

Addis Ababa University

College of Law and Governance Studies

LLM Program in Business Law

Bond Issuance and Regulation in Ethiopia: the Case of Grand Renaissance Dam Bonds

By

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Declaration

I, the undersigned, declare that the thesis is my original work and has not been presented for a degree in any other university and that all sources of materials used in the thesis have been duly acknowledged.

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Acronyms

1. CFTC Commodity Futures Trading Commission
2. CSD Central Securities Depositories
3. FDRE Federal Democratic Republic of Ethiopia
4. FED Federal Reserve Bank Of America
5. FRL Fiscal Responsibility Law
6. GRDBs Grand Renaissance Dam Bonds
7. GSCC Government Securities Clearing Corporation
8. GTP Growth And Transformation Plan
9. IGE Imperial Government of Ethiopia
10. IOSCO International Organization For Securities Commission
11. MENA Middle East and North Africa Region
12. MoFED Ministry Of Finance And Economic Development
13. MTDS Medium Term Debt Strategy
14. ORTN Obrigação Re-ajustável do Tesouro Nacional (inflation indexed treasury bonds)
15. OTC Over The Counter Markets
16. PMGE Provisional Military Government of Ethiopia
17. RBI Reserve Bank Of India
18. SEBI Securities exchange board of India
19. SEC Securities Exchange Commission
20. SELIC Special System for Settlement and Custody (SELIC)
21. UK United Kingdom
22. US, USA United States of America

Abstract

Bond issuance and its market in Ethiopia are at their rudimentary stage and have long distance to go. Well developed government bond market can assist economic development in general and infrastructure development endeavors in particular. Government bond issuance in Ethiopia is not guided and supported by well designed legal and institutional frameworks. Such kind of government bond issuance will leave its own black point on future developments of government bond market and so requires great deal of care. Regulation of government bond issuance and their circulation in secondary markets will be preliminary considerations in any capital markets building. The author of this study found that despite government bond issuance in Ethiopia including the issuance of GRDBs, it is not based on full-fledged legal and institutional frameworks.

Government bonds market needs many measures including cultivating institutional and normative spheres for its development. There are many factors that policy makers should consider in developing government securities markets. Sufficient regulation both in primary and secondary markets is yet to be designed. For instance some institutions which are crucial elements of government bond market like central depositories and settlement centers are not available. Likewise government bond market in Ethiopia is not lucky in utilizing financial intermediaries that are called underwriting or syndicate groups which will serve as market makers. These institutions would assist the bonds distribution to a considerable extent.

Keywords: Government bond, primary market, secondary market, financial intermediaries, underwriters, long term debt instruments, capital market, money market.

Chapter One: Introduction

1.1. Background of the Study

An active and efficient government securities market could be a catalyst for development of broader capital markets. Development of capital markets has long been recognized as an important aspect of economic development by providing strong financial basis for financing needs. Stock and bond markets are two major components of capital markets. Capital markets are markets where people, companies, and governments with excess liquidity transfer those funds to people, companies, or governments who have a shortage of funds. By doing so, capital markets promote economic efficiency by channeling money from those who do not have an immediate productive use for it to those who do have.

When savers make investments, they convert cash or savings into risky assets with the hope of receiving enhanced benefits in the future. It is well known that buying stocks and bonds and investing in real estate are common examples of risky assets. To minimize such risks to the extent possible capital market requires careful regulation. Investment on government bonds is presumed to be the most risk free compared to investment on other securities. Despite that it requires sufficient regulation both in primary and secondary market for various reasons.

Government bond market is the widest market in which great deal of outstanding government securities are traded in developed economies like in US and Japan.¹ Developing an efficient and liquid government securities market in Ethiopia is essential for several reasons. Among the specific functions of a government securities market are²:

1. An efficient government securities market enables the government to handle budget deficits in a non-inflationary manner and at a lower long-term cost than would otherwise be possible.

¹ Meir Kohn, Financial institutions and Markets, 2005, Tata Mc Graw-Hill publishing Company Limited. 12th reprint, 2005, pp522-523

² Ewart S. Williams, Governor, The Government Securities Market in Trinidad and Tobago, public education pamphlet series no. 4, p1

2. Second, government securities can provide an alternative means of saving for the public. A diversified and efficient domestic bond market can also help to safeguard a country's economy from the effects of domestic and international shocks.
3. In most developed economies, government securities are an important instrument for monetary policy implementation and for the transmission of interest rate signals to the rest of the economy; and
4. Interest rate on government bonds becomes valuable reference points for pricing other public and private financial contracts (e.g. corporate bonds), thereby reducing price uncertainty.

Because of the above benefits, government securities market is the centerpiece for the development of the broader capital market, by creating a benchmark for the pricing of other financial assets.³ Because of the aforementioned benefits that government bond market can provide in other jurisdictions, we get reasons to foster the development of government securities market in Ethiopia.

Government bonds are convenient for financing infrastructural projects since they provide long term financing consistent with the long period needed for construction. Government securities market also allows the population to participate in the infrastructural development of the country.⁴ In order to finance wars and to alleviate the burdens of taxation, many countries used to issue government debt securities.⁵ As these securities are usually transferable, secondary market in these securities emerges.⁶

³ Yibin Mu and Michael Horgan, Government Securities, Money Market and Cash Management In Serbia: Key Issues and Recommendations for Development, JUNE 2006, p10

⁴ Mathias M. Siems, The Foundations of Securities Law, 10 September 2008, p5

⁵ During World War I the federal government raised \$5 billion through the sale of Liberty Bonds. Between November 1942 and December 1945 Americans invested in approximately \$150 billion in bonds to finance World War II. The campaigns to encourage Americans to buy U.S. Treasury bonds to finance World Wars I and II were known as war bond drives. Because mass media (radio, newspapers, and magazines) publicized the importance of every citizen's support in the war effort, the campaigns succeeded. Available at <http://digital.library.okstate.edu/encyclopedia/entries/w/wa020.html> visited on 12/1/2014.

⁶ Mathias M. Siems, *Supra* note 4.

Developing countries rarely succeed beyond the stage of primary government securities issuance.⁷ A few emerging market countries, however, move to the next stage of developing liquid secondary markets for government securities and other securities in the private sector. This shows that developing government bond market is very essential even for the development of capital markets in general. Therefore special care is needed and concerned bodies need to pay all the sacrifices it may demand.

Bond issuance in Ethiopia is a relatively new mechanism of financing public infrastructure. Financing infrastructure by bond issuance in other jurisdictions, like in the United States has a long history.⁸ Such jurisdictions had developed efficient legal infrastructure which could provide experience to other jurisdictions. For instance in America securities regulation act was enacted as early as 1933. Since then government bond market has developed steadily and helped the development of securities market and public infrastructures.

In Ethiopia, the Imperial Government issued proclamation no 172/1961 and it's amending proclamation no 262/1969 with a view to develop capital markets and to regulate government bond issuance. Under such framework, the authorized maximum amount of bonds was set for the government. The law was amended during the Derg regime by increasing limits of outstanding bonds from one hundred million Ethiopian Dollars to four hundred Ethiopian Dollars⁹. Since then there have been some piecemeal legislations here and there that regulated bond issuance.¹⁰ Then in 2007 the House of peoples Representatives enacted a Proclamation to enable the Commercial Bank of Ethiopia raise funds. Under this Proclamation the Bank was empowered to raise money more than the authorized amount of four hundred million. The Proclamation states that Ministry of Finance and Economic Development (MoFED) can issue especial government bonds in the amount of birr 2.5 billion with maturity date of ten years.¹¹ This specific

⁷ James Leigland, Accelerating Municipal Bond Market Development in Emerging Economies: An Assessment of Strategies and Progress, 1997. P9 available at

www.developmentfunds.org/pubs/AcceleratingMunicipalBondMktDvpt

⁸ Irwin S. and etals, Issuance of Securities by Public Service Corporations, The Yale Law Journal, Vol. 37, No. 6 (Apr. 1928) P721, <http://www.jstor.org/stable/789670>. Accessed: 16/07/2013 04:15

⁹ Art 2 of Government Bonds (Amendment) Proclamation No 25/1975, Negarit Gazeta, Year 34, No. 21, Addis Ababa, 11th March 1975.

¹⁰ Special Government Bond Proclamation No. 531/2007 available at <http://chilot.me/2011/03/31/a-proclamation-on-special-government-bond-proclamation-no-5312007>.

¹¹ Id, Art 2(2) and art

Proclamation says nothing about amendment of the former proclamation of 1975 which sets the maximum authorized amount.

In addition to special government bonds issued by MoFED to finance the Commercial Bank of Ethiopia, recently MoFED has issued the Grand Renaissance Dam Bond in the domestic market and in the Diaspora community.¹²

The government securities market comprises the issue, distribution, trading and redemption of treasury bills, notes and bonds.¹³ The arrangements and activities related to the issue and initial distribution of these securities constitute the primary market while the subsequent trading of securities is done in the secondary market.

It has been common knowledge that an active and efficient government securities market is a vehicle for development of the broader capital market. The development of capital markets in turn has its own positive impact on the economic development of a country in general.¹⁴ Hence, it is quite advisable to pay all the sacrifices it may require through its course of development. Thus, this paper indicates all those sacrifices needed to build the market at the outset.

In most countries, the process of capital market development invariably follows a certain chronological order.¹⁵ The first stage is normally the development of the market for government treasury bills. Early in this phase, Treasury bill issues are largely aimed at supporting the short term financing needs of the central government as it seeks to compensate for the lack of harmonization between government receipts and expenditures.¹⁶ The second stage is normally the introduction of a primary market for government notes and bonds to help in the financing of government budget and long term development projects.

1.2. Statement of the Problem

Comprehensive normative and institutional infrastructures for the development of the government bond market have not yet flourished here in Ethiopia. This paper examines the need

¹² Supra note 11

¹³ Ewart S. Williams, Supra note 2, p1

¹⁴ Why Do Capital Markets Matter For New Zealand? Capital Market Development Taskforce Secretariat, p10, Available at <http://www.med.govt.nz/business/economic-development/pdf-docs-library/cmd-taskforce-research/why-capital-markets-matter.pdf> accessed on 2/12/2014

¹⁵ ibid

¹⁶ ibid

for, and feasibility of government bond market in Ethiopia. Ethiopia needs to go further to overcome the constraints impeding the development of its bond markets. One can easily notice that the government bond markets in Ethiopia are very shallow and provide limited opportunity for the government to raise adequate resources. A deep, liquid, and vibrant government securities market is necessary to allow governments in developing countries to effectively utilize domestic debt securities market. The mechanism how government bond market could be built, developed and regulated is not well known in Ethiopia. Therefore, the author of this study will search for the reasons for such shallow nature of government bond market and will assess ways how government debt securities market could develop.

The author of this study has the belief that long term government debt securities are not playing roles what they are expected to play in Ethiopia. They can provide the federal government, the regional states and municipalities with long term borrowing from internal sources. For these instruments to play significant role in the economy, the country has to start the move to develop government bond market.

Therefore, this study will address the following questions specifically:

1. What are the legal aspects of government bond market development?
2. What are the possible regulatory institutions and legal frameworks for the issuance of government bonds in Ethiopia?
3. How do we regulate government bond issuance and what could be the possible repercussions of unregulated government bond issuance?
4. What are the justifications that call for full-fledged legal framework for government bond issuance?
5. What are the experiences of other states in this regard?

1.3. Objectives of the Study

The main objective of this paper is to analyze the nature of requisite legal and institutional framework in regulation of government bonds market in Ethiopia. It will attempt to assess the normative sphere which could be conducive for development of government bond markets. It will also identify the problems which will result from unregulated and arbitrary government bond issuance.

This research will have the following specific objectives:

- To examine the mechanisms through which government bond market could be regulated and developed;
- To examine the adequacy or otherwise of the legal framework for government bond issuances in Ethiopia with specific reference to the legal regime for the Grand Renaissance Dam Bond.
- To analyze the legal base and the manner of regulation for primary and secondary government bond markets.

1.4. Significance of the Study

This study will have necessary contribution to the securities market development in general and for the development of government bond market in particular. As the paper is the first of its kind, I believe that it would make good reading material for anyone interested in the area. Moreover it would serve as a stepping stone for further researchers who have interest on the issue. And finally I hope that it will serve as essential input to government policy makers and law makers.

1.5. Scope and Limitations of the Study

The paper is totally devoted to the development and regulation of government debt securities market. Debt security instruments and equity security instruments in the private sector may be raised incidentally. In addition, this paper is not concerned with regulation of other derivatives of financial instruments like futures or options. The author of this study admits that there are areas that need be addressed independently and as such I touched them incidentally and not exhaustively. Moreover literatures in the topic are limited in the legal fields even though there is bulk of literature in other disciplines like banking and finance and economics.

1.6. Methods

This study is made based on mainly qualitative data and thus it is qualitative research as it is mostly descriptive and interpretive analyses. This paper mainly uses documents issued in relation to issuance of GRDBs. Some experiences of different countries with regard to government bond issuance are consulted. It also used interviews using open-ended unstructured questions with

some professionals who are closely involved in sale of GRDBs from Commercial Bank of Ethiopia and Development Bank of Ethiopia.

Chapter Two

2. Overview on Government Bonds and Bond Markets

2.1. Government Bonds in General

Debt securities issued by a state often have special names, like gilts in the UK and Ireland, Bunds in Germany, and treasuries in the US¹⁷. Government bonds are securities, mostly of more than one-year maturity, either issued or guaranteed by the central government on behalf of a nation for purposes of financing general or specific budget expenditures.¹⁸ Government bonds most of the time are backed by the "faith and credit"¹⁹ of the government, not by other physical or financial assets. Medium and long term debt securities are called government bonds and unlike treasury bills, they are traded on capital markets.²⁰ Government bonds have been considered default free, and government securities market generally offers liquid and active trading environment provided that necessary infrastructures are available.²¹

A bond is an interest bearing security or certificate issued by an organization or government in order to borrow money. A bond is like an agreement between the borrowers or issuer, and the lender or investor. Bond is promise by the issuer to repay the investor the principal of the loan by the end of a fixed period of time plus interest²².

Bonds are different from stocks, which are a way of raising money by selling shares in a company. Stockholders are subject to both the ups and downs of a company unlike bond holders who are more secured.²³ Both corporations and governments can issue bonds but governments

¹⁷ Mathias M. Siems, Supra note 4, p13

¹⁸ Clemente Del Valle and et als Developing Government Bond Markets, Hand Book, IMF and World Bank. July 2001, P398

¹⁹ Government is generally presumed to be default free or has higher credit than private economic actors.

²⁰ Mathias M. Siems, Supra note 4, p13

²¹ Clemente del Valle and et als, Supra note 18, p335

²² Vicki Elmer, Bonds and Borrowing , University of California at Berkeley, Department of City and Regional Planning , p1

²³ ibid

do not sell shares to raise money for capital facility. Most of the time bonds are repaid with taxes or revenues from user fees, exactions and leases.²⁴

Government bonds are backed by the full faith of the government and supported by the credit and taxing power of a country.²⁵ This is because at maturity, government can redeem the bond by increasing taxes levied, reducing spending, or simply by printing money.²⁶ The term risk free is coined to express some aspect of government bonds as they are free from 'credit risk'.²⁷ Although we say government bonds are free from credit risk we should not forget 'currency risk'²⁸ and 'inflation risk'²⁹. Currency risk occurs by the change in price of one currency against another, where foreign investors will receive lower return compared to local investors. On the other hand, inflation risk is the possibility of a reduction in the purchasing power of par value. Issuance of inflation indexed bonds can effectively mitigate problems posed by inflation risk.³⁰

Various countries define government debt securities in their laws. For instance, the 2006 government Securities Act of India under its definitional article describes government securities as follows:

Government security means a security created and issued by the government for the purpose of raising a public loan or for any other purpose as may be notified by the government by the official gazette and having one of the forms mentioned in section 3³¹.

USA Securities Exchange Act of 1934 indicates that government security is a very wide concept which includes among other things, the direct obligations or obligations guaranteed as to the principal and interest by the United States.³²

²⁴ ibid

²⁵ See investopedia available at <http://www.investopedia.com/terms/g/government-bond.asp>

²⁶ Soh Wei Chee and Cheng Fan Fah, Macro-economic Determinants of UK Treasury Bonds Spread, International Journal of Arts and Commerce, ISSN 1929-7106 www.ijac.org.uk, January 2013, p163

²⁷ ibid

²⁸ A form of risk that arises from the change in price of one currency against another. Whenever investors or companies have assets or business operations across national borders, they face currency risk if their positions are not hedged, <http://www.investopedia.com/terms/c/currencyrisk.asp>

²⁹ The uncertainty over the future real value (after inflation) of your investment, <http://www.investopedia.com/terms/i/inflationrisk.asp>

³⁰ Soh Wei Chee and Cheng Fan Fah, Supra note 26.

³¹ Section 2(f) of the Government Securities Act, 2006 (NO. 38 OF 2006), 30th August, 2006.

³² Paragraph 42 of the 1934 securities exchange act

a. Government Bonds in Ethiopia

In Ethiopia the financial administration proclamation no 648/2008 provides that security means something given or pledged to secure a financial promise or a financial obligation and includes a treasury bill, a note or a bond.³³ The regulation on financial administration takes government guaranteed bonds as securities deposit together with bills of exchange payable to MoFED.³⁴

Therefore, when we talk about securities we are talking also about government bonds. The Commercial Code of Ethiopia does not define what a bond or a debenture is. It under Article 429 directly delves into providing prohibitive prescriptions on business organizations that cannot issue debentures or bonds. The Commercial Code seems to use both terms interchangeably. Debentures are those debt instruments of business organizations which are empowered to issue them. Thus, the legal system is not as such alien to bonds or debt instruments.

Government bond in Ethiopia can be taken as among tools of government through which it can raise funds from domestic sources. It is among the domestic debt instruments like treasury bills and notes. Domestic debt covers the debts of the central government in forms of government bonds, treasury bills and direct advance from the National Bank of Ethiopia.³⁵ Bonds are different from other short term means of debt by their longevity of maturity and by the fact that they are transferable in secondary markets.³⁶

The position paper of the business community on the revision of the commercial code of Ethiopia, prepared under the auspices of the Addis Ababa Chamber of Commerce and Sectoral Association, has stated the following:

There is no corresponding legal provision that elaborates transferable securities. This area is normally left to the law on stock exchange which is yet to come to Ethiopia. The importance and relevance of such a law is to provide for the establishment and regulation of markets for trade in the different forms of stocks and bonds. Although companies may

³³ Art 2(20) Federal Government of Ethiopia Financial Administration Proclamation No. 648/2009, Negarite Gazeta, 15 Year No. 56 ADDIS ABABA, 6th August, 2009

³⁴ Art 2(7) of financial administration council of ministers regulation no 190/2010.

³⁵ Ministry of Finance and Economic Development Statistical Bulletin, Bulletin No. 11 (2008/09 - 2012/13), P9

³⁶ Ethiopian Renaissance Dam Bond Operational Guidelines and Accounting Manual, the English version, Tahisas, 2004, p5

*issue shares and bonds (debentures) under the Code, the rules for the regulation of the trade are not yet in place.*³⁷

According to this position paper transferable securities, which includes government bonds, are not yet defined and will be defined in the law on stock exchange which is yet to come. It is the belief of the author of this study that defining transferable securities should be the mandate of securities law which is yet to come, not law on stock exchanges. Stock exchanges are organized market places where securities are formally traded. The law on stock exchanges needs to focus on the dos and don'ts of these institutions and the requirements of their establishment. Operational and accounting manual prepared by Development Bank of Ethiopia and National Bank of Ethiopia attempts to throw some light on bond in the following manner:

*Bond, like Promissory note or Treasury bill, is a debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing. It differs from other short term means of debt in its longevity of service. An average maturity of a bond is said to range from 5 – 30 years; but based on a specific situation of respective country it can be longer or shorter.*³⁸

Under this manual bond is taken just like promissory note or treasury bill. Though it has its own element of truth, bond unlike treasury bills is capital markets instrument. Promissory note and treasury bills are among the money market instruments.³⁹The 1961 and 1969 government bonds proclamations of the Imperial era defined bond as written obligation to pay a fixed sum of money or the face value at a fixed time in the future or at the date of maturity.⁴⁰

³⁷Addis Ababa Chamber of Commerce & Sectoral Associations, Recommendations and position paper of the business community on the revision of the commercial code of Ethiopia prepared by a team of fourteen national experts, July 2008, P144

³⁸Ethiopian Renaissance Dam Bond Operational Guidelines and Accounting Manual, the English version, Tahisas, 2004, p5

³⁹ M.L Jhingan, Money, Banking, international Trade and Public Finance, 7th edition, Vrinda Publications, Delhi, 2004, P208

⁴⁰ IGE, Art 3 of proclamation no 172/1961 and art 3 of proclamation no 262/1969.

2.2. Treasury Bills

Treasury bills are government debt securities and are of the temporary or short term in nature. They are the major money market instruments issued with maturity date of less than one year.⁴¹ They are main sources of short term funds for government to bridge the gap between revenue and expenditure. Often time banks take them as attractive form of investment and are main investors of treasury bills.⁴² Unlike government bonds, treasury bills are issued mostly with maturity date of less than one year. Government bonds are issued with maturity date longer than one year which may stay up to thirty years.

2.3. Government Securities and Other Corporate Securities

As there are common features that both government bonds and other corporate bonds share, government bonds have also their own unique quality. To mention few of them government bonds are the most risk free, are exempt from prospectus requirements and sometimes are exempted from taxation.⁴³ Thus, they always get some preference in securities regulatory authorities. This is meticulously expressed by George C. Nnona in the following paragraph.

The exemption of government securities from registration is a common feature of securities' regulation regimes. The exemption recognizes the pervasive acceptance of government as a special class of securities issuer. Usually government securities receive preferential regulatory treatment because of perceived character of the issuer...less amenable to self-serving chicanery in the issue of financial instruments....[G]overnments are perceived as ultimately able to meet their debt obligations, relying on their power over the public revenue⁴⁴.

Therefore, we can notice here that government securities have their own characteristics that set them apart from other securities. But this is only true in relation to their issuance or sale in the primary market. Once they enter into the secondary market they need closer regulation just like other securities as they are not immune from frauds of the secondary market. Thus, both entry and exit of institutions involved in the trading transactions of government bonds require regulation.

⁴¹ M.L Jhingan, Supra note 39, p202. See also IGE, art 3(2, c) of Treasury Bills Proclamation no 263/1969.

⁴² Clifford Gomez, Financial Markets, Institutions and Financial services, Prentice-Hall of India private limited, 2008, p144

⁴³ Clemente del Valle and et als, Supra note 18, P305

⁴⁴ George C. Nnona, The Nigerian Investment and Securities Act: Delineating Its Boundaries in Relation to the Registration of Securities, Journal of African Law, Vol. 50, No. 1 (2006),p37

2.4. Money Market and Capital Markets

Detailed discussion of money and capital markets in this paper is not my main concern and it is not wise to deal with this wide area within a single sub topic. Author of this study preferred to see it slightly as I think that it has some nexus with government bond issuance. Market participants in money markets may involve as market actor in capital markets and specifically in government bond markets. Thus, development of the money market has substantial impact on development of government bond markets.⁴⁵

Money market is market for short term instruments that are close substitutes of money. These instruments are highly liquid and easily marketable. The money market consists of call and notice market, commercial bills market, commercial papers market, treasury bills markets, inter-bank markets and certificate of deposit markets.⁴⁶ All these are closely related and make the money market. Promissory notes, bills of exchange or commercial bills, treasury bills, call and notice money and interbank terms are instruments of the money market.⁴⁷

Capital market is a market for medium term or long term loans and used to supply capital to the industry or government. Normally stocks or shares, debentures of corporations and government bonds are traded in the capital market. Funds which flow into the capital market come from those individuals and institutions having surplus cash.⁴⁸ Commercial banks, investment banks and non bank financial intermediaries such as mutual funds, insurance companies, pension funds often times have funds with the desire to invest in profitable and risk free areas.⁴⁹

Capital markets function via stock exchanges which facilitate buying and selling of capital market instruments. Many times stock exchanges are a market place for old securities in secondary markets. It means such market is used to transact outstanding securities. It can also be a market for new issuances when it assists in the issuance of new securities by government or corporations. Capital market comprises the complex of institutions and mechanisms through

⁴⁵ M.L Jhingan, Supra note 39, p209

⁴⁶ Id, p200

⁴⁷ Id, p202

⁴⁸ Id, p207

⁴⁹ Ibid

which funds are pooled and made available to individuals, business organizations and governments.⁵⁰

2.5. Purposes of Government Bonds

Government securities or bonds can serve a number of functions in both developed and developing countries like Ethiopia, which need a great deal of capital to develop public infrastructures⁵¹. In developing economy, most of the time the government takes the initiative and the commitment to build many of the public infrastructures. Therefore, obviously there is a large need of capital to finance such development projects. Hence, the development of capital markets is indispensable so that the market will play its part.⁵²

In addition to providing financial sources to develop public infrastructure, government bond market can also play great role in macroeconomic policy implementation. Among other things, it serves to manipulate the monetary policy matters. In that it would help to mitigate inflationary pressure in the economy. Therefore, it has crucial importance to channel available public savings to areas of economic activities having great significance. Some of the benefits of government bond markets are discussed in the following subsequent sub topics.

2.5.1. Alternative Way of Public Utilities Financing

Public utilities or public infrastructure can be financed either by governments' revenues derived from their taxing power and/or from different sources of fees that governments collect for its services or by borrowing from different sources.⁵³ Among the different sources of borrowing the banking sector and external sources could be major ones. Government can also generate considerable capital by sale of government debt securities where there is favorable legal environment for development of capital markets.⁵⁴ The main advantage for the state in issuing government debt securities is that this can be faster, more flexible, and less contentious than a raise in the tax rate. Thus, government bonds can provide significant alternative to raise revenue.

⁵⁰ *ibid*

⁵¹ Garry J. Schinasi, and etals, IMF working paper, financial implications of the shrinking supply of U.S Treasury Securities, May 2001, p50

⁵² Ramit Nagpal, Bond Markets: Should India Look For a Regional Solution? The International Lawyer, Vol. 39, No. 3 (FALL 2005), <http://www.jstor.org/stable/40707810> Accessed: 02/09/2013 04:44, p709

⁵³ Otaviano Canuto and Lili Liu, UNTIL DEBT DO US PART, Subnational Debt, Insolvency, and Markets, 2013 International Bank for Reconstruction and Development / The World Bank, p55

⁵⁴ *Id*, p45

These days, due to various reasons the banking sector is unable shoulder all the financing needs. Thus, it is normal to search for other ways of financing public utilities.⁵⁵ That is why many developing economies are resorting to government bond issuance in trying to raise revenue.

However for the effective utilization of government securities there are many other factors that have great connection to the issue. Among others, the development of the contractual savings industry is one. There is a need for high level of public savings in the market that create the demand for government bond issuances.⁵⁶ Moreover, the legal framework for public private partnership is also of paramount importance. This could be possible if government can define all sorts of government bonds that could invite the involvement of the private sector. Say for instance the existence of the revenue bonds in the legal system can sufficiently invite the private sector to the government bond market. We will see what revenue bonds are in subsequent sub-topics.

2.5.2. Inter-Generation Burden Sharing Equity

Long-term borrowing through the instrumentality of government bonds relieves current generations from bearing excessive costs for infrastructure that will serve many generations ahead.⁵⁷ As a result, some argue that financing public infrastructures will equitably transfer some of the costs to the coming generation which will be beneficiary of the development. Otaviano and Lili are among those writers who share the above assertion. Thus they argue:

*The new bond instrument has aimed at creating a framework for medium-term capital budgeting for infrastructure investments. Past budgeting practice did not separate financing of capital budgeting from that of current expenditure. Long-term capital investments need to be financed through debt for intergenerational equity.*⁵⁸

The debts of the present generation should be shared by the coming generation as they are deriving the benefits of the utility. There is a great need of creating cross generational burden sharing. The present generation does not have to shoulder all the sufferings as the utilities of the

⁵⁵ Cedric Achille, Structured financial conditions for infrastructure project bonds in Africa, African Development Bank Group, 2013, p12

⁵⁶ Id, P77

⁵⁷ Otaviano Canuto and Lili Liu, Supra note 53, P542

⁵⁸ Id, p432

project are enjoyed by the coming generation too. Spending on public infrastructures help to increase social productivity and that their cost should therefore be borne by not only the present generation but also by future generations in the redemption and servicing of the public debt issued to finance those investments⁵⁹.

Many times, it is asserted that the future generation should not shoulder the burdens brought by the existing generation. However, at this time, the possible foreign sources of borrowing are decreasing substantially. Hence one can infer from this that the probability of the future generations' debt burden increment is getting less likely if proceeds are invested on long-term infrastructures. Fees from these utilities can finance the redemption of government bonds.

Borrowing enables governments to capture the benefits of major capital investments immediately, rather than waiting until sufficient savings from current income can be accumulated. Infrastructure investments benefit future generations, which should bear a portion of the cost. Borrowing finances infrastructure more equitably across multigenerational users of infrastructure services. Infrastructure services thus can be paid for more equitably by the beneficiaries of the services.⁶⁰

2.5.3 Non-Inflationary Budget Deficit Financing

It is repeatedly argued that budget deficit financing through bond issuance is not inflationary. There are literatures in the economics discipline than in the legal field in this area that elaborate the non inflationary nature of bond financing⁶¹. Economists argue that financing projects by bond issuance is nothing more than transferring money capital from one sector to the other sector which is already circulating in the market.

A study made by John D. Burger and Francis E. Warnock on the development of 49 local bond markets show that policies and laws matter on development of bond markets⁶². They

⁵⁹ Fiscal Debate over Japan's Special Deficit Financing Bond, Nomura Journal of Capital Markets Spring 2003 Vol.4 No.4, Nov 2012

⁶⁰ Otaviano Canuto and Lili Liu, Supra note 53, pp37-38

⁶¹ Stijn Claessens and etals, Government Bonds in Domestic and Foreign Currency: The Role of Macroeconomic and Institutional Factors, Center For Research On Economic Development And Policy Reform, June 2003, p6

⁶² John D. Burger and Francis E. Warnock, Local Currency Bond Markets, IMF Staff Papers, Vol. 53, Special Issue (2006), pp. 133-146 <http://www.jstor.org/stable/30036026>, Accessed: 01/10/2013 08:02

indicated that countries with stable inflation rates and strong creditor rights have more developed local bond markets and rely less on foreign currency-denominated bonds.⁶³

As deficit financing by printing money is inflationary, governments have to have legal frameworks that prefer bond financing than money printing. However, we have to be careful that the proceeds of bond issuances should go to finance capital projects, and not to finance the short term needs of the government. We will see what we call the golden rule with regard to this fact of debt allocation to capital projects than current consumption in chapter three.

2.5.4 Contribution to the Development of Corporate Bond Market

Normally it is believed that the development of government securities market is prerequisite to the development of corporate bond market⁶⁴. This is because it would provide ‘benchmark yield’⁶⁵ for the pricing of corporate bond market. The custom of bond issuance by itself can be created first by repeated government bond issuance and its redemption at maturity. Developing a government securities market supports the development of bond markets for municipalities and corporate sectors.⁶⁶

Government bond market establishes a reference for pricing sub national and corporate bonds, commercial paper, or any kind of private sector fixed-income security.⁶⁷ Because of their usually large funding needs, governments seem to be the most suitable providers of a benchmark yield. Government securities also are used as a hedging tool for interest rate risk, essential for intermediaries, and they serve as underlying assets and collateral for repo, futures, and options markets.⁶⁸

⁶³ *ibid*

⁶⁴ Clemente del Valle and et als, *Supra* note 18, p42.

⁶⁵ Bench mark yield is a standard by which something is measured. For example, bond yields are generally compared to benchmark yields on U.S. Treasury securities of similar maturity.

⁶⁶ Stijn Claessens and etals, *Supra* note 61, p6

⁶⁷ Ewar S. Williams, *Supra* note 2, p4

⁶⁸ Clemente del Valle and et als, *Supra* note 18, p42

2.5.5 Contribution to the Sustainability of the Banking Sector

It is believed that the repeated issuance of government bonds with fixed coupon rate could assist in the determination of the interest rate for the bank loans too.⁶⁹ Ramit Nagpal rightly stated the purpose of development of the bond market to the economy and to the financial sector particularly.⁷⁰

Developed bond markets provide critical pricing information for financing decisions in an economy and, for a market determined term structure of interest rates that reflect the opportunity cost of funds at a wide range of maturities. An active market in government securities and 'a benchmark yield curve'⁷¹ enable the development of new financial products that not only provide tools for risk management but also facilitate operation of monetary policy by the central bank and liquidity management by financial institutions.⁷²

Therefore the development of the bond market has multifaceted functions for the economy. It would provide tools to manipulate the monetary policy to the central banks among other things. It also provides bench mark to making financial decisions in long term and short term investment. Because those who own capital can choose among the available other areas of investment or may choose to invest it on fixed income investments like investment on government bonds.

2.5.6 Different Types of Bonds

a. General obligation bonds, revenue bonds and callable bonds

Revenue bonds are government bonds the redemption of which is guaranteed by the revenue generated by the project financed by the proceeds of the bond sale. Revenue bonds are long term

⁶⁹ Y V Reddy, Issues and challenges in the development of the debt market in India, BIS Papers No 11, P120

⁷⁰Ramit Nagpal, Supra note 52, p698

⁷¹ A line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. The most frequently reported yield curve compares the three-month, two-year, and five-year and 30-year U.S. Treasury debt. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth. see <http://www.investopedia.com/terms/y/yieldcurve.asp>

⁷² Ramit Nagpal, Supra note 52, p698

debt instruments retired by specific dedicated revenues.⁷³ Revenue bonds are designed to be self supporting through user fees or other special revenues. In this context the general taxing power of the jurisdiction is not pledged. The debt created through the issuance of revenue bonds is to be repaid by the earnings from the operations of a revenue producing enterprise or from special taxes.⁷⁴ Revenue bonds are government bonds in which the revenue derived in the project financed by the proceeds of the bond sale could serve as the collateral for the holders of that bond.

Revenue bonds have been used extensively in various countries, including the United States, as a powerful instrument to finance sub national infrastructure by linking project finance with benefit taxation. The debt service is secured by revenue streams produced by the project financed by the bond instrument⁷⁵.

In the case of general obligation bonds the bond's security is generally the taxing power of the state or the jurisdiction. This makes the security of these bonds very high. The full faith and credit backing of general obligation bonds includes the pledge of all general revenues, unless specifically limited, as well as the legal means to raise tax rates to cover debt service. The public entity is authorized to levy property taxes or to draw from other unrestricted revenue streams such as sales or income taxes to pay the bonds principal and interest. The interest rates on these bonds are generally the lowest of any public security due to this superior protection.⁷⁶ General obligation bonds, or "GO" debt, are typically subject to the referendum procedure in many countries.⁷⁷

The redemption of the bonds can be financed easily if the bonds are of the revenue bond type. There is a great deal of projects that could generate revenue in the form of service fees. Hence it is quite advisable to make more of the municipal bonds revenue bonds than general obligation bonds. Because the general obligation bonds are guaranteed by the taxing power of the local authority and such power are lesser in local authorities. One can infer that the general obligation

⁷³id, P365

⁷⁴ Debt Management Plan, Mricopa County,Arizona,Department of Finance Debt Mnagement Division, June 30, 2006, P10

⁷⁵ Otaviano Canuto and Lili Liu, Supra note 53, p443

⁷⁶ ibid

⁷⁷ ibid

bond issuance requires more rigorous procedures than the revenue bonds as the bonds are more secured than others.

Usually, the duration of bonds is fixed. However, there can also be 'callable bonds' which can be redeemed by the issuer prior to maturity.⁷⁸ Creating diversification in bonds by expanding choices of savers may help development of government bonds market. Thus it is advisable to create different kinds of bonds with different characteristics with a view to widen investors' choices.

Chapter three

3 General Conceptual Frameworks about Government Bond Issuance and Regulation

3.1. Regulation of Government Bonds

a. Regulation Defined

The Palgrave Dictionary of Finance defines regulation as action that 'command and control' the individual decisions of firms, in an effort to prevent private decision-making that would take inadequate account of the 'public interest'.⁷⁹ And the principal concern of the laws for regulation is fraud, deception and manipulation in securities markets.⁸⁰ Therefore, protection of public interest is at a center of any regulation including regulation of government bonds issuance and transaction.

The term regulation refers to a set of binding rules issued by a private or public body⁸¹. By a private body we mean availability of code of conduct for the parties in the regulated sector. For instance government securities dealers associations may have their own codes of conduct for their members. A public body which is authorized to regulate may enact rules in the fulfillment of their function of regulation in the sector. Generally, these can be defined as those rules that are

⁷⁸ Mathias M. Siems, *Supra* note 4, p13

⁷⁹ Yohannes Assefa, *Financial Markets Development and Regulation*, power point presentation. Slide three

⁸⁰ Ratner, D., *Securities Regulation Material for a Basic Course*, (2nd Ed, USA, West Publishing Co. 1980), p. 815

⁸¹ Kenneth Kaoma Mwenda, *Legal Aspects of Financial Services Regulation and the Concept of a Unified Regulator*, 2006, p5

applied by all regulators in the fulfillment of their functions. The body issuing these rules must be given the authority to do so.⁸²

Regulation in any area refers to the desire of the public to put the subjects of regulation in a direction that promotes public interest or at least to check that they do not act in a manner contrary to public interest. It is a controlling mechanism through which any desired goal of the general populace can be achieved.

In securities regulation regulators regulate financial products such as, bonds, debentures, stocks etc. and market actors like brokers and dealers, institutions like stock markets. Securities regulation is used to refer to the set of rules, controls and processes, established by state authorities, with the aim to shape or prohibit certain behavior and decision-making bodies involved in the transaction of government bonds.⁸³ As a result in several countries security markets and industries are subject to supervision and control by a public authority or a commission. As the securities market involves intermediaries who buy and sell securities for investors and traders it needs cautious regulation. Hence securities regulation is concerned with the regulation of people and firms engaged in that business, to make sure that they do not take advantage of their better know-how and access to overreach their non-professional customers⁸⁴.

Therefore when we talk about government bonds issuance and regulation we should take the above points into consideration. Thus we should first address questions like what is government bond regulation and what are the regulatory mechanisms or how we can regulate government bond issuance. And what are the possible regulatory tools that the body designated to regulate the government bond market can utilize? In most countries, government securities trade in the secondary market along with all other securities and are therefore subject to secondary market regulation. Effective secondary market regulation is necessary to support a viable government bonds' secondary market. Regulatory concerns in the secondary securities market are concerns of the government securities market too.

⁸² *ibid*

⁸³ Llewellyn, David, , "Institutional Structure of Financial Regulation: The Basic Issues", paper presented at the World Bank and IMF conference Aligning Supervisory Structures with Country Needs, Washington DC, June 5-6, (2006), P. 4

⁸⁴ Kenneth Kaoma Mwenda, *Supra* note 81, p11

b. Nature of Securities

The distinctive features of securities entail more cautious and careful approach to regulate it than any other sector. We need to adopt strong and rigorous regulation for capital markets like in the banking sector. Because parties involved in transaction of regulated market i.e capital markets involve third parties' interests. These parties are taking money from third parties giving nothing of value than a paper in real senses and thus are vulnerable to fraud⁸⁵. As such they need strong and fully fledged normative sphere.

An important focus of securities regulation, therefore, is assuring that, when securities are created and offered to the public, investors need to have an accurate idea of what that claim is and how much of an interest is represented in that particular security⁸⁶. Therefore securities regulation is concerned with at the primary issuance and their subsequent trading in the secondary market.

3.2. Goals of Securities Regulation

The regulation of securities market is common in several countries. The ultimate goal of securities regulation is quite different across countries and unique due to the difference in the actual situations of those countries. However the IOSCO indentifies three goals of securities regulation which are implemented in some countries.⁸⁷ These are investor protection, market efficiency and reduction of systemic risk.

Although we say that government bonds are the most risk free, this is not true concerning their trading in the secondary market. Unless there is efficient and effective regulation in the secondary market, they are prone to forgery and other deceitful practices like any other debt or equity securities. Therefore not only investors in other securities but also investors in government bonds need protection of the regulatory regime.

The regulatory framework for securities markets, including government securities markets, is usually seen as having three distinct objectives—assurance of fair, efficient,

⁸⁵ Zohar Goshen and Gideon Parchomovsky, The Essential Role of Securities Regulation, Duke Law Journal, Vol. 55, No. 4 (Feb., 2006),Duke University School of Law, p741

⁸⁶ Id, p715

⁸⁷ International Organization of Securities Commissions (“IOSCO”), Objectives and Principles of Securities Regulation (2003), p. 1. See also, Weinstein, S., “Securities Law in Canada: Quebec A Case Study”, International Law Vol. 21 (1987), p. 17

*and transparent markets; minimization of systemic risk; and protection for investors and consumers of financial services*⁸⁸.

Therefore any regulatory attempt in capital markets is presumed to incorporate the aforementioned goals as guiding principles of any capital markets development.

a. Protection of Investors

Investors in the securities market refer to the general public who buy securities either from the primary or secondary securities market.⁸⁹ These investors should be protected from misleading, manipulative or fraudulent practices by dishonest promoters and worthless securities.⁹⁰ Investors on government bonds are not significantly different from investors in other securities. They are also vulnerable to different fraudulent practices.

In some countries, especially western countries, the role of securities regulation is to, among other things, promote market confidence and to ensure the development of a transparent and well-informed securities market where every market participant has equal access to information and participates on a level playing field.⁹¹ Edmund W. elaborates one of the goals of securities regulation in the following paragraph:

*A more sophisticated variant of the theme of investor protection is that the purpose of the regulation is to protect investors in order to help issuers and securities salesman sell securities to the public. The public resists buying securities because of fears that any particular issue may be fraudulent. Potential buyers have to invest real resources to protecting themselves against fraud. The regulation, by providing an effective deterrent against fraud, reduces this cost for buyers and makes it possible to sell securities at higher prices, helping issuers and the securities industry.*⁹²

⁸⁸ Clemente del Valle and etals, Supra note 18, P35

⁸⁹ International Organization of Securities Commissions (“IOSCO”), Objectives and Principles of Securities Regulation (2003), p. 5. See also, Weinstein, S., “Securities Law in Canada: Quebec A Case Study”, International Law Vol. 21 (1987), p. 4

⁹⁰ Glocker, W. T., “Protecting Investors in Securities”, Annals of the American Academy of Political and Social Science, Vol. 206, Government Expansion in the Economic Sphere (Nov., 1939), p.69

⁹¹ Lawrence, J., “The Economics of Market Confidence: (Ac) Costing Securities Market Regulations”, Centre for Corporate Law & Securities Regulation, The University of Melbourne, pp. 2-3

⁹² Edmund W. Kitch, a Professor University of Virginia Law School, Regulation Of The Securities Market, 1999, p822 <http://www.law.virginia.edu/lawweb/faculty.nsf/FHPbl/1180712?OpenDocument&ExpandSection=1>, accessed on June 17, 2010

The regulation of the securities market does not seek to ensure that all investors make a return on their investment, nor does it seek to guarantee a specified yield. The ultimate purpose is to build the confidence of the public to actively participate in the securities markets which as researches have shown stimulates economic growth and development.⁹³

The public may resist buying securities because of fears that any particular issue may be fraudulent or worthless. Prospective buyers have to invest on real resources to protect themselves against fraud. Making transaction areas not effectively regulated will increase the cost of accurate information or investors may refrain from buying bonds.⁹⁴

Nevertheless, securities regulation reduces this cost for buyers and makes it possible to buy securities at market prices and help issuers and the securities industry to finance their projects.

In some countries full disclosure of information material to decisions of investors is the most important means for ensuring investor protection.⁹⁵ Meaning creating information symmetry will contribute its own strong role in investors' protection.

In other countries a concerned public authority to regulate the securities market may evaluate the merit of the public offering to verify that it does not expose the public to loss. The IOSCO suggests that only duly licensed or authorized persons should be permitted to hold themselves out to the public as providing investment services, for example, as market intermediaries or the operators of exchanges.⁹⁶

Supervision of market intermediaries should achieve investor protection by setting minimum standards for market participants. Investors should be treated in a just and equitable manner by market intermediaries according to standards which should be set out in rules of business conduct.⁹⁷ Effective supervision of the intermediaries, access to neutral courts or dispute resolution, effective means of compensational and effective enforcement of legal rules are critical in protecting investors.⁹⁸

⁹³ *ibid*

⁹⁴ *ibid*

⁹⁵ International Organization of Securities Commissions ("IOSCO"), *Objectives and Principles of Securities Regulation* (2003), p. 5. See also, Weinstein, S., "Securities Law in Canada: Quebec A Case Study", *International Law Vol. 21* (1987), p. 7

⁹⁶ *Id* p8

⁹⁷ *ibid*

⁹⁸ *Id* p9

b. Market Efficiency

The next goal of securities regulation is to improve market efficiency. Efficient capital markets are generally beneficial to a society. In an efficient market scarce resources are allocated more efficiently among competing uses. For instance surplus funds will gravitate to their highest value user if the financial market is regulated well. In efficient markets securities will get their proper value and this is true when there is accurate information⁹⁹. This will happen if every market participant has the same information. An efficient market is one in which the interaction of a large number of buyers and sellers results in prices that fully reflect publicly available information about the goods traded. The security investors may not be able to value the price of the offering unless full, fair and plain information is disclosed either about the history of the security's market price or about the body that issued the security.¹⁰⁰

In ensuring fair, efficient, and transparent markets, supervisors often aim primarily at avoiding improper trading practices like market manipulation and insider trading. A requirement that information potentially affecting prices be released expeditiously, and to all market participants equally, is important in building fair and transparent capital markets.¹⁰¹

Therefore, governments need to intervene in the securities markets as a regulator to ensure that securities market is efficient and fair. Such efficient market will fuel economic growth and ensure an efficient allocation of resources. This will happen when there are legal and institutional regulatory infrastructures.

c. Minimization of Systemic Risk

The other goal of securities regulation is the mitigation of systemic risk. In finance, systemic risk is the risk of collapse of an entire financial system or entire market, as opposed to risk associated with any one individual entity, group or component of a system.¹⁰² It can be defined as "financial system instability, potentially catastrophic, caused or exacerbated by peculiar events or conditions in financial intermediaries."¹⁰³

⁹⁹ Danils, F. J., "Comparing U.S. and Hong Kong Public Offering Regulation: How Cost Effective is China's Primary Capital Market?", S. Cal. L. Rev. Vol. 691821 (1995-1996), p. 1828

¹⁰⁰ Newkirk, G. R., "Sufficient Efficiency: Fraud on the Market in the Initial Public Offering Context", The University of Chicago Law Review, Vol. 58, No. 4 (Autumn, 1991), p. 1397.

¹⁰¹ Clemente del Valle and etals, Supra note 18, P35

¹⁰² Kenneth Kaoma Mwenda, supra note 81, p4

¹⁰³ Newkirk, G. R., Supra note 99

Systemic risk refers to the risks imposed by interlink ages and interdependencies in a system or market, where the failure of a single entity or cluster of entities can cause a push, which could potentially bankrupt or bring down the entire system or market.¹⁰⁴ Where securities firms' failure does occur, regulation should seek to reduce the impact of that failure and attempt to isolate the risk to the failing institution.¹⁰⁵ Hence, securities regulation promotes and allows for the effective management of risk and ensures that capital and other prudential requirements are sufficient to tackle problems and control excessive risk taking.

3.3. Regulatory Concerns in Government Bonds' Issuance

Generally speaking the focus area of governments' bond regulation should be around the primary and the secondary market regulation. Government bonds have their own peculiar features in some respects as they have similar features that they share with other securities. Therefore many of regulatory concerns in the securities market are shared by government securities regulation too. Thus regulation meant to other securities like equity securities and debt instruments in the private sector has important bearing on government securities since there is no totally independent or separate market to government bonds.

Despite that fact government securities issuance is normally considered to be exempted from prospectus requirements. However this does not mean government bonds are arbitrarily issued. In one way or another primary issuance requires some sort of control or regulation. Many countries require issuance to be approved by legislature.¹⁰⁶ Some others give issuing authority to certain public agency by providing general debt limits or debt ceilings.

A country's legal system need to devise effective mechanisms to prohibit government from excessive issuance of debt instruments. Thus regulation starts from meticulous stipulation of procedures through which a new government bond issuance need to follow¹⁰⁷. It is all about determining the ways how government is controlled so that it does not issue bonds in a manner that hamper an economy. It also includes controlling the issuance process as to its fairness to the market participants. Determining the way of distribution, the authority empowered to issue government bonds, the source of authority of the government concerning borrowing and other

¹⁰⁴ Kenneth Kaoma Mwenda, supra note 81, p50

¹⁰⁵ ibid

¹⁰⁶ Paul Posner and Chung-Keun Park, Role of the Legislature in the Budget Process: Recent Trends and Innovations, ISSN 1608-7143 OECD Journal on Budgeting Volume 7 – No. 3 © OECD 2007, P17

¹⁰⁷ FS series No 12: developing government bond markets, primer diagnostic checklist, and guidelines for preparing a model scope of work, October 2010, P17

such related issues come to the ambit of regulation in the primary market.¹⁰⁸ Any government body empowered to control borrowing by government need also to check the purpose for which debt is issued.¹⁰⁹

Regulation in the primary market includes determining the specific body of the government which has the power to issue government bonds. Some countries give this power to their Ministry of Finance and others to a Central Bank¹¹⁰ or to a Treasury Department within a Central Bank or established independently of the Central bank. In Ethiopia, the Ministry Of Finance and Economic Development is empowered to issue government bonds.¹¹¹

Primary market involves sale and distribution of government securities to the investors by the issuer. Selling and distributing government securities to investors efficiently involves the choice of sales procedure (auctions, retail schemes, tap sales, and/or syndication) and the possible use of primary dealers. In return for meeting the obligations for being designated a primary dealer; governments grant primary dealers some privileges, often including exclusive access to the auctions.¹¹²

*The selection of selling procedures or distribution channels for government securities encompasses a number of policy decisions. The selection should, to the extent possible (i) ensure cost-effectiveness; (ii) encourage participation from a relatively wide range of investors, including foreign institutions; (iii) maximize competition; (iv) minimize placement risk; and (v) foster transparency. For most advanced economies, the main sales technique is typically auctions.*¹¹³

Thus when we see legal framework on government bonds in Ethiopia in light of the aforementioned criterion, we can notice that it does not fulfill many of them. Government bond market in Ethiopia is at its rudimentary stage and requires confronting many pain taking challenges.

¹⁰⁸ *ibid*

¹⁰⁹ *id*, P42

¹¹⁰ Soh Wei Chee and Cheng Fan Fah, *Supra* note 26, p164

¹¹¹ Art 40 of Federal Government of Ethiopia Financial Administration Proclamation No. 648/2009.

¹¹² Clemente del Valle and etals, *Supra* note 18, P15

¹¹³ *id*, P153

3.3.1. Building Primary Market

Establishing primary market basically requires among other things designing rules for auctioning securities. Government bonds need be sold through auction based on sufficient competition so that government could raise money with lesser cost. Scheduled government bond issuance encourages transparency and predictability in financial markets. Thus setting rules with a view to create transparent and accountable issuance could assist in building primary markets to a considerable extent. Market makers and any party having some stake on the issuance should get timely information about government bond issuances.¹¹⁴

Building the primary market requires also making technical organization such as establishing a registry to give a legal title to government securities holdings, a central depository for the custody of government securities, and establishing clearing and settlement system. The systems used to settle and clear financial market transactions need be cost-efficient. They should offer delivery versus payment, and final registration of ownership. They will need to have a clear legal basis and be subjected to regulatory oversight.

3.3.2. General Preconditions for Bond Issuance

The Financial Sector Knowledge Sharing Project prepared by United States Agency for International Development reveals the preconditions for government bond issuance.¹¹⁵ There are many preconditions for the issuance of government bonds and these include the following among other things.

Primarily governments should be credible issuers of securities as investors do not have any other security to their investment than their trust on government. In addition to that the prevailing macroeconomic conditions should have at least some degree of stability. Moreover government should be committed to pay market interest rates on its debt. The financial market should be

¹¹⁴ Al Runde, State Level Debt Issuance, Wisconsin Legislative Fiscal Bureau, Informational Paper 78, January, 2013, P5, available at http://legis.wisconsin.gov/lfb/publications/Informational-Papers/Documents/2013/78_State%20Level%20Debt%20Issuance.pdf. Visited on 2/15/2014.

¹¹⁵ Supra note 107, P16

supported by an appropriate technical and regulatory framework. Finally the public debt and the financial market should have a certain minimal critical mass.¹¹⁶

Government bond market development has its own natural phases. The first three preconditions are developments in the first phase of the establishment of government securities market. The others may be met by development of government securities market in a second phase. These two phases correspond roughly to the primary and secondary markets, respectively.¹¹⁷

Low domestic savings rate; scarcity of institutional investors; proliferation of government agencies issuing securities causing market fragmentation; unpredictable issuance policy; and absence of the required market infrastructure are all that hamper development of government securities market.¹¹⁸ As such anybody who is concerned with development of government bond market needs to act taking all those matters into consideration.

3.3.3. The Golden Rule in Bond Issuance

When government wants to finance certain expenditure, there are principles that it should adhere to. The first is that of ‘the golden rule’¹¹⁹ which upholds that the proceeds of bond sale should only be invested on long term infrastructure. That is, by no means the proceeds of the bond sale should be used to finance current expenditure or consumption for non capital purposes. Using debts for non capital projects would mean imposing debts of today’s generation on the future generation that is not ripping any benefit of the debt.

Long-term borrowing is restricted to financing capital expenditure to ensure that future generations are not held accountable for operational expenditure incurred by the current generation.¹²⁰ The borrowing for long-term capital investment, and not for current consumption, is called the “Golden Rule.”¹²¹ Various developing and developed economies adopted this rule with regard to regulation of government borrowing.¹²²

¹¹⁶ *ibid*

¹¹⁷ *ibid*

¹¹⁸ *ibid*

¹¹⁹ The borrowing for long-term capital investment is called the ‘Golden Rule’

¹²⁰ Otaviano Canuto and Lili Liu, *Supra* note 53, p542

¹²¹ *Id*, P446

¹²² *ibid*

In Mexico, the institutional framework for sub national debt starts with the 1917 Constitution, which maintains a golden rule for state and municipal debt. It sustains that all indebtedness must be used to finance productive public investments.¹²³ In Brazil, Article 167, Section III, of the Federal Constitution establishes the golden rule to prevent the use of borrowing to finance current expenditures: the amount of new loans contracted is limited to the amount of capital expense. Law No. 10028 (October 31, 2000) establishes penalties for public officials not complying with the FRL (fiscal responsibility law).¹²⁴

In line with the above experiences, Japan's public finance law 1947 stipulates strict restriction on the issuance of public debt. Article 4 paragraph 1 of the law states that national expenditures shall be compensated by the revenues excluding proceeds from public bonds or borrowings.¹²⁵ The provisions of this paragraph are referred to as the construction bond rule. The rule concerning the construction bonds and deficit-covering bonds under Article 4 of the Public Finance Law embodies the significant notion that future generations are not to bear any burdens in excess of benefits.¹²⁶

3.3.4. Limiting Crowding Out in the Private Sector

Crowding out refers to displacement of private economic activities by public economic activities.¹²⁷ The subject has long history in macro economic theory and policy debate. In recent years the danger of public borrowing crowding out private borrowing and public spending crowding out private spending has got attention of policy makers.¹²⁸ Regulation of government bonds in the primary market also involves careful consideration of the issuance so that it will not crowd out investment in the private sector. Because thinking economic development without active involvement of the private sector will not be wise. Thus when government plan to issue bonds, it should take such effect of the issuance into consideration or it would be better to put

¹²³ id, p152

¹²⁴ id, p88

¹²⁵ Art 4 of public finance rule of 1947 of Japan.

¹²⁶ Kazuyuki Sugimoto, Policy Research Institute, Ministry of Finance, Japan, Public Policy Review, Vol.8, No.1, June 2012,p21

¹²⁷ Willem H. Buiter, Crowding out and effectiveness of fiscal policy, Economic Research program, research memorandum no 191. Feb 1976, P1

¹²⁸ ibid

certain limit with this respect. Normally increased and uncontrolled government debt issuance will result in less investment in the private sector.¹²⁹

Given the credit standing of government bonds, such securities, especially if priced competitively, will be the preferred investment choice for many market participants. Persistent large government budget deficits, financed by issuance of new government bonds, could absorb national savings, thereby crowding out the private sector from the bond market. Under such circumstances, the private sector will find it impossible to obtain investors for its bonds or will do so only at prohibitively high interest rates.¹³⁰

Government may crowd out the private sector through utilizing various ways. The government may be tempted to finance its fiscal deficit at the lowest possible cost before any nongovernment issuers tap the market whenever any fertile condition is created. This could be achieved by offering government bonds with additional attractive features than the private sector can provide. For instance tax exemptions and backing by proceeds of gold or oil can indeed attract investors on bonds. Government may also require financial institutions to purchase government securities to meet regulatory requirements (captive sources of government funding).¹³¹ With this regard, for instance government bonds in Ethiopia are tax exempted. In addition to this private banks in Ethiopia are obliged to purchase government bonds up to 27% of their credit provision.¹³²

3.3.5. Authority to Issue Government Bonds

Some jurisdictions give the authority to borrow through government bonds to parliaments. Such authorization may be provided in a constitution or in other primary legislation. In US, the congress is authorized to borrow under the US constitution.¹³³ In Japan, government can issue bonds when their parliament which they call it Diet approves the issuance.¹³⁴ Authority for the government to borrow in the domestic market needs to be established as the first fundamental aspect of market development. The law in some countries grants the capacity to borrow directly

¹²⁹ Nora Traum And Shu-Chun S. Yang, When Does Government Debt Crowd Out Investment? P3

¹³⁰ Clemente del Valle and etals, Supra note 18, p382

¹³¹ ibid

¹³² MFA/NBE Bills/001/2011, all CBs except CBE & DBE are obliged to allocate 27% of total loan disbursed during the month for the purchase of the bill.

¹³³ Section 8 of the USA constitution.

¹³⁴ Art 85 of the Japanese constitution provides that expensing the government budget or the government's incurring a liability shall require approval of the Diet.

to the legislature as we have seen here in above. In others' governments are granted the authority, subject to approval from the legislature.¹³⁵

The law may impose prior legislative authorization on the issuance of government securities as a check against abuse of the borrowing authority. As part of its authority, the government should also have the legal ability to delegate borrowing authority and debt management policy to the public agency or department that carries out the debt management work. Some countries have imposed strict limitations on the use of government funding of debt, which in some cases involves an outright ban on domestic borrowing by the government¹³⁶.

With regard to the authority to borrow there is a need for legislative control of the level of government indebtedness. This may be done by providing explicit ceilings for government securities issuance to avoid abuse of the borrowing authority. Limitations on the government's authority to issue debt securities can be established in legislation with a specific ceiling on total debt or minimal net increment limit. Requiring specific approval of the issuance by the legislature is also an alternative way to limit borrowing authority.¹³⁷

It is, however, important to strike an appropriate balance between the need for control and the flexibility and discretion of the issuing authority. Loan-by-loan authorization will clearly not facilitate an efficient operation for the government as an issuer.¹³⁸ Bond issuance in current Ethiopia is based on loan -by-loan authorization and thus it is not cost effective.¹³⁹ Bond issuance during the imperial era was based on specific ceiling of outstanding debts and interest rate.¹⁴⁰ Thus we can notice that the proclamation during the imperial era incorporated fundamental principles than the legal framework at this time in Ethiopia. We will see some of the essential elements of the proclamation that need be brought to the future possible government bonds proclamation in chapter four.

The general rules governing the government's behavior in the primary market are another important aspect of the legal framework on debt issuance. Governments are usually exempt from the disclosure requirements with which private sector securities issuers must comply. This does not mean, however, that governments should be not clear in their operations. The behavior of

¹³⁵ Clemente del Valle and etals, Supra note 18, P34

¹³⁶ *ibid*

¹³⁷ *ibid*

¹³⁸ *ibid*

¹³⁹ Supra note 111, Art 42

¹⁴⁰ IGE, Proclamation on Government Bonds no 262/ 1969, Art 2 and 4

governments in the primary market, furthermore, should be governed by well-established principles of generality, equality, and publicity.¹⁴¹

Unlike a private sector company, governments cannot act with contractual freedom and choose, for example, counterparties arbitrarily. Rather, the government should establish a common set of rules to guarantee equal access and fair competition.¹⁴² This principle does not exclude the use of primary dealers, but requires the selection to be objective and fair. The principle of publicity requires the government to be open about its future securities transactions. Timely public announcements of the government's auction calendar, including amounts of issues and their maturities, and tender or auction procedures, are also necessary for market awareness and assessment of the government's market activities.¹⁴³

The US Congress delegates general responsibility for Treasury debt management to the Secretary of the Treasury. A ceiling on the outstanding stock of debt is set by the Congress.¹⁴⁴ With approval of the President, the Secretary of the Treasury may borrow on the credit of the United States Government amounts necessary for expenditures authorized by law and may issue bonds of the government of the amounts borrowed and may buy, redeem, and make refunds.¹⁴⁵

Therefore, one can notice that many jurisdictions attempt to avoid arbitrary issuance by governments. As it will have negative macroeconomic consequence government debt need be regulated in the primary market. For instance uncontrolled issuance of government bonds among other things may starve or crowd out the private sector.

Unregulated beginning to capital markets development may have spillover effect on the future development of the market. The fragmentation at the very inception of the capital markets may leave black spot on its future fate. As such government a country which seeks to build government bond market should take all the due care so that it would have strong foundation to attain the confidence of various kinds of investors.¹⁴⁶

¹⁴¹Clemente del Valle and etals, Supra note 18, P34

¹⁴² Id, P35

¹⁴³ Id, P35

¹⁴⁴ United States Code Annotated (USCA), Chapter 31, Section 3102-3104.

¹⁴⁵ United States Code Annotated (USCA), Chapter 31, Section 3102-3104.

¹⁴⁶ The Suitability of US Security Laws and Regulations to Serve as a Model Law for Egyptian Financial Markets, Arab Law quarterly, available at <http://www.jstor.org/stable/3382134>. Accessed: 07/09/2013 02:30 p13

When we come to the Ethiopian case the legal provision concerned with bond issuance are scattered here and there without sufficient organization. For example the constitution and the financial administration proclamation touch the issue incidentally. The constitution simply gives the power to issue securities to the federal government.¹⁴⁷ The financial administration proclamation with the view to implement the general policy framework gives the mandate to issue government securities to MoFED.

*Limitations on the government's authority to issue debt securities can be established in legislation with a specific ceiling on total debt or minimal net increment limit or by requiring specific approval of the issuance by the legislature (either through the annual budget law or through a specific law approving a particular issue). If such limits are contained in the legislation, it is important to establish a system of legislative authorization consistent with modern practices for the issuance of government securities. A system that calls for a case-by-case authorization may be inefficient because the legislative process is usually time consuming and has an uncertain outcome.*¹⁴⁸

We can observe that it is indispensable to have some sort of control on governments in order to curtail arbitrariness in government debt management. The controlling mechanism may take various forms depending on a country's specific situation. However it is advisable not to adopt a loan by loan authorization of issuance as it is time consuming.

3.3.6. Other Macro Economic Factors

Uncontrolled inflation, monetary policies, foreign exchange rates and interest rate in the banking sector are all that can have negative impact on the development of government bond market. Thus the concerned regulatory institutions are supposed to work to avoid these negative consequences.

¹⁴⁷ Art 51 of Constitution of the Federal Democratic Republic of Ethiopia Proclamation No. 1/1995", negaret gazeta, Year 1 No.1 ADDIS ABABA - 21st August, 1995

¹⁴⁸ Clemente del Valle and etals, Supra note 18, p284, see also Lili Liu Steven B. Webb, Laws for Fiscal Responsibility for Sub national Discipline International Experience, Policy Research Working Paper 5587, The World Bank Poverty Reduction and Economic Management Network Economic Policy and Debt Department, March 2011. P25.

Higher inflation rate has negative impact on the market's development and may frustrate investors on bonds.¹⁴⁹ Thus countries have adopted mechanisms to curtail problem of such kind by either working to control inflation or by issuing inflation indexed bonds.

Monetary policy is public policy concerned about the circulation of money in a given economy. This is also closely related with inflation and will aggravate the problems posed by higher inflation. Logically speaking a monetary policy that allows large amount of money which is disproportionate to the products in an economy will trigger inflation. Thus the regulatory bodies in securities market should work in cooperation with those who are regulating monetary policy.

Unstable foreign exchange rates will discourage foreign investors when government bonds are denominated in domestic currency. That is due to the fact that local currency will be exchanged with little money in their currency. They do not need that kind of exchange rate which would take all or reduce the interest they earn. Therefore stable foreign exchange rate would be favorable to the development of government bond market. As such securities regulatory body should work in consultation with government body charged with regulating foreign exchange. The legal framework should create the proper coordination with these regulatory institutions.¹⁵⁰

The interest in the banking sector has both negative and positive consequence on the development of government bond market. Interest payable on government bonds should not be much far from interest payable to savings in banks. Even though we say that government bonds are the safest investment, if the interest payable on them is much less than that of the bank, investors may not prefer bonds.

The taxation system can also provide its own regulatory tool in the securities market development. For instance some countries give special treatment to government securities with a view to encourage their sale. They exempt profit from government bonds from income tax or any other sort of tax.¹⁵¹

¹⁴⁹ Norman S. Poser, Securities Regulation in Developing Countries: The Brazilian Experience, Virginia Law Review, Vol. 52, No. 7 (Nov., 1966), P1288 available at <http://www.jstor.org/stable/1071450>. Accessed on : 07/09/2013 02:32

¹⁵⁰ Ricardo P. C. Leal and Andre L. Carvalhal-da-Silva, The Development of the Brazilian Bond Market, The Coppead Graduate School of Business at the Federal University of Rio de Janeiro (UFRJ), P26

¹⁵¹ Catiana Garcia and Anderson Caputo, Reforming Government Debt Markets in MENA, Policy Research Working Paper 5611, The World Bank, March 2011, P47

Moreover institutions that promote public saving will furnish fertile condition for the development of not only government bond market but also to the development of the capital market in general. Development of pension and provident funds, mutual funds, insurance companies have direct relation with development of government bond markets as they compose major investors in the capital market. These institutions many times have surplus funds to invest on fixed income and less risky investment areas.

3.4. Regulatory Concerns in the Secondary Market

Regulation of government bonds in the secondary market is not as such different from regulation of other securities in the secondary market. As we have seen in the preceding sections, in many jurisdictions government securities are being traded with other securities in the secondary market.¹⁵² As such when we talk about regulation of other securities we are talking about regulation of government securities and vice versa.

Secondary market of securities is the market where securities are traded after they are issued by the issuer. Securities by their nature are negotiable or transferable from one holder to another holder without or with consideration. Thus the transaction of securities after they are sold to the underwriters or to any body that is charged with the duty of distributing to the investors is called secondary market.

As the secondary market is composed of many market participants like securities dealers and brokers and final investors of securities, regulation of such market should take such market actors into consideration. Behavior and market conduct of such financial intermediaries is the main focus area of securities regulation in the secondary market.

Therefore secondary market regulation needs regulatory body. Many jurisdictions have securities exchange commission for such purpose. Others have Treasury Department for the same purpose. Others gave the power of regulating the secondary market to either the Central Bank or the Ministry Of Finance.

For example the 1986 Government securities act of USA required all dealers to register with SEC (Securities Exchange Commission). The act also gave the secretary of the Treasury the

¹⁵² Clemente del Valle and etals, Supra note 18, p35

authority, in consultation with the SEC and the Fed, to formulate rules on matters such as capital requirements for dealers and trading practices for ‘repos’,¹⁵³ and reverse repos.¹⁵⁴

The regulatory structure of securities markets is, in many cases, built around SROs, such as exchanges and securities dealers associations, as a supplement to the government regulatory authorities. SROs typically provide the first layer of regulatory oversight, guiding their members to meet the objectives of regulation. SROs ensure adequate flexibility in the regulation and oversight of securities markets, especially in cases where the introduction of new products and practices has come too rapidly for the traditional supervisory structure.¹⁵⁵

The regulatory responsibilities of government securities markets often are assigned to more than one government agency. Thus in some countries the supervision over a primary dealers' arrangement and the issuance process (auctions, for example) is handled by the Treasury or jointly by the Treasury and the central bank, the regulation of the secondary market by a security regulator (which is often a separate government agency), and the oversight of the settlement arrangements by the central bank.¹⁵⁶

The legal framework for government bonds should define responsibilities for all market participants such as the issuing government, the central bank, regulatory agencies, market intermediaries, end investors, and any SROs.¹⁵⁷

Some of the more important areas where a legal framework on government bonds markets should deal include defining the rights and obligations of parties to debt contracts in the primary and secondary markets for issuers, investors, and intermediaries.¹⁵⁸ This definition should include (a) minimum guidelines for disclosure of material information, (b) liability for entities involved in distributing securities and for entities handling third party investment accounts, and (c) vehicles to allow proper legal recourse against mutual funds, pension funds, and even the government as an issuer¹⁵⁹.

¹⁵³ Repos are simply transactions with a combination of an immediate securities sale with simultaneous agreement to reverse the transaction in the future.

¹⁵⁴ Meir Kohn, *Supra* note 1, P521

¹⁵⁵ As cited in the Clemente del Valle and etals *Developing Government Bond Markets, Hand Book*, IMF and World Bank. July 2001,P36

¹⁵⁶ p36

¹⁵⁷ Clemente del Valle and etals, *Supra* note 18, p33

¹⁵⁸ *ibid*

¹⁵⁹ *ibid*

Regulation of government bonds in the secondary market envisages, among other things, controlling the manner of their trading and the parties who are involved in the trading. Thus it includes regulating the sale and transfer, the settlement and clearing, depository issues and regulation of the conduct of the market participants.

Regulation in the secondary market also includes regulation of the financial intermediaries. Therefore in Ethiopia not only regulation of the financial intermediaries but also working towards their development should be part of that regulation. Here one may wonder how regulation could be carried out in the absence of the market and market participants. The author of this study is discussing regulation of financial intermediaries with a contemplation of their creation in the future.

The financial intermediaries are those licensed organizations in securities trading. They are also called dealers or brokerage institutions and investment banks. It is also important to regulate financial investment advisors. All these institutions are crucial elements of the securities market development.

It also involves paving the ways that will create fertile condition for the creation of securities exchanges. Securities exchange is a centralized platform where securities could be traded. Many developed countries have managed to build effective securities exchanges. Abundant existence of securities exchanges could also offer other essential wing of securities regulation if self regulation by them is implemented.

Effective regulation of the secondary market should include (i) regulation of market intermediaries, (ii) market conduct regulation (including trading rules) and market surveillance, and (iii) transparency requirements, which will vary according to the choice of market structure¹⁶⁰.

3.5. Market Participants in Government Securities Trading

Government securities are traded predominantly in all over-the-counter market comprised of a network of dealers, brokers, and investors who make transactions in government securities. The market is largely a wholesale one in which institutional investors, such as banks, dealers, pension

¹⁶⁰ Supra note 18, P287

funds, insurance companies, mutual funds operate. A significant number of small, retail investors also trade government securities through brokers and dealers.¹⁶¹

Primary dealers are those firms with which the authority having power to issue government bonds conducts its transaction with. For instance in United States the Federal Reserve conducts its open market operations with primary dealers.¹⁶² As early as in 1990's in USA there were approximately 1,700 brokers and dealers (including banks) trading in the secondary market, the 38 primary dealers comprise a majority of the trading volume.¹⁶³

A. Primary dealers and brokers, investment advisors, rating institutions, and their regulations

The parties usually involved in securities transaction are financial intermediaries including underwriters, primary dealers and other investors which play their significant part so that the market will boom. Investors in the securities market need assurance from any concerned body that the market would function free from securities fraud. Thus the governments need to design efficient and effective regulatory framework to the market participants.

Most of the time primary dealers as main participants of government bonds market are regulated by governmental regulatory bodies having stake in the market's regulation. For instance in United States the Treasury, as the issuer or guarantor of government securities, has had substantial power to shape the institutions and practices of that market¹⁶⁴. The Federal Reserve, as the Treasury's fiscal agent in dealing with the market, enjoys substantial powers too. Other federal agencies have varying degrees of indirect control. For example, as participants in the dealer market, commercial and investment banks are subject to federal oversight through the various banking agencies and the SEC.¹⁶⁵

Public confidence in the integrity of the, government securities market is essential for governments to sell its securities at the lowest cost. This confidence was shaken throughout the first half of the 1980s, in US America, when several unregulated government securities dealers failed and investors lost money. As a result, to protect investors and to insure fair, honest, and

¹⁶¹ Joint Report on the Government Securities Market, DEPARTMENT OF THE TREASURY, WASHINGTON, January 22, 1992, p,ix-x

¹⁶² *ibid*

¹⁶³ *ibid*

¹⁶⁴ Meir Kohn, *Supra* note 1, p521

¹⁶⁵ James B. Burnham, *The Government Securities Act of 1986 A Case Study of the Demand for Regulation*, CATO review of business & government, p78.

liquid markets in government securities, Congress passed the Government Securities Act of 1986.¹⁶⁶

The act specified that the areas of registration, recordkeeping, capital adequacy, financial reporting, and audit were to be regulated. The act placed rule enforcement authority with the Securities and Exchange Commission (SEC), working through industry self-regulatory organizations, such as the National Association of Securities Dealers.¹⁶⁷

B. Investors on Government Securities

Contractual savings institutions, pension funds and provident funds and insurance companies, which have a strong appetite for long term debt are the largest investors in government bonds both in developed and developing economies.¹⁶⁸ Investments by provident funds owned by government and government-dominated insurance sector are restricted due to directed fund deployment rules of governments.¹⁶⁹

We can notice that as government bond markets develop the investors base will change from the banks to other investors. Moreover it is noticeable that at the very early years of government bond markets development investment banks are major components of the market. for instance across Asia except in Japan, banks hold over half of the local currency bonds compared to 11 percent in the United States¹⁷⁰, 35 percent in Japan¹⁷¹, and 42 percent in Germany¹⁷². The high proportion of government bonds held by banks in the Asian economies is partly attributable to statutory requirements in those countries.¹⁷³

¹⁶⁶ Richard L., Fogel Assistant Comptroller, General U.S. GOVERNMENT SECURITIES More Transaction Information and Investor Protection Measures Are Needed, Sept 1990.

¹⁶⁷ *ibid.*

¹⁶⁸ Ramit Nagpal, *Supra* note 52, p709

¹⁶⁹ *ibid*

¹⁷⁰ *ibid*

¹⁷¹ *ibid*

¹⁷² *ibid*

¹⁷³ *ibid*

3.6. Some Normative and Institutional Infrastructures

3.6.1. Settlement of Government Securities

In United States electronic system used for settlement of Treasury securities and many other government securities is the commercial ‘book-entry system’¹⁷⁴ maintained by the Federal Reserve System.¹⁷⁵ Funds are transferred simultaneously over the system. This system enables government securities trades to be settled quickly and with relative cheapness, thus contributing substantially to market liquidity.¹⁷⁶ Much of the trading activity in government securities is settled through the Government Securities Clearing Corporation (GSCC), a clearing organization that provides its members with automated trade comparison and netting services for Treasury and other government securities. The most active brokers, dealers, and banks in the government securities market are GSCC members¹⁷⁷.

Therefore the government securities clearing corporation’s establishment served many purposes for the ease of transactions of government securities. Hence authorities in the developing world including in our country, Ethiopia, with the dream to create and develop government securities market need to consider its role.

In many countries with capital markets Central Securities Depositories (CSDs) manage the after-trade activities that take place in organized and over-the counter (OTC) markets.¹⁷⁸ Regardless of ownership, the operations, policies and procedures of these organizations are vital to the success of the financial markets they serve. CSD may be responsible for the clearing of securities, in such a manner that the net position of each market investor is identified. CSDs are nearly always responsible for the settlement of securities that is to say the payment and physical or virtual delivery of purchased financial products and the accounting for those product transactions.¹⁷⁹

¹⁷⁴ Book entry system is a system, often automated, for recording the ownership of securities.

¹⁷⁵ The Federal Reserve in the U.S. Payment system, p84, available at www.federalreserve.gov/pf/pdf/pf_7.pdf

¹⁷⁶ *ibid*

¹⁷⁷ Joint Report on the Government Securities Market, DEPARTMENT OF THE TREASURY, WASHINGTON, January 22, 1992, p,ix-x

¹⁷⁸ Market Potential Assessment and Road Map Development for the Establishment of Capital Market in Ethiopia, Produced and distributed by the Addis Ababa Chamber of Commerce and Sectoral Associations with financial support from the Swedish Agency for International Development Cooperation, Sida, pp49-50

¹⁷⁹ *ibid*

3.6.2. Substantive Measures Needed to Cultivate Institutions in Ethiopia

We need to take different measures if we desire development of the bond market in Ethiopia just like India and Brazil have done¹⁸⁰. India took a series of steps with a view to foster development of its bond market since 1990s. These measures nursed the emergence of an active market in government securities in India¹⁸¹. The Reserve Bank of India (RBI) and the government have, over time, sought to improve institutional infrastructure, provide depth and liquidity as well as the market microstructure, and create an enabling regulatory framework and transparency in the market for government bonds in India. The effects of this are evident in the rise in the amount of funds that the federal and state governments have mobilized from the market.¹⁸²

The absence of an active secondary market for debt instruments had made investors feel that their investment in debt is highly illiquid.¹⁸³ However the government took several measures with the view to enhance the capital market in India¹⁸⁴. These included several reforms in the securities market—e.g., the establishment and empowerment of the Securities and Exchange Board of India (SEBI), market determined allocation of resources, nation-wide screen based trading in securities, de-materialization and electronic transfer of securities, rolling settlement and ban on deferral products, sophisticated risk management and introduction of derivatives trading.

All these have helped improve the regulatory framework and efficiency of trading and settlement. The equity segment of the Indian capital market is now comparable with that of many developed markets in terms of a number of qualitative parameters. For developing a deep and liquid secondary markets in government securities, the Reserve Bank of India (RBI) has initiated legal, regulatory and taxation reform, infrastructure and technology improvement, safe settlement systems, and market dissemination of information on all trades in the wholesale

¹⁸⁰ André Amante, The search for liquidity in the Brazilian domestic government bond market, BIS Quarterly Review, June 2007, p69

¹⁸¹ Rajesh Chakrabarti, Bond Markets in India, Indian School of Business, Electronic copy available at: <http://ssrn.com/abstract=1149322>

¹⁸² Between 1980-81 and 1992-93, the combined gross market borrowings grew at a CAGR of 15%. In the next 14 years, the CAGR rose significantly to 19%.

¹⁸³ Rajesh Chakrabarti, Supra note 178

¹⁸⁴ *ibid*

market. It has also enlarged the repo markets and ensured adequate liquidity in the secondary markets through the dealers.

Like India Brazil has benefited from government bond markets by taking different measures with a view to develop government bond markets. For instance introduction of inflation indexed government bonds in 1964 can be taken as meaningful reform.¹⁸⁵ Now Brazilian federal public debt market is one of the most liquid and sophisticated among emerging markets, offering a wide range of debt instruments (fixed-rate, floating-rate and inflation-indexed bonds).¹⁸⁶

Therefore Ethiopia can take important lessons from these emerging economies. It should make many reforming measures to develop government debt market. Such measures may include starting from enacting securities law and government securities law up to establishing institutions and arming them with all necessary tools for their functioning.

Securities laws including government securities law, law on Securities exchange markets, Securities commission or authority, rating and accounting institutions, financial intermediaries like Dealers and brokerage institutions, mutual funds and investment banks, Investment advisors are essential elements of not only government securities market but also to development of the capital market in general. Because a government issuer is a public body, the process through which it issues debt should be set out in law. Clemente Del firmly argues that this law, or laws, should include prescriptions concerning the following major elements of government securities regulations.¹⁸⁷

1. clear authority to issue debt and, if the issuance of debt is to be made by a government agency, ability to delegate that authority to the appropriate agency;
2. a description of the process by which the legislature enables the government to issue debt, including any limitations on borrowing;
3. a description of the internal management process and legal authority with respect to issuance of government securities and management of the debt portfolio; and
4. The legal status of the different types of government securities. The secondary market in government securities should be supported by effective regulation through a

¹⁸⁵ Ricardo P. C. Leal and Andre L. Carvalhal-da-Silva, *Supra* note 147, p21

¹⁸⁶ *Id.*, P25

¹⁸⁷ Clemente del Valle and etals, *Supra* note 18, p282

securities regulatory authority, and rules related to market intermediaries, market conduct, transparency requirements, and clearing and settlement.

According to debt and securities market specialists¹⁸⁸ in the World Bank there are five building blocks that normally sustain deep and liquid public debt markets. These are (i) money markets; (ii) primary market (issuance policy and placement mechanisms); (iii) secondary market organization; (iv) investor base; and (v) clearing and settlement infrastructure.¹⁸⁹

When we see the Ethiopian government bond market in light of all the above yardsticks we notice that there are lots of works not yet done. Thus Ethiopian government needs to take such concerted measures with great commitment. We will see some of the available rudimentary institutional and legal infrastructures in Ethiopia with better depth in the next chapter.

Chapter Four

4. Bond Issuance and Regulation in Ethiopia: the Case of Grand Renaissance Dam Bond

4.1. Introduction

The World Bank and IMF's Hand Books on the development of government bond markets provide some essential strategic steps that anyone concerned with the creation and development of government bond market needs to uphold.¹⁹⁰ Government bond issuance is not something that anybody can carry out without following certain principles and rules. One cannot do it from the scratch without certain legal framework.

With regard to Primary Market Structure, establishing efficient distribution channels for securities by institutionalizing underwriters that assist in market creation in government bond issuance will be indispensable element of the government debt issuance strategy. Despite their significance such underwriting or syndicate groups have not yet emerged in Ethiopia. They will facilitate and assist government bond issuance to a considerable extent. Thus, Ethiopian government should think of their creation and regulation along with setting institutional and legal frameworks.

¹⁸⁸ Catiana Garcia and Anderson Caputo, Supra note 151

¹⁸⁹ Id, P2

¹⁹⁰ Clemente del Valle and etals, Supra note 18, p53

4.2. General Debt Portfolio of Ethiopia as of 2012

Ethiopia's Medium Term Debt Strategy (MTDS) [2013-2017] provides that the total debt stock (domestic and external) reached US\$ 13,251,600,000 (Birr 237.3 billion) at the end of June 2012¹⁹¹. Out of the existing public debt the external debt represented about 67% while the share of domestic debt was 33%. The strategy paper affirms that there is significant increase in the domestic debt portfolio, reflecting relatively improved market activities and participations.¹⁹² Still this share of the domestic market on government debt indicates that it requires further development. As many of the holders of government bonds are those we call captive sources of financing, we need to resort to market based government bonds market building.

When we closely examine Ethiopia's Medium Term Debt Strategy we can observe some signals as to future plans on the government bond market. According to the MTDS, diversifying alternatives and possibilities to ensure the Ethiopian Government's financing needs is among the primary objectives of debt management to accomplish the GTP within sustainable debt levels, and by minimizing costs and risks of the existing and future portfolio. Its secondary objective is to enhance the domestic debt market, by enhancing and developing efficient local primary and secondary debt markets for government securities, gradually minimizing dependence on foreign sources¹⁹³.

We can understand here that government has some future plan to work towards development of primary and secondary government bond markets.¹⁹⁴ Therefore, it needs to pave the ways for such markets development. Paving the way includes furnishing all necessary normative and institutional frameworks. Thus, it is the aim of this chapter to analyze various aspects of government bond market development in Ethiopia in light of the practice on the ground.

4.3. Major Holders of Government Bonds in Ethiopia

Before the issuance of the Grand Renaissance Dam Bond the major holders of government securities in Ethiopia are the National Bank of Ethiopia and the Commercial Bank of Ethiopia

¹⁹¹ Ethiopia's Medium Term Debt Management Strategy (2013-2017), October 2012, P17

¹⁹² *ibid*

¹⁹³ *ibid*

¹⁹⁴ *Id*, P35

followed by other government and private banks and insurance companies, Public Servants Social Security Agency and other public enterprises.¹⁹⁵ However, after the issuance of the GRDBs, individuals and other institutions became considerable investors on government bonds. These institutions and many individuals invested their scarce capital on the bonds not based on market principles but rather due to the sentimental attachment to River Nile or Abay. These may not be bad but we need to build government bond market on strong base based on market principles so that bond buyers will have economic motive.

Institutions which encourage and increase public saving like insurances, provident funds, mutual funds, social securities and investment banks have direct relation with government bond market development¹⁹⁶. Thus working towards development of all these sectors should also be concern of policy makers in order to create viable government bond market in Ethiopia.

4.4. **Regulatory Authorities of Government Bonds in Ethiopia**

Regulators and supervisors of government bonds in Ethiopia are not identifiable with sufficient precision. This may be due to the fact that securities market including government bonds market is at its infant stage if it exists at all. For instance the bond issuance itself is not economical and modern as there are no such institutions like underwriting groups that participate in auction process. However, there is no auction which is significant element of government bond markets in developed and developing economies. There are no financial intermediaries like primary dealers, investment advisors, brokerage institutions and securities markets which would be the subject matters of regulations. Even though we do not have matured securities markets at this time it is inevitable to have such markets in the future. Therefore we need to search for some adaptable experiences from other countries.

In India, the regulatory responsibility for the securities market is vested in an overlapping manner among the RBI, SEBI, Department of Company Affairs, Department of Economic Affairs and the Ministry of Finance. The regulatory jurisdiction between the RBI and SEBI was clarified by an amendment to the Securities Contract Regulation Act in 2000 which gave RBI the

¹⁹⁵ id, p25

¹⁹⁶ Shahadath Hossain and etals, , Dynamics of Mutual Funds in Relation to Stock Market: A Vector Autoregressive Causality Analysis, International Journal of Economics and Financial Issues, Vol. 3, No. 1, 2013, P191

regulatory jurisdiction over the money and government securities markets and SEBI jurisdiction over the corporate debt markets.¹⁹⁷

Major entities in the government securities markets such as insurance companies, mutual funds and provident funds are outside the regulatory purview of the RBI, although it is the regulator of government securities market¹⁹⁸. Stock exchanges in which government securities could be traded are under the purview of SEBI. All these having regulatory concern on financial markets, believing in the importance of coordination started formal consultations. High-Level Committee on Capital Markets comprising the RBI, SEBI, the insurance regulator and the Finance Ministry was established to facilitate the coordination so that regulatory gaps will be avoided.¹⁹⁹

In the U.S also there are a multitude of agencies, at both the state and federal levels that have separate yet sometimes duplicative regulatory authorities over the financial services industry. This high level of duplication is caused by a combination of functional and institutional regulation. In USA the securities Regulation Act of 1986 required all dealers except banks to register with the SEC. It gave the Secretary of the Treasury the authority in consultation with the Fed and the SEC to formulate rules on matters such as capital requirements for dealers and trading practices for repos.²⁰⁰

Thus, the relationship between these institutions having regulatory concern need be clear and be provided for by a statute. The structures and objectives of regulatory frameworks differ from one jurisdiction to another. Developing economies may take securities market development as their primary objective than developed economies.

4.4.1. Concepts of Unified Financial Services Regulation and Institutional Regulation

Generally, we may find two types of regulatory institutions. The first is unitary regulatory structure, for instance Monetary Authority of Singapore and Financial Services Authority of England regulate banks, insurance and securities.²⁰¹ The other sort of regulatory arrangement is

¹⁹⁷ Y V Reddy, Supra note 69, p 124

¹⁹⁸ *ibid*

¹⁹⁹ *ibid*

²⁰⁰ Meir Kohn, Supra note 1, p521

²⁰¹ Kenneth Kaoma Mwenda, Supra Note 81, P63

fragmented regulatory structure, for instance in USA SEC, CFTC, Federal Reserve and State Insurance Commissions regulate separately and sometimes with overlapping responsibility.²⁰²

Over the years, financial supervision has often been organized, in silo style, around specialist agencies that have separate responsibilities for banking, securities, and insurance sectors, but in recent years there has appeared a trend towards restructuring financial supervision into unified regulatory agencies. These agencies have to supervise two or more of these areas.²⁰³

The arguments in favor of the unified regulation relate to such factors as the economies of scale and scope that arise because a single regulator can take advantage of a single set of central support services; increased efficiency in allocation of regulatory resources across both regulated firms and types of regulated activities; the ease with which the unified regulator can resolve efficiently and effectively the conflicts that inevitably emerge between the different objectives of regulation.²⁰⁴

With the increasing integration of the financial markets, there are more instances of the same participants coming under the influence of multiple regulatory bodies. These features have raised the potential for regulatory gaps and overlaps, thereby underpinning the need for greater coordination among various regulators.²⁰⁵ Most of the time at the initial stage it is better to adopt the institutional approach of regulation. Gradually this type of regulation may develop into unified regulation.

4.4.2. Securities Regulation and Other Financial Services Regulation

In many jurisdictions securities regulation and other financial services regulation are related and are regulated by related regulatory institutions. The securities sector, the banking sector and the insurance sector are related financial institutions. For instance, in Sweden, United Kingdom and Denmark the three sectors are supervised by a single supervisor.²⁰⁶ In some other European countries the securities market is supervised and regulated together with the banking sector by the same supervisor. Example of such regulation is Belgium and Finland.²⁰⁷ In some other countries central bank together with securities supervisor is given the mandate to regulate both

²⁰² Id, P6

²⁰³ Kenneth Kaoma Mwenda, *Supra* note 81, p41

²⁰⁴ *ibid*

²⁰⁵ *ibid*

²⁰⁶ *Supra* note 201, p8

²⁰⁷ *ibid*

the banking sector and the securities market.²⁰⁸ In Netherlands and Portugal the central bank in addition to regulating the banking sector supervises the securities market together with the securities supervisor.

When a regulatory framework is designed, it is important that the drafters understand, first, the size and structure of a particular industry and, second, the role of a regulator in that country.²⁰⁹ In most jurisdictions, enormous power is bestowed upon regulators to authorize the commencement and cessation or entry and exit of businesses. Thus, both entry and exit together with market conduct need be sufficiently controlled.²¹⁰

4.4.3. Role of National Bank of Ethiopia in Government Bonds Regulation

Generally we have seen that unified regulation is form of control exercised by a single body on the three financial sectors. National Bank of Ethiopia has taken the mandate of regulation of the banking sector and the insurance sector. There are also some signals that the bank is sending its hand to securities area in that it regulates central securities depositories. It is also highly involved in the preparation of the operational manual for government bonds distribution and sale including the GRDBs.²¹¹ It is conventional that regulatory bodies need be independent from interference.²¹² Independence of National bank of Ethiopia is not clear as government may influence it through MoFED.²¹³ The council of ministers regulation provides that MoFED can give direct instructions with regard to financial needs of government borrowing proclamations.²¹⁴

Indeed it may be difficult to characterize securities regulation in Ethiopia as there is no formally organized secondary market. To characterize the nature of regulation in the securities market of Ethiopia, it seems not time ripe. We need to know the institution to regulate the secondary market like the dealers both in the primary and the secondary market and the regulator of prospective stock exchanges. Financial advisors, rating institutions and accounting institutions,

²⁰⁸ *ibid*

²⁰⁹ Rafael La Porta, and etals, What Works in Securities Laws? The Journal of Finance, Vol. 61, No. 1 (Feb., 2006), P27

²¹⁰ *Supra* note 198, p6

²¹¹ Operational manual, p4

²¹² M. Quintyn & M. W. Taylor, Should Financial Sector Regulators Be Independent? economic Issues 6 (IMF 2004), p34

²¹³ Art 49(1) of Financial Administration Council of Ministers Regulation No 190/2010

²¹⁴ *ibid*

underwriting groups, stock exchanges are all essential elements of government bond markets and so need be sufficiently and wisely regulated. But here in Ethiopia not only the regulation but also working towards their creation should also be concern of the government.

Whatever the structure of the future securities regulator, one thing what we have not to forget is to establish and ensure proper coordination framework with regulators of the financial sectors. Thus the future securities commission or capital markets authority of Ethiopia may be independently established or be established as part of either Ministry of Finance and Economic Development or National Bank of Ethiopia. If it is independently established outside of these institutions there must be clearly defined legal base for their coordination.

a. Clearing and Settlement of Securities in Ethiopia

The national payments Proclamation of Ethiopia defines Central Securities Depository as an entity in whose register securities or other financial instruments are immobilized so as to enable their transactions to be finally processed by book entry.²¹⁵ As per Art 4 of the Proclamation, the National Bank shall establish, own, operate, participate in, regulate and supervise Central Securities Depository.²¹⁶ Therefore, this specific provision indicates something about regulation of government securities in Ethiopia. The National Bank will have considerable power of regulation of central securities depositories.

There is confusion as to how transactions in the secondary market will be settled and cleared in Ethiopia. The Grand Renaissance Dam Bond guideline provides that whenever there is transaction the parties should appear before either in the Commercial Bank or any institution in which the Development Bank of Ethiopia will delegate such power of sale of the bonds.²¹⁷ That means these institutions are to carry out what clearing and settlement institutions will carry out. The aforementioned proclamation provides that clearing and settlement institutions are to be established and regulated by the National Bank of Ethiopia. However, when we see the practice, it is difficult to find securities clearing and settlement institution established as promised in this Proclamation. Clearing is defined as the process of transmitting, reconciling and confirming

²¹⁵ Art 2(4) National payment System Proclamation no 718/2011, Federal Negarit Gazeta No. 84 18th July, 2011

²¹⁶ Id, Art 4(1)

²¹⁷ The Grand Ethiopian Renaissance Dam Bond Operational Guidelines and Accounting Manual. P43

funds or securities transfer instructions prior to settlement and include the netting of instructions and the establishment of final positions for settlement.²¹⁸

As per this Proclamation, the body that is going to give clearing service for securities transactions is the National Bank of Ethiopia or any other entity authorized by the National Bank of Ethiopia. One can notice that the institution with regulatory power is charged with activities that can be carried out by regulated institutions. This is not wise design of regulation and should be reconsidered.²¹⁹

In Brazil, secondary market transactions are cleared and settled through SELIC on a delivery-versus-payment basis (DVP).²²⁰ Brazilian federal bonds can be negotiated in the secondary market in two forms: over-the-counter and through the screen. These transactions, as well as those over-the-counter, are registered with SELIC²²¹.

While a principle of safe and efficient payment and settlement applies to the settlement of any securities, trading of government securities requires exceptionally safe and efficient settlement arrangements because of the large value of the transactions and the need to enable active trading. Poor management of settlement risks in government bond trading can generate major systemic risks to the financial system. The legal and regulatory framework must provide clear rights and obligations of parties in government bond transactions in settling executed trades. There should be clear legal treatment of, and effective regulatory enforcement against, failure to pay upon receipt of securities in both primary and secondary markets. In the trend to dematerialize securities with application of modern technology, we need careful and closer regulation²²².

In many countries, the government securities market is supported by a dedicated settlement infrastructure operated by central banks.²²³ However, there are gradually increasing number of cases in which the government securities custody and delivery function has been transferred out

²¹⁸ Supra note 215, art 2(5)

²¹⁹ Id, Art 2(6)

²²⁰ Ricardo P. C. Leal and Andre L. Carvalhal-da-Silva, Supra note 147, P25

²²¹ Payment, clearing and settlement systems in Brazil, CPSS – Red Book – 2011, p34

²²² Clemente del Valle and etals, Supra note 18, p291

²²³ Rafael La Porta, and etals, Supra note 209, p11

of the central banks and consolidated with central securities depositories serving all types of securities.²²⁴

The regulatory agency with oversight responsibility should have clear authority over the clearing and settlement system, including the ability to conduct examinations, impose conditions, and review and approve rules.²²⁵ The rules and operating procedures governing the payment and settlement arrangements for government securities should be available to market participants. Payment and settlement organizations should be required to have a framework that allows the oversight or regulatory agency to ensure accountability of the systems and to monitor developments in the payment and settlement systems. Finally, the payment and settlement organizations should be required to report periodically to the oversight or regulatory agency and, if necessary, submit periodic audits and examinations.²²⁶

4.5. The Grand Renaissance Dam Bonds (GRDBs)

4.5.1. General Information about the Project

Ethiopia started to construct a dam for power generation on the River Abay after many years of study by different companies. Studies on the possibility of constructing dam on the river have started since early 1920s. For instance in 1927 a company called G.G Engineering and from 1956- 1964 a company called American Bureau of Reclamations have made studies on feasibility and different aspects of projects on Abay.²²⁷

The project will generate about 6000 Mega Watt electricity per year. It is hoped that in its finalization it will reduce power interruptions from 11.5% to 5.6%.²²⁸ The dam is the largest yet in Africa which will contain about 74 billion cubic meter water. The height of the dam and its length has been projected to be 145 meters and 1.8 kilo meters respectively.²²⁹

²²⁴ Clemente del Valle and etals, Supra note 18, p292

²²⁵ ibid

²²⁶ ibid

²²⁷ ታላቁ ህዳሴ፣ልዩ እትም፣መጋቢት 24 ቀን 2005 ዓ ም, p20

²²⁸ ibid

²²⁹ ibid

Thus, such huge project requires obviously great deal of capital. It has been projected that the construction of the dam will cost about 78 billion birr. Political leaders are heard to saying that an attempt to finance through loans from foreign sources face obstacle due to problems posed from Egypt.²³⁰ Thus, government has planned to finance it from various internal sources. The government hopes to raise some 20% (around 14.5 billion birr) of the total project cost, from Ethiopians at home and abroad, mainly through the sale of treasury bonds issued for this purpose. Data released this year indicate that Birr 11.3 billion has been pledged so far of which, about 7.1 billion has been paid.²³¹

4.5.2. Government Bond Issuance Strategies

For successful issuance of government securities, government has to win trust and confidence of financial market participants. In addition to pursuing sound and sustainable fiscal and monetary policies and establishing an appropriate legal and regulatory infrastructure, government needs a credible government bond issuing strategy, based on a strong commitment to market financing. It must also devise procedures for marketing government securities issues and establish efficient distribution channels and encourage the development of secondary markets²³².

In market based financing, government needs to adopt market discipline, ensure broad market access and fairness, and take steps to make government debt issuance and operations transparent and credible to investor on bonds.²³³ Clemente del Valle and etals provide that:

A market-oriented government funding strategy is an essential pillar for developing a domestic securities market. Such a strategy includes the government's adherence to basic market principles in its funding operations, the need to design a sustainable issuance

²³⁰ Former Prime Minister, Meles Zenawi, when responding to journalists about the different aspects of the project.

²³¹ ETV news of 1 pm and 8 pm on Feb, 21, 2006, see also Daniel Berhane, available at <http://hornaffairs.com/en/2013/04/29/nile-ethiopians-raise-billions-foreign-backed-saboteurs/>.

²³² Supra note 18, p93

²³³ Id, p94

*strategy, and the government's proactive approach in developing the necessary regulatory frame work to support market development.*²³⁴

Adherence to market discipline requires government to cease borrowing from the central bank and also remove requirements that force commercial banks and other captive institutions to lend to the government at below-market interest rates.²³⁵ Fairness in issuing government bonds require creating a level playing field by providing clear, transparent, and equitable rules and regulations that apply to all market participants. This will build trust among investors and intermediaries and attract the greatest number of market participants.²³⁶

Transparency in government bond issuance is also important element of government bond market development. Thus, it is better for government to have specific and well known issuance calendar. Creating clear and reliable issuance structure by announcement of detailed annual and quarterly issuance calendars is crucial element of government bond markets in developed markets such as in Germany.²³⁷

4.5.3. Issuance of the Grand Renaissance Dam Bond

Ethiopian government has issued the Grand Renaissance Dam Bond denominated both by local and other main foreign currencies. The issuance seems to lack legal framework at least primary legislation which will define the rights and obligations of the parties involved in the transaction. Borrowing in many countries needs legislative support. Thus, a parliament enacts a law authorizing debt issuance. Of course, there is a guideline to that effect prepared by the DBE and NBE.²³⁸ However, such guide lines lack formal authority as they are not primary legislations enacted by law making body. Efficient legal framework is among the prerequisite for the issuance of government bonds.

²³⁴ Ibid

²³⁵ Id, p95

²³⁶ Id p97

²³⁷ German Government Securities Strategy, Fderal Republic of Germany Finance Agency, Spring 2010, p13, available at www.deutsche-finanzagentur.de/en/institutional/primary-market/auction-procedure/. Accessd on 2/2/204.

²³⁸ The Grand Renaissance Dam Bond Operational Guidelines and Accounting Manual, 2004,

The government bond market in Ethiopia needs lots of efforts for its development. Therefore, the main theme of this paper is to indicate the measures to be taken by concerned bodies. Even the informal markets' level of development is not well studied and there is serious shortage of data about the status of over-the-counter-market. Therefore, this paper would try to throw some light on how government bond market is proceeding.

The issuance, distribution, trading and redemption of treasury bills, notes and bonds constitute the government securities market.²³⁹ The act of issuance and distribution of these securities by the borrower to the bond buyers constitutes the primary market while the subsequent trading of securities constitutes the secondary market. However, there is no such well organized secondary market in Ethiopia. To the belief of the author of this paper, the absence of such market is also attributable to the absence of sufficient and full-fledged legal framework. This obviously will seriously hamper the sale and circulation of the Grand Renaissance Dam Bond in a way contemplated by the government.

When we see the issuance of GRDB in Ethiopia with regard to conventional ways of issuance strategies discussed in the preceding section, we can notice that it is far apart from that conventional method. Firstly, it is difficult to say the issuance is based on market principles as there was no auction in which the so called market makers participate and the issuer takes prices. This is because these market makers are not created in Ethiopia. Secondly, there is no regulatory and institutional framework for consistent, clear and transparent government bond issuance. Issuance of government bonds in Ethiopia has very short history and the market is at its formative stage. This may be the cause for many of the gaps and problems manifesting themselves in the country. The author of this paper believes that GRDBs would have more market and demand had there been those market infrastructures.

4.5.3.1. Bond Issuance by Private Placement

The Grand Renaissance Dam Bond Guidelines provides that Commercial Bank of Ethiopia, Development Bank of Ethiopia, Ethiopian embassies abroad and other institutions to be designated by the Development Bank of Ethiopia are agent sellers of the Grand Renaissance

²³⁹ Ewart S. Williams, *Supra* note 1,

Dam bond. These other institutions probably are to mean micro finance institutions which are involved in the sale of the bond to the rural community at this time in practice.²⁴⁰ They are paid .05% of the sale of the Grand renaissance dam bond for their services.²⁴¹

Thus, the issuance and distribution modality preferred by government inclines more to private placement. Private placements do not contribute to market liquidity as much as other issuance techniques, since bonds placed privately are usually held to maturity by buyers and rarely traded. For this reason, private placements can be less cost effective and contribute less to secondary market development than auctions.²⁴² In other jurisdictions like in Germany government securities are sold via members of the “Bund Issuance Auction Group” (currently 31 international banks) who participate voluntarily in pre-announced auctions.²⁴³

It is difficult to characterize the modality of the distribution preferred by MoFED as either syndication or auction system. Can we take these institutions delegated by the Development Bank of Ethiopia as underwriters? Underwriters are market makers which guarantee minimum price of issuance of government bonds. Therefore, the institutions designed as agents of the GRDBs sale could not be taken as underwriters or syndicate groups since they did not push and guarantee the minimum price of the bonds’ issuance. We can say that it is rather imposition by government as these institutions are public enterprises owned and run by government. Thus, these institutions could not take the task of distribution of the bond for profit purpose voluntarily. Moreover, these institutions are competent in the capital market as the government bond market will absorb their customers. Thus, there is clear conflict of interest.²⁴⁴

There are no such primary dealers which can assist or take the responsibility of distributing government securities. In other jurisdictions like in USA and in India primary dealers play significant role for the development of government bond markets. As we have no such primary dealers in Ethiopia, government bond market lacks one of its essential components.

²⁴⁰Supra note 238, p7

²⁴¹ Interview made with Ato Enyew Assefa, Bond reconciliation Center Manager in the commercial Bank of Ethiopia. January 20/05/2014.

²⁴²Clemente del Valle and etals, Supra note 18, p165

²⁴³ German Government Securities Strategy, Fderal Republic of Germany Finance Agency, Spring 2010, p13, available at www.deutsche-finanzagentur.de/en/institutional/primary-market/auction-procedure/. Accessd on 2/2/204.

²⁴⁴ Ato Ahmed Mengistu, Fund Management Principal Officer in the Development Bank of Ethiopia.

The main function of intermediaries in the government securities market is to place securities with investors and provide liquidity to secondary markets. One of the more important intermediaries in the secondary market is, in many cases, the primary dealer, which often acts as a market maker in government securities.²⁴⁵ A market-making obligation helps ensure a market for investors who wish to sell a security before its maturity. Policymakers should recognize both the importance of market-making intermediaries for secondary market liquidity and the need for this activity to be profitable for the intermediaries. Market making entails interest and liquidity risk as the dealer may not always be able to sell at a reasonable price the securities it has purchased from a customer.

4.5.3.2. GRDBs In Light of Bonds Issued During the Imperial Era

During the imperial era there was a proclamation promulgated in 1961 to regulate government bond issuance. In this proclamation government was restrained from arbitrary issuance of bonds by providing the maximum limit. The maximum limit was set to be Birr thirty million.²⁴⁶ Then this proclamation of 1961 was amended in 1969 by increasing the maximum limit from thirty million to one hundred million.²⁴⁷ There is no that much substantial difference in these two proclamations except in the amount of the ceiling of outstanding bonds. The 1969 government bonds proclamation was then amended during the Derg regime only by increasing the maximum limit. The preamble of the amendment proclamation stated that since the maximum limit of one hundred million birr is not sufficient to support economic development and to assist those segments of society who are victims of natural catastrophes, a need arises to increase the max amount.²⁴⁸ Thus the proclamation increased the maximum amount of money from one hundred million to four hundred million.²⁴⁹

²⁴⁵ Narayan Y. Naik and Pradeep K. Yadav, How do Dealers in Government Bond Markets Manage Their Spot Risk with Derivatives? Evidence from London, September 2000, p10. See also Dr. Nasser Saidi and etals, Local Bond Markets as a Cornerstone of Development Strategy, Dubai International Financial Center, p4 available at <http://papers.ssrn.com/sol3/DisplayAbstractSearch.cfm> accessed on 12/11/2013

²⁴⁶ Art 2 of Government bond Proclamation no 172/1961,

²⁴⁷Supra note 140, Art 2

²⁴⁸ Preamble of Government Bonds amendment Proclamation no 25/ 1975

²⁴⁹ Id, Art 2

The then proclamation and the regulations by Ministry of Finance on government bonds provide some characteristics of the bonds.²⁵⁰ Thus the bonds were easily transferable to third parties with delivery or endorsement. It is provided that the interest rate can be increased to the maximum of 7.5% and by no means will it exceed this limit. The bonds' maturity date was not exceeding ten years. The bonds can be pledged, rendered to insurance and pension or for whatever means as they serve as near money.²⁵¹ Any income in the form of interest or premium from government bonds was tax free.²⁵²

Under these proclamations the then ministry of finance was authorized to enact regulations on government bonds.²⁵³ Following the enactment of both proclamations the then Ministry of finance had issued various kinds of bonds backed by regulations. Thus the government bond issuance and its redemption was clear and transparent as the issuance is fixed in advance by regulations.²⁵⁴ This very fact will increase transparency and accountability of government which is required in government bond issuance. In issuing bonds government should not be opaque rather open and transparent.

The preambles of these two proclamations provide the policy purpose of government bond issuance. Accordingly it provides that to encourage savings and capital markets development proclamations on government bonds is proclaimed. When we closely examine the preamble of the proclamation, we find a meaning therein that savings and capital will be invested with full security where they are backed by legal regime.²⁵⁵ We can notice from these preambles that government should take proactive measures to develop and build capital markets including government bond markets.

When we examine the GRDBs in light of bond issuance during the imperial era, we can notice that there are very important elements we need to bring to the present bond issuance practice and to the would be proclamation needed to be enacted by this government. For instance fixing the maximum amount of outstanding bonds is essential for various reasons. In addition setting the maximum limits of interest rates for government bonds could also avoid the possibility of

²⁵⁰ Supra note 140, Art 4

²⁵¹ Id, Art 6

²⁵² Id, Art 7

²⁵³ Supra note 246 Art 8 and Supra note 140 art 9

²⁵⁴ See regulation no 368/1969, regulation no 274/1963

²⁵⁵ See preambles of proclamation no 172/1961 and proclamation no 262/1969.

crowding out private investment. Clearly indicating the public body which is authorized to enact rule for regulation of bond issuance is also important lesson that we can take from experiences of those days.

Thus this government needs to take basic elements of these preceding proclamations on government bonds when it prepares new proclamation on government bonds. It is obvious that this government should enact a new law that takes current situation of the country and other circumstances in financial markets into consideration.

4.5.3.3. Purpose of Issuance of the GRDBs

We get general information about the issuance of the Grand Renaissance Dam Bond from the Grand Renaissance Dam Bond Operational Guideline and Accounting Manual prepared jointly by Development Bank of Ethiopia and National Bank of Ethiopia.²⁵⁶ The operational guideline provides that the main purpose of the issuance of these bonds is to create funds for the Development Bank of Ethiopia. The authority to mobilize funds through bond issuance is given to DBE by council of ministers regulation while the owner of GRDBs is considered to be MoFED.²⁵⁷

The general populace knows that the proceeds of the GRDB go to fund the Grand Renaissance Dam bond. The distribution or sale of the bonds has greatly benefited from the sentimental attachment that the Ethiopian people have with river Abay and thus to the construction of the dam there on. Thus it is the belief of author of this study that the purpose of the GRDB should be redefined in ways that show its real purpose beyond fund raising to DBE.

Here under are the direct words of the operational guideline.

Both the Bank and its owner, in consultation with the Central Bank of the Country, i.e. the National Bank of Ethiopia (NBE), have thus, decided to devise a resource mobilization strategy for the Bank for ultimate lending to meet the growing credit demand from the Bank by the rapidly growing sectors of the Ethiopian economy. The purpose of the resources mobilization strategy through the issuance of the Grand Ethiopian Renaissance Dam Bond

²⁵⁶ Supra note 238, P4

²⁵⁷ Art 6(9) of the Development Bank of Ethiopia Re-establishment Council of Ministers Regulations No 83/2003

*is, therefore, to create a sustainable source of finance for the Bank by selling the Grand Ethiopian Renaissance Dam Bond to rural and urban communities, and/or to other potential savers in the economy, which has never been practiced before, in the history of the Development Bank of Ethiopia.*²⁵⁸

The Ethiopian legal regime with regard to government bond issuance has no clear and precise position as to granting the authority of issuance. The parliament clearly has given the power of government bond issuance to MoFED. However there are inclinations here and there towards giving authority to DBE.²⁵⁹

It is better to give the authority of issuance to DBE for the sake of clear regulation and control by the NBE. We can say at this moment that government bonds market is not regulated and has no committed owner. Of course NBE attempts to give general guidelines to DBE with regards to government bonds sale. Accordingly, based on the general working guidelines issued by the National Bank of Ethiopia (NBE), the Grand Ethiopian Renaissance Dam Bond Operational Guidelines and Accounting Manual are prepared by a Facilitation Committee for the Issuance of the Grand Ethiopian Renaissance Dam.²⁶⁰ Such preparation of the guide line clearly indicates the regulatory concern of the National Bank. Therefore it is again indicative of the trend towards unified financial markets regulatory model in Ethiopia.

The Guideline tries to define what a bond is in general terms. Accordingly it stated that bond is debt instrument like promissory notes and treasury bills. It is different from treasury bills as it is issued for a longer period of time.²⁶¹ Government bond has various features and benefits as we have seen it in chapter two above. The guideline lists the benefits of the grand renaissance dam bond to the country and to the investors or buyers. Thus, encouraging saving and investment thereby contribution to economic development and job opportunities, bringing foreign currency and expansion of financial markets are mentioned as benefits of the bond to the country.²⁶²

²⁵⁸ Ethiopian Renaissance Dam Bond Operational Guidelines and Accounting Manual, the English version, Tahisas, 2004, p4

²⁵⁹ Supra note 257

²⁶⁰ Supra note 238, p4

²⁶¹ id, p5

²⁶² ibid

The risk freeness of the bonds, saving, the tax free nature of the income, its transferability via donation, testament or inheritance, its tradability in the secondary market and the fact that it can be pledged to borrow money are mentioned as benefits of the bond to the bond buyers in the operational guideline.²⁶³

Ethiopian government has issued government bonds to finance the Grand Renaissance Dam on river Abay. Government's plan to raise the funds required to the project from Ethiopians and persons of Ethiopian origin seems to get satisfactory response from Ethiopian citizen at least.²⁶⁴ Government has managed to get considerable amount of money from the sale of bonds, especially from government employees. The introduction part of The Grand Renaissance Dam Bond Guideline states that it will create opportunity to the Ethiopians and individuals of Ethiopian origin to put their finger print in the Dam.

The Grand Renaissance Dam Bond's interest rates vary depending on the date of maturity. Bonds of maturity 1-5 years have interest rate of 5.5 % while bonds that have maturity dates of more than 5 years have interest rate of 6%.²⁶⁵ And the interest is payable bi annually on December 31 and June 30 (Tahisas 22 and Sene 22 in Ethiopian calendar).²⁶⁶ Nevertheless there are no such arrangements to pay either the principal or the interest in the aforementioned time. Manager of Commercial bank of Ethiopia Debremarkos branch said that bond buyers come and request us to redeem their bonds. But since there are no directives how it will be redeemed they do not accept the request. Ato Argaw said that as the number of bond buyers requesting redemption increased, he requested the upper managers concerned as to how to handle the problem. And the upper managers advised him to convince the bond buyer's so that they may relinquish their redemption request.²⁶⁷ Such unwillingness could be taken as misrepresentation of facts. This may leave black spot on the future development of government securities market. In other jurisdictions there is liability for misrepresentations in a public offering particularly in offering corporate bonds.

²⁶³ Id p3

²⁶⁴ Supra note 238, p7

²⁶⁵ ibid

²⁶⁶ ibid

²⁶⁷ Interview with Ato Argaw Zerihun, manager of Commercial bank of Ethiopia, Debremarkos Branch. On 05/03/2006

4.5.3.4. Procedures to Purchase the Bond for the Ethiopians in The Diaspora

The guideline provides about five ways of purchasing bonds to the Ethiopians in the Diaspora. Any Ethiopian in the Diaspora can purchase bonds via SWIFT²⁶⁸, Foreign Embassies, Money Transfer Agents, banks in Ethiopia having Diaspora account, or in person at a branch of Commercial bank of Ethiopia.²⁶⁹ Many of the ways through which bond is sold are not accompanied by simultaneous delivery of the bond with payment of the bond price. This very fact may have its own negative impact on the sale of the bond together with the absence of clear legal framework defining rights of parties involved in the transaction.

The Ethiopian government tried to devise some incentive mechanisms to stimulate the sale of GRDBs for the Ethiopians in the Diaspora. The guideline provides that government will cover all the costs of transferring the bond price to the Ethiopian commercial bank if the amount of bond purchased is above 500 euro or pound sterling or US Dollar.²⁷⁰

4.5.3.5. Transferring the Bonds to Third Parties

It is possible to transfer the bond to Ethiopians or foreigners with Ethiopian blood. If the transferor and the transferee agree that the principal will be paid in Ethiopian birr it is possible to transfer to Ethiopian nationals.²⁷¹ The condition provided to transfer bonds of the Ethiopians in the Diaspora to Ethiopian nationals is not as such clear. This may unnecessarily hamper the bonds' transaction in the secondary market while we need to devise mechanisms that facilitate transferability.

It is provided that the bond can be transferred to third parties in the secondary market by endorsement only at the back of the bond up to three persons.²⁷² One can also transfer it through endorsement only by donation or testament. If a need arises to transfer it to more than three

²⁶⁸ Founded in Brussels in 1973, the Society for the Worldwide Interbank Financial Telecommunication (SWIFT) is a co-operative organization dedicated to the promotion and development of standardized global interactivity for financial transactions. SWIFT currently provides messaging and transaction processing services for over 7,000 financial organizations located in 194 countries worldwide.

²⁶⁹ Supra note 235, pp7-10

²⁷⁰ id, p7

²⁷¹ id, p11

²⁷² See the Back of the Bond Certificates for GRDBs.

persons the holder may appear before an embassy or consul or transfer it to another party. The bond holders can also pledge it and borrow money from domestic banks.²⁷³

4.6. Diaspora Bonds in Ethiopia and ‘patriotic discount’²⁷⁴

Ethiopia issued bonds for Ethiopians in the Diaspora in 2008 for the first time, called the ‘Millennium Corporate Bond’, with an intention to finance the Ethiopian Electric Power Corporation (EEPCO) hydroelectric power project.²⁷⁵ According to Seliatou K., this bond issuance did not meet revenue generation expectations for reasons ranging from lack of trust in the ability of the utility to service the debt to the overall political climate in Ethiopia. Due to lack of secondary markets, which renders the investment highly illiquid, investors abroad did not express major interest.²⁷⁶

Ethiopia has issued GRDBs to the Ethiopians in the Diaspora denominated in three main foreign currencies of the world i.e. Euro, US dollar and Pound Sterling. Diaspora bonds have been issued with floating interest rate.²⁷⁷ There is some fear that Ethiopian government may reserve the right to repay its liabilities to bondholders in local currency under some circumstances.²⁷⁸ Such fear may obviously hamper the sale of GRDBs to Ethiopians the Diaspora. Thus law on government bonds including Diaspora bonds is of a great help. The rights and privileges of bond holders should be clearly defined in law. The obligations of government need also be clearly known.²⁷⁹

Bonds issued to Ethiopians in the Diaspora are sold exclusively to individuals of Ethiopian blood. Foreigners who reside in Ethiopia can buy the bond if they agree that the redemption will be made in birr and if they reside in Ethiopia.²⁸⁰ The reason why government preferred to exclude foreigners from purchasing the bond is not clear. Indeed, excluding foreigners in Diaspora bond

²⁷³ *ibid*

²⁷⁴ Patriotism or the desire to do good in the investor’s country of origin, such a discount can also be explained by the fact that Diaspora investors may be more willing and able to take on sovereign risks of default in hard currency as well as devaluation as they may have local currency liabilities and they may be able to influence the borrower’s decision to service such debt.

²⁷⁵ Seliatou Kayode-Anglade and Nana Spio-Garbrah, *Diaspora Bonds: Some Lessons for African Countries*, African Economic Brief. Volume 3, Issue 13, December 2012, P5

²⁷⁶ *ibid*

²⁷⁷ Grand Renaissance Dam Bond Operational Guidelines and Accounting manual, Amharic version, p19. See also Supra note 275

²⁷⁸ Supra note 275, P4

²⁷⁹ Clemente del Valle and etals, Supra note 18, P381

²⁸⁰ Supra note 238, p16

issuance is not peculiar to Ethiopia. India also had excluded foreign investors from purchasing its bonds. In cases where restrictions on nationality are explicitly applied, the basis for doing so is made clear. While limiting the potential size of the market, the Indian authorities felt that they could better target their marketing towards the Indian Diaspora versus other investors.

They also felt that Indians in the Diaspora, as opposed to investors of other nationalities, would be less harsh in the case of default and would not be as such disappointed to be paid in local currency instead of a hard currency. Although the need to explicitly exclude foreign investors is debatable, experience shows that the marketing and design of the instrument are more strategically aligned to the end buyer.²⁸¹

There are no such financial intermediaries in the country which will assist the distribution of government bonds in many other countries. The financial intermediaries called either primary or secondary dealers participate in the auction of government bonds issuance. Therefore they help the government to sell government bonds with less cost if the competition in government bonds is high. Such competition will be created if favorable condition is created for emergence and participation of financial intermediaries in government bonds trading.

Government debt securities must be supported by a clear legal framework that grants government the authority to issue debt, binds it to meet its repayment obligations, and governs the rights and responsibilities of those who purchase and trade in government debt securities.²⁸²

4.6.1. A call for Secondary Markets in Ethiopia

Securities are bought and sold in two principal setups, i.e. issuer's transactions and trading transactions. Issuers' transactions or primary markets are those involving the sales of securities to investors in order companies, governments and other groups obtain financing through debt or equity based securities.²⁸³ The absence of a secondary market in Ethiopia renders bonds illiquid. Investors on GRDBs have to hold them until maturity since there is no secondary market in which bonds can be traded. Even if secondary market exists, number of participants is likely to

²⁸¹ *ibid*

²⁸² Clemente del Valle and etals, *Supra* note 18, p281

²⁸³ Tikikile Kumulachew, *Regulation of Initial Public Offering of Shares in Ethiopia: Critical Issues and Challenges*, unpublished, 2011. P.3, see also Jack G. and Ananth M. *primary securities markets in Emerging nations: a case study of Peru*. Nov 23, 1998, P1

be small due to absence of financial intermediaries. Holders of GRDBs are selling their bonds with great discount to illegal dealers whenever they need liquid cash.²⁸⁴ Thus we can notice that formal secondary market in Ethiopia is badly needed.

Existence of regulatory framework, diversified investor base, existence of financial intermediaries, large series of securities and price transparency are all essential elements of government securities market development.

The secondary market should be supported by effective regulations by regulatory authorities. The required rules relate to market participants, market conduct, transparency requirements, and clearing and settlement procedures.²⁸⁵ They should reduce informational asymmetries and ensure a more level playing field within each class of market participant. Government securities should be held by a large number of investors. This is one of the key factors to enhance market liquidity. The more investors are holding a series of securities, the easier it is for a buyer to quickly find a seller fast, and vice versa. A large amount of securities outstanding in any series contributes to market liquidity and price transparency.²⁸⁶ A large size is one of the principal features of a benchmark security. It should be easy to determine the price of a security. Assets with values too complex to assess trade less and trade slowly since buyers and sellers are wary of making a mistake.

Primary markets are facilitated by underwriting groups, which consist of investment banks that will set a beginning price range for a given security and then oversee its sale directly to investors.²⁸⁷ Despite that we are not lacking since our legal system does not have such underwriting groups or investment banks. Primary capital markets involve the exchange of cash for claims against the issuers. These markets are of great importance to both investors and issuers, especially in emerging markets where capital is scarce relative to investment needs.

²⁸⁴ Interview with ato Ahmend Mengistu, Fund Management Principal Officer In The Development Bank of Ethiopia. He added that ministry of defense had collected the bond certificates and deposited them to tackle the problem.

²⁸⁵ Philip Turner, Bond markets in emerging economies: an overview of policy issues, BIS Papers No 11 p8

²⁸⁶ Stijn Claessens and etals, Supra note 61, P18

²⁸⁷ For instance Investment banks assist with underwriting & issuing by guaranteeing a minimum price for securities.

These markets are significant because they provide the link between the investment needs of the issuer and investors with extra capital.

In Secondary markets, great deal of transaction including purchasing and selling of outstanding securities among investors is made. Once the initial sale is completed, further trading is conducted on the secondary market, which is where the bulk of exchange trading occurs each day in developed economies.²⁸⁸

4.6.2. Over the Counter Markets (OTC) in Ethiopia

In developed economies stock exchanges face increased competition not only from other exchanges but also from other forms of trading. Although trading of securities outside exchanges has the disadvantage that it provides less liquidity and fragmented transactions. However, this may be counterbalanced by the fact that trading outside exchanges can be cheaper, faster, more confidential, and less constrained by regulation than trading on an exchange. Securities-trading outside exchanges is not without problems

In detail, there are different forms of trading outside exchanges. First, trading ‘over the counter’ (OTC) means that securities are traded directly between two parties. The dispersal of trading away from stock exchanges leads to a fragmentation of markets. Thus, there is the danger that the markets in securities become more shallow and illiquid. Further, price formation can become less efficient and price volatility can increase.²⁸⁹

There is a contract that is given together with the bond when buyers of Grand Renaissance Dam Bond take the bond. There are also prescriptions on the bond concerning the transferability of the bond. It says each bond holder is entitled to transfer the bonds in the secondary market and to pledge them. The facts of transfer need be registered in either the commercial bank of Ethiopia or in the development bank of Ethiopia. In four branches of commercial bank and development banks of Ethiopia I interviewed managers as to the status of transaction in the secondary market. Unfortunately the market is almost not available. There was no person who transferred his bond

²⁸⁸ Frank J. Fabozzi, *The Handbook of Fixed Income Securities*, seventh edition, U.S. Treasury and Agency Securities, April 2004, for example For the first quarter of 2004, primary dealers reported daily trading activity in the secondary market that averaged \$482 billion per day in US. Available at www.newyorkfed.org/cfcbsweb/Treasuries_and_agencies.pdf accessed on 5/3/2013

²⁸⁹ Supra note 107, P29

to third parties. This may be due to lack of awareness about government bonds or absence of institutionalized facilities for such trading.

Thus we can conclude that even though there are government bonds, their transactions in the secondary market are illiquid. This is mainly due to absence of stock markets and financial intermediaries like brokers and dealers in the secondary market. Thus in Ethiopia, secondary market for government securities is almost absent. Such illiquidity can have negative consequence on the future development of the government bond market.

4.7. The Need for Full-fledged Legal Regime

During the Reign of Emperor Haileselassie there was initiation to build securities market. The attempts were not sterile as they managed to create the market. Ethiopia had formal securities market only as short phenomenon during Imperial Regime.²⁹⁰ It also enacted laws on government bonds in 1961 and 1969 to facilitate the financing of development projects of the government and stimulate the development of the securities. In the then proclamation the maximum amount that the government can issue is not more than Birr one hundred million.²⁹¹

Then in 1975 Dreg has amended the maximum limit of one hundred million to four hundred million.²⁹² This proclamation is not amended or repealed by clear statute. Therefore we hope the law is operational if it is not repealed either impliedly or tacitly. Thus one may ask questions like how the Ministry Of Finance And Economic Development managed to raise such amount of money via bond issuance. Can we say that the act of the Ministry is law violation or is it possible to amend a clear statute through disuse? The author of this paper could not get solution to such questions of wise observer. Can we say that this special government bond proclamation no 531/2007 is impliedly repealing proc no 25/1975? If we say that is implied repeal then what about the amount raised by sale of Grand Renaissance Dam Bond? There are some irregularities here and there about government bond issuance. Therefore the country needs to have fully fledged legal regime and regulatory frameworks and institutions.

²⁹⁰ Dr Solomon Abay, financial markets development policy and regulation, the International Experience and Ethiopia's Need for Further Reform, Unpublished, April 2011, p150

²⁹¹ Supra note 140

²⁹² Supra note 248, Art 2

The lack of efficient and full-fledged legal framework can hamper development of government bond market not only today but also in the coming few decades too. Because the problems manifesting themselves in today's market have the potential to leave their own foot print in the future government bond issuances. Therefore the government should take sufficient care at the baby stage of the capital market development.

Legal framework we expect to come in the future need to address matters like an explicit empowerment of the government to borrow, budgetary rules for the issuance of government securities, rules for the organization of the primary market, role of central bank as agent for the government and clear relationship between various organs of government in relation to debt management, the debt-management framework, rules governing issuance of government securities, and rules pertaining to the secondary market.²⁹³

In this way, the legal framework defines incentives for all market participants—the issuing government, the central bank, regulatory agencies, market intermediaries, end investors, and any SROs.²⁹⁴

At another level, the legal framework must define the rights and obligations of parties to debt contracts in the primary and secondary markets for issuers, investors, and intermediaries. This definition should include (i) minimum guidelines for disclosure of material information, (ii) liability for entities involved in distributing securities and for entities handling third-party investment accounts, and (iii) vehicles to allow proper legal recourse against mutual funds, pension funds, and even the government as an issuer. Investment regulations need to permit sufficient flexibility for investors, yet create adequate safeguards for prudent operations and for the safeguarding of fiduciary obligations, as in the case of pensions.²⁹⁵

4.8. Government Borrowing in Ethiopia

Financial administration and debt management is the power of the federal government in Ethiopia. Borrowing through the issuance of securities or by direct advance is possible for the

²⁹³ Hans Blommestein, Legal and Regulatory Framework for Developing Government Bond Markets – Suggested Issues for Discussion, Second OECD-China Forum on Public Debt Management and Government Securities Markets, 15 and 16 September 2005, Xi'an International Conference Center, Qujiang Hotel. P2

²⁹⁴ *ibid*

²⁹⁵ *Id*, P3

federal government. FDRE constitution the federal government may determine by law the conditions under which the regional states can borrow money from domestic sources²⁹⁶. It shall administer the National Bank, print and borrow money, mint coins, regulate foreign exchange and money in circulation; it shall determine by law the conditions and terms under which States can borrow money from internal sources.²⁹⁷

According to the financial administration proclamation, no borrowing is made without the permission of the House of People's Representatives.²⁹⁸ That means whenever the executive body of the federal government needs to issue any security it requires the permission of the parliament. This can be taken as the mechanism to check on the power of the executive branch. Government need be controlled in order to prevent abuse of its borrowing power.

That is why many countries avoid arbitrary issuance of government bonds either through debt ceilings or legislative approval.

The proclamation provides that where the House of People's Representatives authorizes to borrow money on behalf of the Federal Government, the Minister may, subject to the Proclamation authorizing such borrowing, borrow all or part of that money by direct advance or security.²⁹⁹ From this provision we understand that any borrowing including via issuance of bonds needs authorizing proclamation from the parliament. However when we come to issuance of the Grand Renaissance Dam Bond we get no authorization proclamation.

*The law may impose prior legislative authorization on the issuance of government securities as a check against abuse of the borrowing authority. As part of its authority, the government should also have the legal ability to delegate borrowing authority and debt management policy to the public agency or department that carries out the debt management work.*³⁰⁰

The government's borrowing authority is delegated clearly to MoFED in a parliamentary legislation. Practically MoFED has delegated its authority of bond issuance to Development

²⁹⁶ Art 51(6) of the Constitution of the Federal Democratic Republic of Ethiopia Proclamation No. 1/1995, Federal Negarit Gazeta - No.1 21st August 1995 -

²⁹⁷ *ibid*

²⁹⁸ *Supra* note 111, Art. 40(1)

²⁹⁹ *ibid*

³⁰⁰ Clemente del Valle and etals, *Supra* note 18, p34

Bank of Ethiopia. The delegation has been made by memorandum of understanding between DBE and MoFED.³⁰¹ Development Bank of Ethiopia in turn has delegated its delegated power of bond sale to other financial institutions. We may remember at this particular point the Latin principle i.e *delegate potest non potest delegate* which means power delegated may not be re-delegated, with regard to delegated power.

However it begs a question on that what could be the yardstick for the parliament to allow or to forbid the issuance of debt securities. In Japan the public finance act as I have discussed it in subtopic 3.3.3 explicitly specifies the conditions under which government can issue government bonds. For instance the act forbids issuance of bonds for deficit financing. Therefore the parliament should have at least clear guidelines by which it can permit or forbid debt issuance by the government.

Some countries give the authority to issue government debt securities to central banks and others give that power to ministry of finance. And some others established independent government agencies like treasury department in US. When we come to Ethiopia the power to issue securities and give guarantees to government securities is exclusively given to the ministry of finance and economic development.³⁰² It is also provided that no money shall be borrowed or security issued by or on behalf of the Federal Government without the authorization of the House of Peoples' Representatives.³⁰³

Security is defined in this proclamation as something given or pledged to secure a financial promise or a financial obligation and includes a treasury bill, a note or a bond.³⁰⁴ Hence it means only the ministry of finance and economic development can issue government securities including the issuance of treasury bills. However it is common to hear from the mass media that it is the national bank of Ethiopia that issue treasury bills of different maturity.

³⁰¹ Interview made on 20/05/2006 with ato Ahimed Mengistu, Fund Management Principal officer in the development bank of Ethiopia.

³⁰² Supra note 111, art. 40(2)

³⁰³ ibid

³⁰⁴ Id art 2(20)

4.8.1. Borrowing by MoFED without the Permission of the Parliament

MoFED can borrow money without the permission of the parliament if the borrowing is for the purpose of repayment of former debts or maturing securities or for the consolidation of loans.³⁰⁵ Thus if the borrowing is required for the payment of any direct advances, or securities that are maturing or have been called for redemption, government may not require permission of the parliament. However who checks weather the issuance is for repayment of former loans if there is no sufficient transparency in debt issuance. There should be clear and accountable issuance of debts to win confidence of investors and in order to develop the market.

We can here justify the borrowing without the permission of the legislature as the proceeds of the issuance directly go to finance the former debt which is created by the legislature, it is needless to require the permission of the parliament.

Therefore one can see here that whenever government needs raise capital it should get the permission of the parliament. The only scenarios that government may not require permission of the parliament are mentioned above. The issuance of the Grand Renaissance Dam Bond without parliamentary authorization is not clear. The regulatory frame work for debt issuance in Ethiopia could be characterized as incomplete.

4.9. A Need for Financial Intermediaries and their Regulation in Ethiopia

Here in Ethiopia there are no such underwriting systems in the process of distribution of the government securities. Financial intermediaries are also not available. Credit rating institutions which are crucial components of any capital market are also missing in the legal system. Therefore there is a need to make substantial financial reform taking all the above facts into consideration.

Market intermediaries should be subject to entry or licensing standards, including proficiency and capital requirements. They should likewise be subject to ongoing capital adequacy requirements and to internal control requirements to ensure sound risk management. Market intermediaries should be subject to business conduct rules and required to have standards for

³⁰⁵ Id art 43

professional conduct. The regulator should have full authority to conduct examinations of market intermediaries, impose conditions on them, and enforce compliance with regulations.³⁰⁶

The regulatory authority should have the ability to monitor trading and enforce trading rules regardless of the market structure. Most bond markets are OTC or dealer markets, and in this case the regulator may impose post-trade reporting, record-keeping, and audit track requirements on market intermediaries. If the bond market is an exchange, the securities regulatory authority should have the ability to license exchanges and impose requirements for reporting, record-keeping, fair access, and risk management on exchanges.³⁰⁷

Fundamental rules pertaining to market conduct should be included in securities regulation. These rules should address fraud and misrepresentation, duty to clients, market manipulation, and self-dealing. The securities regulatory authority may rely on the exchange to carry out market conduct regulation and market surveillance. Despite such reliance on self regulation it should maintain appropriate oversight of the exchange's regulatory functions.

The securities regulator should consider setting out minimum market conduct standards in its own rules in order to ensure consistency across trading systems.³⁰⁸

In an OTC market, the securities regulatory authority should develop market conduct rules and should have access to necessary trading records which is to be kept at the market intermediary or at a reporting location, if applicable in order to investigate compliance with the rules.³⁰⁹

4.10. Some Available Regulatory Institutions for GRDB

Despite the fact that there is no institution formally established with a view to regulate government securities in particular and the capital markets in general, there are some institutions with regulatory stake. Even though their interest and power is not clearly defined in law, practically the following institutions are taking part in regulation of the government bond market in Ethiopia.

³⁰⁶ Clemente del Valle and etals, Supra note 18, p290

³⁰⁷ Id, p288

³⁰⁸ id, P289

³⁰⁹ id, P290

A. The legislature

Government borrowing including government bond issuance is subjected to parliamentary control. Thus, the parliament is the first institution having regulatory interest and power in government bonds issuance. However, such parliamentary control of debt issuance by government does not seem as such effective in Ethiopia. First of all case by case authorization of debt issuance by parliament preferred by Ethiopia is not wise and cost effective. It is better to have certain standards of issuance and borrowing and to fix them in law so that arbitrary issuance by government might be avoided. It is also possible to provide certain ceiling with reference to budget or GDP.

B. Ministry of Finance and Economic Development

The next is MoFED which has the authority to issue government bonds on behalf of government. This institution as owner of government bonds need to follow up the well functioning of the government bond market. However, practically we observe minimal role of it as it is not taking substantial role in the bonds distribution and their trading in secondary markets. Of course it receive reports from DBE concerning how much of the GRDBs are sold. Experience of other countries shows that public bodies having regulatory concern have task of controlling behavior of market participants by setting rules of conduct or any other means considered proper.³¹⁰ MoFED has passive role with this regard as it has not set such rules yet.

C. Development Bank Of Ethiopia

Another important institution is Development Bank of Ethiopia which is very much involved in the issuance and distribution of the GRDBs. It is delegated to follow up the sale of GRDBs. However, the relation between Development Bank of Ethiopia and MoFED is not clear. The bank itself has been given the power to issue bonds by Council of Ministers regulation.³¹¹ What is meant by this specific regulation? Does this mean there is other public agency which is empowered to issue government bonds other than MoFED? The guideline provides that the bond owner is MoFED while the bonds supplier is Development Bank of Ethiopia (DBE).³¹² Who will be finally responsible and answerable in case there is default in bond redemption? Investors on

³¹⁰ Supra note 211, P12

³¹¹ Supra note 257

³¹² Supra note 238, p7.

bonds or savers attitudes are intricate or fragile and thus government should be careful if it bothers about future development of government bond markets.

This is possible by clearly establishing the interaction between various public agencies having stake on the government bond market development. Obviously all National Bank of Ethiopia, MoFED and Development Bank of Ethiopia have concerns on the development of bond markets in Ethiopia.

D. National Bank of Ethiopia

National Bank of Ethiopia has provided operational guideline and accounting manual with regard to bond issuance and sale including GRDBs.³¹³ This is one indication of regulatory concern of the Bank on government bonds market in Ethiopia. The operational guideline prepared by a Facilitation Committee for the Issuance of the Grand Ethiopian Renaissance Dam Bond is based on the general working guidelines issued by the National Bank of Ethiopia (NBE). The Grand Ethiopian Renaissance Dam Bond Operational Guidelines and Accounting Manual is prepared by a Facilitation Committee for the Issuance of the Grand Ethiopian Renaissance Dam Bond which has been established by the Management of Development Bank of Ethiopia.³¹⁴

In the absence of clear legal demarcation between monetary and fiscal authorities, expecting the Central Bank to formulate independent monetary policy measures is difficult. The National Bank of Ethiopia as monetary authority needs the discretion to use any policy instruments to bring about macroeconomic stability in full force.³¹⁵ Again the relation between Ministry of Finance and Economic Development and National Bank of Ethiopia with regard to government bonds issuance needs further clarity.

The unlimited amount of direct advances to the government and purchase of government securities in primary markets by NBE is also another concern for government bond market development. Domestic debts are composed of three instruments only, Bonds, Treasury Bills and funds owed to the National Bank of Ethiopia (NBE) for cash advance.³¹⁶

³¹³ The Grand Renaissance Dam Bond Operational Guidelines and Accounting Manual, Tahisas 2004. P4

³¹⁴ *ibid*

³¹⁵ By Abdulmena M. Hamza, <http://addisfortune.net/columns/subservient-monetary-policy-unsustainable/>.

³¹⁶ The Federal Democratic Republic Of Ethiopia-The Federal Pefa Repeat Assessment Report, unpublished, (September 30th, 2010), p52

National Bank of Ethiopia, as it is central bank, needs independence from influences from MoFED. The fact that Central Bank enjoys independence does not mean there is no need for coordination with fiscal authorities. There must be a coordination mechanism without compromising the independence of the Central Bank.³¹⁷

National Bank of Ethiopia establishment proclamation provides that upon authorization by the Ministry of Finance and Economic Development NBE manages public debt transactions; manage and sell treasury bills, bonds and other securities of the Government³¹⁸; buy and sell unconditional negotiable treasury bills and government bonds issued by the Government.³¹⁹ We can see the central bank's stifled independence from these provisions.

National Bank of Ethiopia should be allowed to issue its own government securities for monetary policy manipulation purpose. Countries allow their central banks to issue government bonds for monetary policy purposes. For instance in Brazil, the Central Bank was allowed to issue its own securities for monetary policy purposes.³²⁰

Among the responsibilities of National Bank of Ethiopia includes purchasing, selling, and transferring or taking custody of bills of exchange, promissory notes and securities.³²¹ When we closely analyze the responsibility of National Bank of Ethiopia with respect to government bonds we can observe some sort of anomaly. The proclamation consider the bank sometimes as buyer of government securities, and sometimes as seller of government securities and an another times as regulator of government bond market.

4.11. Measures Ethiopia Needs to Take to Regulate Government Bond Market

Ethiopia needs to take a number of rigorous measures so that its government bonds market and other securities industry will develop. Other countries like India take such pains taking measures before their respective government securities market develop. For instance range of structural

³¹⁷By Abdulmena M. Hamza, Supra note 315

³¹⁸ Art 12(5) of "the National Bank of Ethiopia Establishment (as Amended) Proclamation No. 591/2008".

³¹⁹ Id art 12(7)

³²⁰Ricardo P. C. Leal and Andre L. Carvalhal-da-Silva, Supra note 150, p23

³²¹ Supra note 318, Art 12(2)

and operational changes have been introduced in India over the past decade in the government securities market.³²² In the primary market, diversified debt securities - zero coupon bonds, floating rate bonds, and capital index bonds - are issued through the auction system at market-related rates across maturities to develop a benchmark yield curve.³²³ To build the secondary market, a system of primary dealers was set up to provide two-way quotes for the transactions.³²⁴

The Negotiated Dealing System was introduced to facilitate screen-based negotiated dealing for secondary market transactions in government securities, money market instruments, online reporting of transactions, and dissemination of trade information to the members. The Clearing Corporation of India was established to facilitate settlements using the higher versions of Delivery vs. Payment mechanism and to act as a central counterparty for clearing and settlement of securities transactions. Active credit rating agencies have been woven into the regulatory framework.³²⁵

The same was true in Brazil before government took various measures as the market for debt securities were very small. The high inflation rates, the limits on the interest rate, and the prohibition of indexation rendered debt securities very unattractive. Until 1964 the Brazilian financial system lacked a well structured legal support. In 1964, a law allowing inflation indexation was introduced and the government started a government bond market with the ORTN's (Adjustable Treasury Bonds).³²⁶ With indexation, the National Housing Bank (BNH) was created to foster financing for the housing market through a savings and loans system.³²⁷

All of these measures taken by these developing countries can lend significant lesson to other countries including Ethiopia with a desire to cultivate and develop capital markets.

³²² Ramit Nagpal, *Supra* note 52, p706

³²³ A line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates. This yield curve is used as a benchmark for other debt in the market, such as mortgage rates or bank lending rates. The curve is also used to predict changes in economic output and growth. Some of the most common pricing benchmarks are on-the-run or the most current series of government bonds. Many bonds are priced relative to a specific government bond. For example, the on-the-run 10-year government bond might be used as the pricing benchmark for a 10-year corporate bond issue.

³²⁴ Ramit Nagpal, *Supra* note 52, p706

³²⁵ *ibid*

³²⁶ Timothy S. Douppnik, *The Evolution of Financial Statement Indexation in Brazil*, UNIVERSITY OF SOUTH CAROLINA, *accounting Historians Journal*, Volume 13, number 1, Spring 1986, p5

³²⁷ Ricardo P. C. Leal and Andre L. Carvalhal-da-Silva, *Supra* note 150, p9

4.11.1. Some Regulatory Models and Ethiopia's Approach

Although there are many models of financial services regulation let us see functional regulation and institutional regulation or regulation by silos.³²⁸ In general, the idea of institutional regulation, unlike that of functional regulation, relates to the regulation of each single category of financial services by a different authority.³²⁹ This model is sometimes referred to as “regulation by silos” or “the by-markets regulatory model.” The concept of a unified regulator is almost the antithesis of institutional regulation.³³⁰

From much of the data gathered in a seminal study on unified financial services supervision, covering countries as varied as Iceland, Hungary, Canada, Denmark, Norway, Sweden, Poland, Bulgaria, and the United Kingdom, it was observed that, in many cases, models of unified financial services supervision started out along the lines of institutional before graduating into functional regulation.³³¹

In short, this is not a simple choice between institutional regulation and functional regulation. Nor are the two entirely opposed. They can complement one another, providing a country with mixed and rational attributes of both institutional and functional regulation, or one system can run as a precursor to the other.³³²

Now let us see the Ethiopian approach to regulation of financial service in light of the points discussed here above. The banking and insurance and other financial institutions are under the regulatory sphere of the National Bank of Ethiopia as it licenses and supervises them.³³³ The term other financial institutions may be taken as to mean institutions in the securities market or micro finance institutions. However since institutions in securities market are not available here in Ethiopia such interpretation may not hold water. Thus financial institutions in the securities sector are not given regulatory body since they have not yet been created.

The experience of the Scandinavian countries has shown that as a financial market develops and its range of services provided expands, merging several financial

³²⁸ Supra note 211, P8

³²⁹ id, P9-10

³³⁰ ibid

³³¹ ibid

³³² ibid

³³³ Supra note 318, Art 5(7)

*supervisory authorities into one provides for more efficient supervision of the transactions in the financial sector, including an opportunity to assess market conditions more objectively and duly identify risk factors that could affect the interests of market participants and clients....A unitary system for supervision of capital market has been successful in the Scandinavian countries, Australia, Canada, Japan, Korea, Singapore and Great Britain.*³³⁴

Therefore for Ethiopia as a beginning it is not as such advisable to adopt unified or single regulator in the financial services regulation. As we have seen from experiences of other developed economies, institutional regulation is precursor of unified regulation. In many cases it is the institutional regulation which finally graduates into unified or single regulator. As such it is better for Ethiopia to establish capital markets commission which will be devoted to regulation of securities market.

The authorizing legislation should be set out in the authority to delegate debt issuance responsibility and may also define the administrative process for debt management.³³⁵ Whether in the form of a government agency, the central bank, or within the finance ministry, a debt management office's role, function, and organization need to be defined in appropriate law and regulations along with record-keeping and reporting requirements. To eliminate any doubt by potential creditors, the law should clearly indicate that financial obligations incurred by a delegated agency fully and wholly bind the state³³⁶.

The administrative organization for the management of public debt must have a sufficient degree of functional autonomy to fulfill its mandate without undue political interference. The debt manager must be given sufficient latitude to allow him or her to execute debt management effectively. Such autonomy, however, carries with it the requirement that the debt management office be accountable and transparent in its operational activities, procedures, and results.³³⁷

³³⁴ Supra note 211, P63

³³⁵ Clemente del Valle and etals, Supra note 18, p284

³³⁶ Id, p285

³³⁷ ibid

4.11.2. The Need for Transparency and Accountability

The government debt issuance practice should be transparent and accountable in order to assure investors that the contract (repayment of the debt and payment of interest) is a secure investment. When governments report to the legislature on public-debt management, such records provide a basis for the legislature to exercise its control. Of course, a balance between accountability and transparency and excessive bureaucracy, should be struck. In addition, the issuance and management of public debt must be subject to audit and internal control procedures.³³⁸

Government's bond issuance needs clear schedules so that it will be accountable and transparent. Similarly government as issuer needs to abide by its schedule of issuance otherwise the market cannot develop if the government issues smaller amounts than announced or altogether cancels a scheduled auction.³³⁹

4.11.3. A call for Capital Markets Commission or Authority

The starting point for every legal and institutional capital market base is a proclamation that mandates the foundation of a financial regulatory body. Without this proclamation, a capital market authority cannot be established. It is proposed by the study made under the auspices of the Addis Ababa chamber of commerce that the Financial Services Authority be established as a unit of the National Bank of Ethiopia.³⁴⁰ The author of this study does not agree, especially with the nomenclature of would be regulatory body. Because Financial Services Authority seems to presuppose unified regulation as financial services is all inclusive term. Thus it will be better to call the regulatory body capital markets commission or authority. This will better qualify the institution. The draft law on securities prepared with national bank of Ethiopia jointly with World Bank also called it securities commission.³⁴¹

The establishment of Securities Commission as a regulator, on the one hand, and securities enforcement on the other, is necessary for the establishment of a capital market. Imagining

³³⁸ *ibid*

³³⁹ *Supra* note 107, P18.

³⁴⁰ *Supra* note 178, p48

³⁴¹ Section 3, Art 1 of the Draft Proclamation to Provide for The Establishment of the Ethiopian Securities Commission, 2010.

capital markets without regulatory body is difficult. The informal capital market in Ethiopia is creating many problems on investors especially in the private sector capital market.

Therefore, it is essential that the relevant government bodies initiate the implementation of a financial services authority. In the light of the growing unregulated market for share companies under formation, the foundation of Ethiopian Securities Commission seems also inevitable in order to ensure investor protection and market trust. This would guarantee consumer and investor protection, and also provide the basis for a properly regulated Ethiopian capital market.³⁴²

4.11.4. Concept of Inflation Indexed Government Bonds

Introduction of inflation indexed government bonds to Ethiopian legal system will contribute its own part in the development of the market as it has helped other developing and developed economies³⁴³. The grand renaissance dam bonds need be inflation indexed so that investors get real interests in their investment. Not only interests on government bonds but also interests on bank deposits need to be above inflation rates so that saving will be encouraged. However there is no guarantee as to their adjustability in relation to inflation as such arrangement is not guaranteed by legislation properly enacted by the law making body.

Developing countries benefited a lot by introducing such inflation indexed government bonds. For instance Brazil has introduced such kind of bonds in 1964.³⁴⁴ Nowadays, the Brazilian federal public debt market is one of the most liquid and sophisticated among emerging markets, offering a wide range of debt instruments (fixed-rate, floating-rate and inflation-indexed bonds).³⁴⁵

³⁴² *ibid*

³⁴³ Richard C. K. Burdekin and Xiaojin Hu, China's Experience with Indexed Government Bonds, 1988–1996: How Credible Was the People's Republic's Anti-Inflationary Policy? *Review of Development Economics*, p66

³⁴⁴ Ricardo P. C. Leal and Andre L. Carvalhal-da-Silva, *Supra* note 150, p21

³⁴⁵ *Supra* note 150, P25

4.11.5. Minimizing Captive Sources of Finance in Ethiopia

Although NBE has lifted credit ceilings on commercial banks, it recently issued a directive requiring the latter to invest 27% of their gross loans in NBE bonds³⁴⁶. The proceeds are, to be channeled to the Development Bank of Ethiopia for lending to priority projects.³⁴⁷ Government need to resort to market based financing through the use of marketable instruments sold at market price. Thus it should avoid captive sources of funding.³⁴⁸ Government in Ethiopia is extensively using captive sources of finance since many of the investors on government bonds are captive sources of finance. With this regard Government in Ethiopia has to rethink the use of captive sources of finance. It needs to define and adhere to principles of market access and transparency in government funding operations. It needs also to define clear objectives and a debt management strategy that involves market financing.³⁴⁹ Moreover it should build a sound institutional framework for debt management with appropriate governance structures. The responsibilities of the debt managers should be explicitly stated; the organization should be endowed with adequate operational capacity, including the ability to attract and retain professional staff in the debt management functions.³⁵⁰

The market cannot develop if the government enacts regulations to create a captive investor base by compelling some institutions to buy government securities thereby enabling the government to issue at artificially low rates.³⁵¹

One problem with rules forcing institutional investors to hold a high proportion of their assets in government bonds is that they can create a “captive” market. This can undermine the creation of a true market in bonds, and in effect deter other investors.³⁵² The natural growth of healthy government bond market should minimize such captive sources of funding.

³⁴⁶ Directive no MFA/NBE Bills/001/2011, all CBs except CBE & DBE are obliged to allocate 27% of total loan disbursed during the month for the purchase of the bill See also <http://www.coface-usa.com/Economic-studies/Ethiopia>. visited on 1/19/2014,

³⁴⁷ Federal Democratic Republic of Ethiopia country strategy paper 2011-2015, African development bank group, April 2011, p3

³⁴⁸ Clemente del Valle and etals, Supra note 18, p53

³⁴⁹ ibid

³⁵⁰ id, p54

³⁵¹ Supra note 107, P18

³⁵² Philip Turner, Supra note 285, p6

Different scholars in the banking sector argue, like IMF Resident Representative Jan Michelson, that the national bank's measure will further reduce private banks' ability to extend loans to customers.³⁵³ About 61 percent of new bank deposits worth 10 billion Ethiopia birr (\$535 million) were used to buy central-bank bills in the fiscal year ending July 7, 2012, according to Addis Ababa-based Research Company.³⁵⁴

The level of the yields applicable to government bonds and other financial assets should be market determined, not administratively set. The government should be committed to developing the market, financing itself through the market (not through captive investors), accepting market rates, and not canceling auctions.³⁵⁵

The major holders of government securities in Ethiopia are the National Bank of Ethiopia and the Commercial Bank of Ethiopia followed by government and private banks and insurance companies, Public Servants Social Security Agency and other public enterprises³⁵⁶. We can see here that institutional investors like mutual funds and investment banks which will be considerable investors are absent in Ethiopia.³⁵⁷

³⁵³ <http://www.bloomberg.com/news/2013-02-26/ethiopian-central-bank-order-may-mean-more-t-bills-less-lending.html>

³⁵⁴ *ibid*

³⁵⁵ *Supra* note 107, P18

³⁵⁶ Ethiopia's Medium Term Debt Management Strategy (2013-2017) October 2012, P25

³⁵⁷ Mario Catalan and etals, Contractual Savings or Stock Markets Development: Which Leads? The World Bank Financial Sector Development Department Financial Sector Vice Presidency, August 2000, P4

Chapter five

5. Conclusion And Recommendations

5.1. Conclusion

Building a government bond market is a complex and challenging task requiring concerted effort in macroeconomic policy, debt management, and market-building efforts over several years or even decades. Government bonds regulation and issuance in various countries requires careful regulatory design. Because it is related with many other macroeconomic matters beyond mere concern of fund raising to fund public projects. As such to address all those issues, regulation both in the primary and secondary market is of paramount importance. Despite bond issuances by government it is difficult to see their trading transaction in a secondary market. The transaction and circulation of securities which would ensure their liquidity is essential element of the securities market. Otherwise their mere issuance while there is no sufficient circulation and liquidity in the secondary market makes the transaction incomplete. There are no market makers called primary dealers which are responsible for the distribution of bonds. The existence of financial intermediaries is very crucial which are not available in Ethiopia.

It is also possible to say that government bonds are not attracting interests of investors as investors on bonds seem to be suspicious of their redemption. Moreover as inflation would reduce the value of money, investors on bonds seem to be reluctant to purchase them. Many are buying bonds with the view to support the construction of the Dam on the Nile River which was age old dream of any citizen. However investors should have confidence and interest on the bond's purchase as business men. They should have more economic motivation than any other considerations so that the securities market will prosper. And the author of this study believes that confidence and economic motive will be created when the country's legal system has sufficient normative and institutional infrastructure for their regulation both in the primary and secondary markets.

Government bond issuance in Ethiopia has started during the reign of Emperor Haileselassie. In those days, the pre conditions to government bond market development were in the formation stage. Share dealing groups as financial intermediaries were there together with the then stock market. Then during the Derg Regime the law that provides the maximum limit of borrowing

through bond issuance was amended and increased the maximum limit from one hundred million to four hundred million. Normally since the regime was not favorable to the development of the private sector, the government was not able to get investors having voracious appetite to government bonds. Then in 1988 PDRE has enacted special order on government bond issuance that enabled the national bank of the country to buy government bonds of up to 1.5 billion birr.³⁵⁸

Then in 2007 the parliament enacted statute to enable the Commercial bank of Ethiopia raise funds of up to 2.5 billion birr. This proclamation does not expressly repeal either proclamation no 262/1969 or proclamation no 25/1975 or special order no 4/1988.

The proclamation that defines powers of the executive branch provides that the government may issue government bonds. However whenever the government intends to issue government bonds it should get the approval of the law making body. Then the parliament should approve the issuance through a proclamation. Despite that provision the Grand Renaissance Dam Bond was issued without enacted proclamation. The proclamation that is concerned directly with government bond issuance is not clearly repealed or amended. Therefore it would be very difficult to get any legal base to the government's bond issuance to finance the Grand Renaissance Dam. We only get the manuals prepared by Development Bank of Ethiopia on the issuance and sale of Grand Renaissance Dam Bond.

There are legal and institutional infrastructures that are crucial elements of not only government bonds but also to other securities in the private sector. The financial intermediaries including primary dealers, brokers, investment advisors, rating institutions, investment banks, pension funds and securities markets are important components of securities markets in general and government bond markets in particular. Each of them in developed and developing economies have their own associations that will serve as self regulatory institutions. Such self regulatory institutions could assist the state regulators in the regulatory sphere.

Unfortunately such infrastructures are not available in Ethiopia or are available in rudimentary form. Had they been at least in the formative stage they would have assisted the distribution and trading of the Grand Renaissance Dam Bond meaningfully. The bonds trading even in the OTC or secondary market is not common. Therefore as the Grand Renaissance Dam Bond is not liquid it will leave its negative foot print on the development of government bond markets in the future.

³⁵⁸ Special Government Bonds Council Of State Special Decree no 4/1988, Negaret Gazette, No 23, 7th June,

While the growth in the equity markets has caught the attention of the domestic investors in Ethiopia, it is not the case for the bond market. Ethiopian government has to lay the infrastructural, and institutional frameworks for building its bond markets, but the lack of a critical pool of issuers, market makers or financial intermediaries and investors would remain a serious impediment to any further development.

5.2. Recommendation

The author of this study recommends the following measures to be taken by policy makers or the Ethiopian government.

1. The development of government bond market is not only significant to get fund to public infrastructure but also to the development of private sector bond markets. It will provide macroeconomic policy tools too, as it will serve as bench mark to other financial institutions. Thus it requires considerable attention from the government.
2. Arbitrary government bond issuance might have various negative consequences on the country's economy such as crowding out private activities and other macro economic problems. That is why many countries tried to control governments borrowing through various means like debt ceilings and subjecting it to legislature's approval. Despite the fact that bond issuance needs legislature's approval by proclamation³⁵⁹, issuance of GRDB seems to lack such authorization proclamation. Thus government needs to support the bond issuance by proclamation. The debt by debt authorization of issuance is what Ethiopia preferred even though it is not wise and cost effective method.
3. The development of formal stock market and financial intermediaries is also another area that the policy makers need to consider. Firstly, the government should work for the development of the institutional infrastructures. These institutional infrastructures provide the operational basis for the market. These institutions include intermediaries that provide trading, investment and financial advisory services, stock exchanges, over-the counter markets, market information services, transaction clearance and settlement systems, and securities transfer, registration and custody; and providers of subsidiary services such as accounting and auditing, and financial valuation and debt rating services. Development of government bond market is also related with developments of mutual

³⁵⁹ Supra note 111, Art 40 and 42(1)

fund industries and institutional investors. As such anybody concerned with the development of the market need to work towards the development of such institutions which will encourage public savings and capital market development.

4. The above mentioned institutions should also be accompanied by proper regulatory institutions. The regulatory concerns both in the primary and secondary market need be addressed. The problems that are faced by investors in government bonds may have long term negative consequence on future issuances. For instance some investors are heard to express their fear that the government may not buy it back. Therefore the government needs to be more careful at the very embryonic stage of the market development.
5. Furthermore the government should base its issuance on law properly enacted by the parliament. Government need to enact securities law that will hamper the problems in the present government securities market. The securities and other laws should be enacted to provide for property rights, contractual relationships, and rights and responsibilities of participants in the market. The securities law should also establish and specify the powers and responsibilities of the government supervisory authorities and self regulatory organizations.
6. The preambles of proclamations on government bonds during the imperial era provide the policy purpose of government bond issuance. Accordingly it provides that to finance development and encourage savings and capital markets development the proclamations are proclaimed.³⁶⁰ We can notice from these preambles that government should take proactive measures to develop and build capital markets including government bond markets. When we examine the GRDBs in light of bond issuance during the imperial era, we can notice that there are very important elements we need to bring to the present bond issuance practice and to the would be proclamation needed to be enacted by this government. For instance fixing the maximum amount of outstanding bonds is essential for various reasons. In addition setting the maximum limits of interest rates for government bonds could also avoid the possibility of crowding out private investment. Clearly indicating the public body which is authorized to enact rule for regulation of bond issuance is also important lesson that we can take from experiences of those days.

³⁶⁰ See Preambles Of Proclamation No 172/1961 And Proclamation No 262/1969.

7. Investors who intend to invest their money on government bonds may like to shield their investment against inflation or other risks. Thus government should consider issuance of various kinds of government bonds like inflation indexed bonds. Diversifying the types of bonds will have its own role in the market's development by addressing various concerns of investors in bonds. For instance considering issuance of revenue bonds will increase the confidence of investors in bonds' redemption.

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