

C. Interest rate fluctuations:

As Asrat (2003) pointed out that the fluctuations in interest rates, which occur in a financially competitive environment, make planning more difficult for both borrowers and savers. He added that the additional efforts required for information gathering and decision making in such environments, together with the need for borrowers and savers to adjust their positions more frequently over time, constitute costs brought about by a liberalized financial system.

D. Intermediation and regulation:

According to Jetu E. (2004) the absence of institutional, legal and policy framework for stock market activity, may adversely affect liquidity thereby adversely impacting economic development. He added that there is lack of commitment on the part of the government to establish prudent regulatory infrastructure thereby hampering Ethiopia's stock market development. He also pointed out that in the absence of interest of the government to facilitate the emergence and coalescence of stock market, the current stoke brokerage in out of the counter (OTC) market unfolds, and much work is bound to be required in the future to address the problems associated with such dealer markets. As Jetu (2004) confirmed that even worse, the present unregulated market for stock exchange in the OTC market may severely affect public confidence up to a level which can be counterproductive against future pursuits toward a strong, reliable and efficient stock market.

As Asrat (2003) said that the specialized services of financial intermediaries in securities markets are costly, yet indispensable. Moreover, the strategic position that financial intermediaries hold in the market system in terms of access to information and control over transactions can lead to profiteering behavior that decreases the benefits accruing from the mobilizing and allocating functions of the securities markets system as a whole.

Africa capital market news (2019) said that top priority is to set up a regulatory institution and create a government regulatory framework, and the private sector can incorporate the stock exchange. It explained the need to have stock brokerage firms and investment banks. Moreover, stock traders have to be trained and the local accounting and auditing firms have to build their capacity. It also confirmed that financial media is the key component in capital markets.

As Ezana K. (2012) pointed out that in Ethiopia, currently there are a growing number of share companies in formation that are promoting initial public offering in the primary market. He confirmed on the hand that there is no regulated primary or secondary stock market in the country that enables investors to create a market for these share companies in a secondary market. Ezana (2012) also added that another strong indication for the establishment of a stock market in Ethiopia is the recent privatization of public enterprises.

Mebrahtu (2014) pointed out that for countries like Ethiopia where systems and structures are not well organized, the availability of legal framework and supervisory body is vital for the establishment and development of capital market to ensure the macro and microeconomic stability.

2.2 Emperical Review

There are controversial issues among several empirical studies conducted on the capital market establishment in different countries.

The empirical studies conducted by Loayza and et al(2000) suggested that deeper, broader, and better functioning financial markets can stimulate higher economic growth. Ndikumana (2000) also supports the view that financial development has a positive effect on economic growth in African countries.

Guiso and Jappelli (2005) conducted a research based on 39 countries data over the period 1980 to 1988, and found out that a strong, positive and statistically significant relationship existed between stock markets and economic growth. However, Anokye (2008) later criticized using an expanded data and an alternative model and concluded that stock markets has little relevance for economic development.

Some other researchers also supports the positive relationships between stock market and economic development. For example, evidence presented by Guiso and Jappelli (2005) confirmed that the causal link between financial factors and economic development is crucially dependent upon the nature and operation of financial institutions, markets and policies pursued by individual countries. However, the evidence presented by Murinde (2006) later showed that the relationship between stock markets and economic development in the US was largely positive, but insignificant in the case of Germany. This shows that the relevance of stock market can differ between countries. Hence every country should continuously conduct researches to confirm the importance of stock market to the country.

A study conducted by Aduda and et al(2012) noted that there is a direct link between privatization and stock market establishment. The study showed that governments choose privatization as a means of developing their stock markets.

Most African stock exchanges are still at early stage of development and face several constraints facing such challenges like political instability in some Economies, high volatility in economic growth, macro economic uncertainty, liquidity constraints, limited domestic investor base, underdeveloped trading and settlement structures and limited market information (Kumo, 2008).

The emperical study made by Tiruneh (2012) found out that the existence of the financial markets encourages the private sector involvement in the economy. He also added that financial markets help to mobilize local savings, enhance competition among financial institutions, increases remittances, lead to improved corporate governance, reward sound economic policies, provide for sources of project financing, allow deconcentration of ownership, improve accounting and auditing standard and help privatization efforts. Tiruneh (2012) also confirmed the relevance of the financial markets in Ethiopia to further speed up the growth of the economy.

Chapter 3

Methodology of the Study

Many researches confirmed on the benefits that come from strong modern capital markets in any economy. In addition to this, many researches have been conducted on the benefits and challenges of capital markets which are not modern. The benefits, for instance, of one country may not be the benefits of the other because of the existing economy and capital market implementation. Thus, the benefits of the modern capital market in a modern economy may not be the benefits of Ethiopia, which strives to have a modern economy in the future and is going to start up the secondary market in the near future.

The Ethiopian officials' perception towards to the implementation of the secondary capital market does not bring success or failure of the country's economy. One of the contributing factors for the success or failure of the market is the implementation of the market without the prior analysis of the country's data regarding the factors that contribute to the success or failure of the capital market. For this reason, asking somebody for the benefits and challenges of the secondary capital market in Ethiopia is not relevant (or does not make sense) without the analysis of the prevailing data. So, the research is not intended to analyze the perception of officials (because most of the benefits and challenges have been theorized by many scholars) rather it is the analysis of the country's data.

Thus, this research is conducted analytically because it is argumentative in its very nature. So, the research digs out the benefits and challenges of capital market in any economy, and try to persuade those that are peculiar for Ethiopian economy using the secondary data obtained mainly from NBE and World Bank.

Chapter 4

Analysis and Interpretation of Data

4.1 Benefits of Capital Markets in Ethiopia

From the current situation of the country Ethiopia, the prominent benefits of having capital markets are reviewed with the help the secondary data obtained mainly from the web page of NBE and World Bank. These benefits are not mutually exclusive and supplement each other.

1. Help to complement the development of the financial sector

Financial sectors need huge money to develop. As Addis Fortune (2015) suggested that When the smaller banks that are barely above and way off the 500 million birr paid-up minimum capital requirement set for June 2016, find it difficult to increase their capital buffer significantly every year to hold two billion birr capital ratio by end June 2020, then, it may be necessary for them to have the second plan for a merger with banks having bigger assets and capital. However, it is not too difficult to raise it through the modern and efficient capital market with a short period of time. This is manifested by some newly upcoming private banks under formation.

As evidence from the webpage of new business Ethiopia shows that 34.22 billion birr is invested in 16 private banks operating in Ethiopia : Awash International Bank, Dashen Bank, Cooperative Bank of Oromia, Hibret Bank, Wegagen Bank, Nib International Bank, Bank of Abyssinia, Oromia International Bank, Addis International Bank, Berhan Bank, Abay Bank, Debub Global Bank, Bunna International Bank, Zemen Bank, Anbessa International Bank and Enat Bank, for instance. Since this amount of money is contributed through primary market, capital market helps for the development of financial sector.

As Ethiopian business portal reported that Amhara bank S.C is a new bank under formation which has received a license from the National Bank of Ethiopia (NBE) to start selling shares to the public. It managed to collect 5.3 billion birr subscribed capital from more than 145,000 shareholders. The process of establishing the bank began before few months. Near the end of January 2020, Amhara bank S.C has sold over 4.1 billion birr worth of shares out of which 3 billion is paid up. Moreover, as of March 2020, Amhara bank S.C has sold over 5 billion birr worth of shares out of which 4 billion is paid up.

As Ahbabu A. said Hijra bank was being established with a registered capital of 1 billion birr and with a paid up capital of half a billion birr (Addis G., 2019).

According to the Hijra bank staff report within three months the ZamZam was able to sell over 1.2 billion birr in subscriptions and half of it has already been paid. For both the paid and subscribed capital of the bank is the history in the financial industry since there were no one able to collect such kind of sum as a start up in the industry. On the other hand, the achievement of ZamZam and Hijra, who sells shares almost the same period but achieved their target within a short time, stated as an indicator how much huge finance was idle from the market due to potential buyers refused to run or part of conventional banking(Staff reporter, 2019).

As Dawit A.(2019) reported that Gadaa bank S.C. has begun selling the shares for the public four months back and sold 250 million Birr worth of shares until end of July.

Some of the contributed huge amount of money for the formation of the above four private banks may be idle money or may not be productive as desired. Thus the equity market can increase the productivity of the resources. Without the capital market, the country will have few banks and difficult to ensure the development of the financial system and hence the growth of the economy.

2. Highly efficient mechanism for channeling local savings to investments

Saving is not encouraging in Ethiopia as real interest rate is negative. The interest rates on deposits do not compensate the high inflation rate in the country. The National bank has set the minimum interest rate on deposits at 7%, but according to trading economics inflection rate is fluctuating between 18.7% and 22.9% in 2020. Even though the annual inflation rate in Ethiopia is decreased to 19.8 percent in May of 2020 from 22.9 percent in the previous month, it is much more than the saving rate.

The above contributed amount of money for upcoming four private banks in Ethiopia also shows that capital markets contribute to channel savings to investments. Moreover, the equity investment offers attractive return than saving. Even though the basic saving rate in banks is 7% (for interest bearing banks), the data reported by Addis perspectives (2019) shows that the minimum earning per share for the fiscal year ending in 2018 of the fourteen private banks in Ethiopia is 13.1%. This shows that capital market can yield better return than savings. Moreover, capital market is the best means for those who need to save in interest free banks to cope up with inflection. This shows that capital markets not only channel local savings to investments but also brings more savings than before.

Liberalizing the economy and privatize state-owned companies in telecommunications, aviation and banking, is part of reforms. Other corporations listed for privatization are Ethiopian Airlines, Ethiopian Shipping and Logistics Services Enterprise and Ethiopian Electric Power. In 2018, Ethiopia said it would terminate the monopoly of state-run Ethio Telecom and Ethiopian Airlines by opening up the market to both private domestic and foreign investments (James A., 2019). Since these companies require huge amount of money, it will be too difficult to secure them without the equity market for most of private domestic investors. Thus, the capital markets play an important role for the achievement of the government, and also enable to transfer ownership to the public. This is also a highly efficient mechanism for channeling local savings to investment.

Countries economy in the world are ranked on their ease of doing business, from 1-190. The larger the ranking the more conducive the regulatory environment to the starting and operation of a local firm. Ethiopia is ranked 159 among 190 economies in the ease of doing business, according to the latest World Bank annual ratings. According to trading economics the rank of Ethiopia remained unchanged at 159 in 2019 from 159 in 2018 following from behind its neighboring countries; Rwanda(rank 38) and Kenya (rank 56). Even it is less than Sub-Saharan Africa average(140). Moreover, according to World Bank Group(2020) Ethiopia's starting a business and getting credit rank are 168 and 176. Whereas its neighboring country Rwanda has rank 35 and rank 4 of starting a business and getting credit respectively; and Kenya has respectively rank 129 and rank 4.

Country	Starting a business	Getting Credit
Ethiopia	168	176
Kenya	129	4
Rwanda	35	4
Sub-Saharan Africa average	120	113

Table 1. Two of the criteria for doing business of Countries
Source: World Bank(2020): Doing Business Rank

It is too difficult in Ethiopia to get credit when we compared with its neighbors Kenya and Rwanda; even its rank is less than Sub-Saharan Africa's average. Hence capital market enable the country to pool up the savings to investment so that improves its rank of doing business to attract investors.

3. Reduce cost of capital and unemployment

The more the liquidity of the capital market, the more the investors' interest to participate in the market, and the less the cost of investing. The capital market pools up individuals money, which may not be enough to start up business or may give a small chance for employment, to start up new businesses or strengthen the existing businesses and contribute to reduce unemployment at large, which is one of the main problem of the country Ethiopia.

As Mamo Mihretu, Prime Minister Abiy senior policy advisor, said that at least two million job seekers join the market every year. The country has a plan to create around 20 million jobs in various sectors in the coming ten years. He also added that the private sector's contribution in job creation has not been going as expected and the government's current economic reform focuses on supporting the private sector to the engine for job creation (Ethiopian Monitor, 2019). However, achieving this goal is not simple without supporting or funding entrepreneurs in Ethiopia, which is not an easy job.

The unemployment rate in Ethiopia in 2019 was 1.8% of total labor force (World Bank). Thus to address each year's unemployment and help the government to achieve the goal of reducing unemployment, capital market formation plays a vital role to finance new Entrepreneurs and the existing businesses for the reduction of unemployment.

The country Ethiopia can change the rank of doing business by having capital market and hence will be in a better position to strengthen the local investment and attract foreign investment. This ultimately reduce unemployment rate.

The largest commercial bank in Ethiopia, Commercial Bank of Ethiopia (CBE) has 34,879 permanent employees and the newly established Amhara bank currently employees over 3,600 individuals. According to Dawit Astatike(August 5, 2019) the Gada bank will be expected to create over 2,000 job opportunities when it begins opening the proposed 30 branches for the first phase of its operation. This shows that the investment in financial institutions can create jobs and reduces unemployment. For the establishment of the financial institutions and other investments that need huge amount of money, capital markets play the leading role for their source of the money. Thus, directly or indirectly capital markets contribute in reducing the unemployment rate.

As Trading Economics compiled the World Bank 2020 report, only 42.9% of the total populations of Ethiopia have access to electricity. Due to Ethiopia's fast economic growth the energy demand is increasing enormous. This energy demand is not only for household consumption and small businesses but also for large factories, which contribute to reduction of unemployment. This will be achieved with the help of the Great Ethiopian Renaissance Dam (GERD), which has been under construction since 2011. It was assumed to finish its construction in 2017. According to Wikipedia the total fund estimated for the dam is $4.8 billion USD. Out of which US$1.8 billion are reportedly financed by Chinese banks. This would leave US $3 billion to be financed by the Ethiopian government through other means.

The government has been issuing bonds to finance the $3 billion. Since the dam has been constructing with the known international company Salini Constructori S.P.A, there is no question about its risk. Because of this if there had been a capital market, investors in the world will be motivated to participate in buying and selling of GERD bonds and hence the country will finance the construction with relatively short period of time, which enable us finish as planned and contribute in reduction of unemployment.

4. Offer Liquidity to investment

Now a day, the Ethiopian government calls investors especially foreign investors to alleviate unemployment. This will be facilitated with liquid capital market and providing an opportunity to reduce their risks (See Bib. 27).

The invested amount of 34.22 billion birr of 16 private banks operating in Ethiopia (which is stated under the first benefit of capital market) shows that at least this amount of money is not available whenever needed or the security will be sold without reasonable price. Thus market illiquidity will demotivate the investor to invest. Liquidity allows the investors to reduce their risks. Moreover, with the liquidity of capital market an investor can withdraw himself/herself from the company. This ultimately gives foreign investors to invest in the country.

Even though Ethiopia is the fastest growing economy in Africa, it is also one of the poorest, with a per capita income of $790 (World Bank, 2019). This does not mean that there are no millions of individuals who can invest in the capital market. Thus, in one way or the other most Ethiopians get their money back with reasonable loss or gain whenever they need it. Unreasonable cost of searching for the likely buyers does not reflect the fair value of the asset and can refrain the investors from investing in the capital market. The fair value of the securities obtained from liquid capital market will attarct even the foreign investors to invest more than what they have invested today. Hence liquidity plays a crucial role in attracting and providing confidence for the investors to participate in the market and contribute for the development of modern economy, which is vital for the economic growth.

Ethiopia has already collected several hundred million dollars from the public at home and 56 million U.S. dollars' through bond to finance the Great Ethiopian Renaissance dam (Xinhua, 2018). The investors have to wait for five years to get the money back from the government. However, if there had been a capital market the investors can get the money back whenever they need it irrespective of the bonds maturity and they will be motivated to invest it again. Moreover, the government can also issue a long term bonds, say 10 years and can get relief and finish the construction with the specified time period and may reduce the conflict that we have been in with Egypt.

5. Reduce investment Risks

One of the reasons for Ethiopians to participate in traditional financial practices, Edir and Ekub is to reduce their risk of loss of their money. Since strong and modern capital market provide an opportunity of reducing the risk of investing, it will be a good chance for these people to invest in what they have been investing a huge money through Ekub.

There are situations that bring opportunity to one industry than the other or that bring threat to almost all industries like the pandemic COVID-19. This pandemic has occurred in the world since December 2019. Ethiopia is one of the countries that the pandemic starts to attack at large. Since there was information for COVID-19 to be pandemic in the near future, the investors had a chance to withdraw some of the investments from riskier industries if there were capital markets.

6. Contribute for unification of the country

After 1991, the political approach of the ruling government EPRDF has created wrong perception on the nations and nationalities of Ethiopia. Naturally individuals need those which are closer to them; family, friends, tribe and so on to invest. However, it is because of ethnic rivalries in Ethiopia.

Ethiopia's parliament had decided to open up the country's financial sector for about five million diaspora who have taken other nationalities, including allowing them to buy shares in local banks and start lending businesses. Ethiopia's population, like other African countries, is young and growing rapidly, and the economy has been expanding at a near double-digit annual rate for more than a decade. However, the Prime Minister Abiy's reformist drive has been in danger by long-simmering ethnic rivalries that have burst into the open in recent weeks, through sporadic acts of violence (Routers).

The ethnic rivalry may have impact on the financial sectors by choosing the same ethnic group to be the shareholders of the institution. This may not bring fairness and equity in the financial system. Moreover, it may not create competitive environment in the market. To avoid this problem and contribute to the unification among the people and able to build modern market, the capital market plays a vital role in the financial system. This market can help us mix the ethnic groups in owning the company by reducing ethnic extremism. Ultimately, it will even contribute for the stability of the current political situation and hence it will help to bring the country's unification.

7. Help for Government Financing

Unexpected events such as natural disasters and pandemic that quickly require large government funds necessitate the rapid issuance of government papers.

As I said earlier under 'liquidity' the government needs huge money for the Great Ethiopian Renaissance dam and has been issuing bonds to finance it. However, it is not a simple job to do it in this way to collect such huge money within a reasonable period of time without the capital market.

Moreover, the government issues short term government papers for the deficits and to implement the monetary policy, to avoid inflation, for example. Ethiopia recorded a government budget deficit equal to 3.70 percent of the country's Gross Domestic Product (GDP) in 2018, as reported by trading economics (2020). The last five years data for government deficit, as reported by trading economics accounts 2.78 percent of the country's GDP in average.

Year	Government deficit (in %)
2015	2.6
2016	2.4
2017	1.9
2018	3.3
2019	3.7

Table 2. Government deficit for the year 2015-2019.

The government deficit in table 2 was financed through government short term securities with 4.5% weighted average interest rate for the domestic public and publicly guaranteed debt (see Bib. 39). So, the capital market plays a vital role to ensure stable rapid government financing and budgeting at relatively low cost with both short term and long term securities.

4.2 Challenges of the country related to capital markets

Leave alone the financial system, every activity of the country has to be regulated and controlled from the betterment of the achievement. Unless the capital market is regulated and controlled it may deter the financial system rather than supporting it. This will ultimately contribute to establish for the strong and modern capital market, from which we obtain the above benefits. Unless we properly regulate the capital market we may entertain certain costs.

1. Experience of Expertise

Countries go to the market; there is a general lack of capital market expertise in many African countries (Vera S., 2014).

In Ethiopia, universities and other higher learning institutions do not specialize and excel in some specific disciplines. Almost all are multidisciplinary offering wide range field of studies. Courses do not directly train soft skills that are crucial for the real world. Rather, work experience gives us the opportunity to apply our skills. Moreover, experience in large companies differs from experience in small companies. Even if expertise in Ethiopia capital market have experience in other countries capital market, they may face problem until they properly handle and implement fully in Ethiopia capital market, which is an emerging market in a new cultural background.

2. Effective regulation and supervision

Effective regulation and supervisory will contribute for the effective implementation of capital market and obtain the above listed benefit or many more. However, if the country fails to regulate the market, most of the benefits of the capital market become costs to the economy. For example, unless the regulatory body closely follows the market the current "ethnic perception" of the individuals does not ascertain equity and fairness. Moreover, it does not provide equal opportunity for competition and leads to information asymmetry. These will hamper the market. Ultimately, these will higher the risks of investment for some investors and bring illiquidity of the investment. This will bring financial crises for the economy and hence the capital market will not achieve the intended objectives.

3. Financial infrastructure

First let's see about the role of banks in capital markets. An organization which holds securities (like shares, debentures, bonds, government securities, mutual fund units etc.) of investors in electronic form at the request of the investors through a registered depository participant is called depository. It also gives services related to securities transaction. However bank holds the funds for depositors. The comparison of bank and depository is given below.

Bank	Depository
Fund holder in an account	Securities holder in an account
Transfers funds b/n a/cs on the order of the account holder	Transfers securities ··· the bond holder
Transfer facilitator without having to handle money	... without having to handle securities
Safekeeping facilitator of money	Safekeeping facilitator of securities

Table 3. Comparison of bank and depository. Source: Bib. 35

The above description shows that banks plays vital role in capital market and its infrastructure contribute to the effective implementation of the capital market. To see this, let's consider the Commercial Bank of Ethiopia (CBE), the largest commercial bank in Ethiopia.

Up to June 30th 2019 CBE has more than 22 million account holders and the number of Mobile and Internet Banking users also reached more than 2.5 million. Active Automated Teller Machines (ATM) card holders reached more than 8 million. As of June 30, 2019, 2,513 ATM machine and 9,539 POS machines were available (Webpage of CBE).

This means 1 ATM machine is for 8755 customers, which is not as such enough. Thus the country has to maintain the financial infrastructure not only for the financial system and also has to be ready for the upcoming implementation of the capital market. From this fact, we see that even the largest commercial bank, CBE has no enabling digital payment system[1].

Bank branches per 100,000 adults of Ethiopia increased from 0.83 in 2004 to 2.93 in 2012 growing at an average annual rate of 22.19%. As compared

[1] One of the main enabling minimum standards to operate a stock exchange market as stated under subunit 2.1.6

to some Sub-Sahara African countries, for example Kenya (2.69 in 2004 and 5.17 in 2012) and Rwanda (0.40 in 2004 and 5.76 in 2012) (IMF), Ethiopia is a country with a lot of its people unbanked even if there is no available data about the current bank branches per 100,000 adults.

As Ato Zemedeneh said financial media is also a key component. The existing financial media should extend their financial news coverage or the new one has to be established (Ethiopian Herald, 2019). However, there are no new financial media(newspapers, TV, radio, online etc) or strengthened the existing media for financial news coverage. The existed media still report as usual. Thus without the financial infrastructure it is difficult to make the capital market effective.

The familiarization of the system to the local private sector is one of the main enabling minimum standards to operate a stock exchange market[2]. This can well be achieved with the help of media. It plays a significant role in enhancing the public awareness(consequently influences the investment behavior of citizens) and informs individuals, groups entities and governments about the overall financial system and the new capital market development. However, there is no media that works on public awareness regarding the upcoming 2020 implementation of capital markets. Leave alone the orientation of the public through online, there is no updated information about the establishment of the upcoming capital markets except the meeting held before years. This could be one of the challenges since it is one of the main enabling minimum standards to operate a stock exchange market.

4. Financial Literacy of Investors

Financial literacy is essential to one's financial success and that is why an effort has to be made to improve it. Financial literacy helps individuals to budget, manage debt, and create a savings and retirement plan. Moreover, managing debt and creating savings plans could help reduce household debt levels and take households out of poverty. Ultimately it will put Africa's youth,in general, in control of their money or finances. It will also allow Ethiopia's youth to confidently participate in the financial market and invest in products that match their financial goals. In terms of the financial system and economy, financial literacy will arouse economic

[2] Subunit 2.1.6

activities; lead to better regulation of the industry and healthy competition in financial services and products offered. Therefore, it is vital that policies and measures are put in place to increase financial literacy rate on the continent Africa. According to Future Africa Forum African countries score the worst in terms of financial literacy in the world. Based on the survey, the most financial literate country is Botswana at 51% and the least is Somalia at 15% according to the survey. The financial literacy of Ethiopia is 32%.

From the webpage of CBE we saw that there are only 2.5 million mobile and internet banking users out of 22 million CBE bank customers. This shows that the financial literacy of the savers to use technology is low. Above this, capital markets require investors to read and understand financial statement or need to be well aware of the capital markets. Technology is not only changing existing markets but also expand the scope of markets.

The media, in general, could be used as a medium to spread financial literacy education. However, there are no new financial media in Ethiopia or the old ones are not strengthened. Thus this literacy level of investors could be one of the challenges for effectively implementation of the capital market.

Chapter 5

Conclusions and Recommendations

5.1 Conclusions

Modern financial system can play a key role in economic growth. Moreover, the more developed and deep capital market can play a role in supporting the financial system so that it contribute the transmission of the monetary policy which help us influence the financial stability which plays a great role for economic growth.

The benefits and challenges of the capital markets will depend on the financial system and also the modernity of the economy of the country. Without well regulated modern capital market some of the benefits that it gives for the economy may be costs of the economy.

Evidences enable us to conclude that strong and modern capital markets in Ethiopian economy have the following benefits.

- Help to complement the development of the financial sector.
- Highly efficient mechanism for channeling local savings to investments.
- Reduce cost of capital and unemployment.
- Offer liquidity to investment.
- Reduce investment risks
- Contribute for unification of the country.
- Help for government financing.

Even though the capital markets have several benefits to the economy, it is not without challenges. Unregulated and uncontrolled capital markets may deter the financial system than contributing to an economic growth. The country Ethiopia may face challenges on the following issues.

- Experience of expertise.
- Effective regulation and supervision.
- Financial infrastructure.
- Financial literacy of investors.

If the country overcomes these challenges, it will entertain many more benefits than those listed above that will contribute to the economic growth.

Leave alone the other benefits of capital market, the peculiar benefit of the capital market in Ethiopia: contribute to bring unification of the country; enable us to start up the secondary market. Hence capital market is relevant for the country, Ethiopia.

5.2 Recommendations

Africa's long-term economic success is intrinsically linked to the successful development of its capital market, and strengthening them is essential if Africa is to fulfill its vast potential (Africa Business insight, 2011). When we employ the techniques to reduce the challenges of the country regarding the markets, we benefit more and contribute to the economic growth. For the successful implementation of the markets the country has to employ the following measures. To enjoy the benefits and reduce the costs that results from the stated possible challenges, the National Bank of Ethiopia should:

- ⧫ increase the financial literacy of the public regarding the benefits of investing in capital markets.
- ⧫ orient the professionals' about the likelihood of the occurrence of the challenges and made them ready for it.
- ⧫ provide in-service training for the expertise which plays a vital role for the modernization of the markets.
- ⧫ develop well-functioning capital markets regulatory, compliance and risk-monitoring system, and strengthening the controlling mechanism during implementation.

- enforce the market participants to strictly follow disclosure rules and accounting standards to improve transparency.

- enforce all financial institutions to improve their financial infrastructure that facilitates the automated systems across all markets to make the transactions smooth and create a competitive environment.

- conduct continuous academic research during implementation for the betterment of the markets in order to reduce the threats of the markets.

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