

Establishing financial markets in Ethiopia: the environmental foundation, challenges and opportunities

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Abstract

This paper intends to examine the environmental foundation for establishing financial markets in Ethiopia, identify the potential challenges and opportunities. The environmental foundation is assessed using the PEST (political, economic, social and technological) perspectives. Emphasis is given to identify the roles that financial markets can play in expediting Ethiopian economy, the environmental factors that need to be analyzed the current situation of Ethiopia in terms of each factor. An exhaustive analysis of literature has been made on the secondary data obtained from different sources. The research method employed in the study has both qualitative and quantitative features. The findings of the study are presumed to be of paramount importance in providing input information for policy makers towards establishing financial markets in Ethiopia. As a way forward the Government of Ethiopia (GoE) need to take timely actions to further investigate the environmental situation to establish financial markets, appreciate the potential opportunities and make preparations towards addressing the direct challenges.

Keywords: Financial Market, Securities Market, Environment, Governance

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Background

History tells that share market has existed in Ethiopia during the Imperial regime. Before the nationalization of private property in 1975, there had existed a rudimentary share market in Ethiopia. Share dealing was handled by the National Bank of Ethiopia, department of Share Exchange and later the bank allowed other financial institutions and few private share dealers known under the name of “Share Dealing Group” to participate in shares trading. The Share Dealing Group was engaged in facilitation of transaction of shares and other services in the share markets. The financial institutions that played an intermediary role in transferring and delivery of traded shares were the Addis Ababa Bank, the Commercial Bank of Ethiopia and the Ethiopian Investment Corporation. They provide over-the-counter² share dealing services and enjoyed a significant confidence of the private investing community. The volume of shares expanded at a faster rate from Birr 152,300 in 1959 to Birr 1,159,090 in 1963. The major development seen during this period was that there had been an excess of sales to the public over purchases from the public exhibiting an increasing interest of the private saving community in the investment of shares.

A short-lived stock market started informally in the late 1950s and was formally instituted in 1965. The stock market was administered by the National Bank of Ethiopia which was the known regulatory body in the

²In the over-the-counter market, trading occurs via a network of middlemen, called dealers, who carry inventories of securities to facilitate the buy and sell orders of investors, rather than providing the order matchmaking service seen in specialist exchanges

Ethiopian financial sector. The Imperial government tried to improve resource mobilization through the National Bank tried by establishing a share-dealing group – which served as the connecting link for buyers and sellers in an auction process. The National Bank laid out the rudimentary rules and regulations for the auction market. According to Asrat (2003) the stock market was moderately successful in its pioneering efforts to provide an organized market for companies whose shares were relatively widely held. Workable trading practices and standards had been developed and a smoothly operating market mechanism had been created.

Since the abolition of the Addis Ababa Share Dealing Group in 1974 by the military government ruling Ethiopia at that time, no capital market has been in place in Ethiopia. For more than forty years, Ethiopia has been trying to have its own financial market but didn't succeed. The need for financial markets, as the next step in the ongoing financial liberalization is gaining consensus among various stakeholders in the country. A number of efforts, notably by scholars from academia, Addis Ababa Chamber of Commerce and Sectoral Association (AACCSA) and National Bank of Ethiopia (NBE) are being made towards institutionalizing the financial market. Virtually all of the researchers came up with findings in favor of establishing financial markets in Ethiopia. It was also indicated by Ruecker (2011) that the National Bank of Ethiopia reportedly undertook a study on the “Feasibility of Establishing Securities Exchange Market in Ethiopia” and also prepared a draft Securities and Exchange proclamation. Furthermore, the Addis Ababa Chamber of Commerce and Sectoral Association (AACCSA) has produced a research on the “Market Potential Assessment and Road Map Development for the Establishment of Capital Markets in Ethiopia” where

the findings highlighted the significance and inevitability of financial market in Ethiopia.

Statement of the problem

According to studies, Africa is the only developing region where development assistance flows exceed private capital flows (Lemma and Otchere, 2008). This was mainly attributed to the lack of well developed financial markets and the poor economic policies and institutions in African countries, where Ethiopia is not an exception. Financial markets are vital part of an economy making it possible for industry, trade and commerce to flourish without any obstacle in terms of financial resources. The financial markets play a pivotal role in expediting the nation's economic growth (Firew, 2009). The financial markets also assist the role of the private sector in the economy by providing the required financial resources, diversified investment options and liquidity functions.

Currently there is adequate shareholding constituency in Ethiopia allowing the establishment of share companies. There are more than 60,000 shareholders in Ethiopia where there is no market for share trading and re-trading implying that there is high share illiquidity. If this illiquidity persists, the existing shareholders tend to frustrate and new shareholders will be discouraged to get into share company business which in effect hinders the growth of investment and private sector involvement in the Economy (Mohammed, 2010). All the mentioned conditions signify the need for establishing financial market in Ethiopia. However, establishing financial markets is not an easy exercise; rather it is constrained by several factors in the environment such as political, economic, social, and technological.

Objectives of the study

The main objective of this study is to review pertinent literatures on the establishment of financial markets, challenges and opportunities. Specifically the research attempts to:

- Find out whether Ethiopia would benefit from establishing financial market.
- Assess whether there is a favorable environmental foundation for the establishment of financial market.
- Identify the challenges and opportunities of establishing financial markets in Ethiopia.

Methodology

This study fully relied on secondary data obtained from various sources. These sources mainly include publications of scholars from academia, financial institutions, Addis Ababa Chamber of Commerce and Sectoral Association (AACCSA), and articles posted in different websites. The research approach applied is a mix of qualitative and quantitative methods depending on the nature of data. The qualitative approach as used in this article is characterized by more of descriptive and aimed at creating a common understanding of the subject being studied. On the other hand, the quantitative approach is based on numerical observations and aims at generalizing a phenomenon through analysis of the quantitative data.

Introduction to financial markets

The Reserve Bank of Australia (www.rba.gov.au/Glossary/text_only.asp, cited in Amare, 2008), defines financial markets as “a generic term for the markets in which financial instruments are traded. Financial instruments

have no intrinsic value of themselves”. They represent a claim against the income or wealth of a business firm, household, or unit of government represented usually by a certificate of receipt or other legal document and usually created by the buying of securities – both debt and equity. The four main financial markets are the share or equity market, the fixed interest or bond market, foreign exchange market, and the derivatives market.

People and organizations wanting to borrow money are brought together with those having surplus funds in the financial markets. A financial market is therefore an arrangement where financial assets such as stocks and bonds can be purchased and sold. Financial markets facilitate the flow of funds and thereby allow financing and investing by households, firms, and government agencies (Madura, 2012). Financial market provide long term finance of two types: (i) loans with periodic payments of interest with principal usually repaid at maturity, and (ii) equity shares for which there is no commitment to repay funds but a right to share in the profits of the venture paid as dividends. Thus, the providers of funds in the financial market deal essentially with the long term risk related to payments of interest and principal on the debt or dividends on equity shares (Elias, 1995).

Does Ethiopia need to have financial market now?

The universal vision of governments is to become ‘strong’ through economic growth and modernization. This vision is realized when there is an increase in GNP, Per Capita income, national efficiency and employment. Contemporary literatures argue that stock markets provide services that boost economic growth and contribute to the achievement of these national goals. Some literatures also argue against importance of

stock markets for economic growth. The popular researchers in the area, Levine and Zervos (1996) conducted an empirical study and found out that there is a strong positive correlation between stock market development and long-term economic growth.

In countries like Ethiopia, bank loans are the most important source of capital, but are limited by the amount of deposits banks are able to mobilize. As a result, banks tend to be very conservative in their lending policies, thereby penalizing younger or emerging companies whose business risk is higher than those faced by established firms, and yet contribute to the dynamism and future growth potential of the economy through innovations. Thus, the role of the private sector is limited due to the banks unwillingness in granting loans to risky investments on long term basis. Since banks in emerging economies are also mostly owned and run by governments, they extend loans to priority sectors in response to government directives without due regard to quality, and often at interest rates below the bank's cost of funds. This leads to inefficient resource allocation and widespread loan delinquencies. The prevalence of these problems reduces the level of private investments, productivity of capital and the volume of savings (Asrat, 2003).

Excessive dependence on bank loan limits the growth of private investment which is considered as "the engine of economic growth". But if securities markets are established, they promote economic efficiency by channeling money from those who do not have an immediate productive use for it to those who do. A well-functioning financial market, coupled with a developed financial sector, is the main asset for every national economy since it promotes economic growth and supports the eradication of poverty (Elias, 1995). Securities markets also create better opportunities for small

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

Many scholars and researchers indicated that if countries establish a well-functioning securities market, it will provide substantial benefits for economic developments. More specifically, capital market and financial sector development promotes growth in different ways as identified by (Asrat, 2003; Applegath, 2004; Ruecker, 2011; Elias, 1995; Yishak, 2000; Kibuthu, 2005; Dahou, Omar and Pfister, 2009).

Promotes private sector development

Public investments vastly exceed private investments in developing economies amongst which the Government of Ethiopia is one of the front liners in public investment and the last in terms of private investment (Yishak, 2000). Financial markets provide for access to and easy movement of financial resources which fundamentally influences the prospects for private sector growth in developing country economies. Existence of financial markets enhances the extent that existing firms can borrow and grow, the ability of emerging firms to act entrepreneurially, their willingness to invest in assets, and the ability to allocate their assets freely. All these enhancements ultimately lead to economic growth. For instance, India and China are adding hundreds of companies in their stock exchange annually. The immediate benefit of the flourishing capital market activity in Asia is reflected in the sizeable increase in the momentum of private sector development (Applegarth, 2004).

Liquidity function

Financial markets enable security holders to easily convert their investment in securities into cash at the prevailing market price. Increased number of players, number and amount of financial transactions, generates liquidity and promotes active trading. Liquidity has a proven relationship with economic growth; studies have found that countries with liquid markets experience faster rates of capital accumulation and greater productivity gains (Applegarth, 2004).

Helps mobilize local savings and makes resources available for local decision making

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

Enhances competition among financial institutions/banks and develops a greater diversity of financial institutions

Studies show that the competition among financial institutions/banks is weak in the Sub-Saharan Africa as it is reflected in the large gap between deposit rates for savers(which tend to be very low) and interest rates for borrowers (which tend to be very high). Establishing financial markets cultivates channels for firms to issue various debt instruments and raise equity, while simultaneously providing more long-term options for saving and asset management for investors that will benefit enlarging economies by

increasing market efficiency. Therefore, financial markets are presumed to stimulate competition and speed up economic growth (Applegarth, 2004).

Increases remittances and facilitate their use

Instead of depositing their money in the banks, the Diaspora community can invest in corporate bonds and stocks which yield attractive returns compared to the interest income on bank deposits. An investment in such securities is helpful in coping with price fluctuations as security prices can be adjusted to changes in prices. Remittance is one of the rapidly emerging sources of private capital in developing countries. As indicated by Ruecker (2011) in 2008, Ethiopia recorded an inward remittance flow of 387 million USD as compared to the outward remittance flow of 21 million USD. Remittances offer a promising and single potential for increasing domestic savings and fostering domestic investment. A developed financial market with a variety of financial instruments will increase the overall attractiveness of Ethiopia as a place for investments, especially for Diaspora.

Leads to improved corporate governance and promotion of specialized financial institutions and services

Financial market development necessitates the creation of a legal and regulatory framework incorporating increased transparency and information dissemination. It is imperative to consider that establishing financial markets warrants paying due attention for fiscal and regulatory environment, improvement of corporate financial reporting and disclosure, and the promotion of specialized financial services and institutions such as stock brokerage firms, money market firms, investment banks, leasing companies, etc.

Rewards sound economic policies and create tools to conduct monetary policy

In recent decades, a well-developed securities market has been the principal channel through which governments carry out their fiscal and monetary policies to stabilize the economy, avoid hyperinflation, shape the public borrowing and spending plans, growth of jobs, production and pricing of goods and services. If open-market operation is not available, the only effective tools are direct credit controls, ceilings on loans and interest rates, as well as reserve requirement manipulations. Also, deficit financing is carried out by either borrowing directly from the National Bank or by selling bonds to commercial banks. Consequently, deficit financing puts pressure on the money supply and leads to inflationary pressures. As a result, financial repression is common in countries with banking-oriented financial systems. Full-scale financial sector reform (liberalization) may be impossible unless the economy has well-developed securities markets (Asrat, 2003).

Help in resource allocation

In a market economy, issues of securities help raise capital for projects whose outputs are in the highest demand by society, and those enterprises which are most capable of raising productivity. One of the most pressing issues for developing countries is to channel existing scarce resources into productive investment so that they can stimulate productivity, create employment, provide individuals and enterprises with basic utilities, contribute to efficient natural resource management and ultimately maximize overall health of the economy (Dahou, Omar and Pfister, 2009).

Allow deconcentration of ownership

Equity sales provide for a wider participation in enterprise management and for a wider distribution of corporate profits. These factors would help allay the fear that a few individuals or groups would dominate the private sector. Wider distribution of corporate profits develops a general sense of ownership and an assumption of responsibility on the part of the citizen. People will now be united by their common defense of their business interests, ethnic and religious differences would gradually dissipate (Asrat, 2003).

Improve accounting and auditing standards

Securities purchasers rely in part on corporate information provided in financial reports to make their investment decisions. The development of securities markets is usually accompanied by increased reporting standards and requirements, which contribute to the efficiency of the markets and their mobilizing and allocating functions. A regular disclosure of adequate, reliable and timely information makes it possible to compare performance of various companies. The development of widely accepted accounting procedures, checked by independent external auditors is also an important benefit derived from the development of securities markets. Availability of good information helps corporations make better decisions and provides better statistics for economic policy makers. Good information may even help tax authorities collect taxes in a more efficient and equitable fashion. The need for disclosure of financial information is a strong incentive for the improvement of accounting and auditing standards (Kibuthu, 2005)

Promote efficient financial system

Securities markets break the oligopoly that would be enjoyed by the banks in the absence of securities markets. The government does not automatically have privileged and subsidized access to funds and must compete on equal terms. Securities markets provide impetus for the establishment of financial prices based on scarcity values rather than on administrative fiat. Such market-determined financial prices and investment options, in turn, attract more savings, creating a virtual circle of innovation and mobilization that contributes to the overall efficiency of the financial system (Asrat, 2003).

Despite the aforementioned significances, there are no secondary securities markets in Ethiopia. Thus, one of the key institutions missing in Ethiopia is the Ethiopian Securities Market. With regards to the specific roles that the Market can play in Ethiopia, Petros (2009) stated that the stock exchange will benefit Ethiopia by serving as governing instrument, making exit for minority shareholders from underperforming or oppressing companies, raising country's competitiveness in post World Trade Organization (WTO) accession, and facilitating liquidity of securities. Moreover, the transfer of risk and transfer of waiting, marketability and valuation of securities and firm, protection of financial investors under what is called a self-regulatory scheme and improving the financial sector's growth as additional source of capital with banks are also the other purpose of financial markets for Ethiopia (Mohammed, 2010).

There is an increasing number of share companies and shareholders in the Ethiopian economy, which is estimated to be much more than 60,000 (this is the 2011 figure) shareholders (Abera, 2011). This number clearly indicates that there is a wide-ranging prevalence of share illiquidity which signifies

the need for secondary financial markets in Ethiopia. If this illiquidity persists, it will frustrate existing shareholders and discourage the market for new offerings (Mohammed, 2010; Petros, 2009).

Critics on financial markets

The role of financial markets in economic development continues to attract increasing attention both in academia and among policy-makers. Evidence from recent empirical studies suggests that deeper, broader, and better functioning financial markets can stimulate higher economic growth (Loayza and Beck, 2000). Although evidence on Africa is still limited, the results from existing empirical work supports the view that financial development has a positive effect on economic growth in African countries (Ndikumana, 2000).

To the contrary, scholars also stated some arguments against financial markets saying that establishing financial markets is a mixed blessing, rather it has considerable limitations. The first critic is that financial market prices do not accurately reflect the underlying fundamentals when speculative bubbles emerge in the market. In such situations, prices on the financial market are not simply determined by discounting the expected future cash flows. Under this condition, the financial market develops its own speculative growth dynamics, which may be guided by irrational behavior. This irrationality is expected to adversely affect the real sector of the economy. Critics further argue that financial market liquidity may negatively influence corporate governance because very liquid financial market may encourage investor myopia. Since investors can easily sell their securities holdings in more liquid financial markets, their commitment and incentive to exert corporate control may be weakened. In other words, instant

financial market liquidity may discourage investors from having long-term commitment with firms whose securities they own and therefore create potential corporate governance problem with serious ramifications for economic growth.

Critics also point out that the actual operation of the pricing and takeover mechanism in well functioning securities markets lead to short term and lower rates of long term investment. It also generates perverse incentives, rewarding managers for their success in financial engineering rather than creating new wealth through organic growth. This is because prices react very quickly to a variety of information influencing expectations on financial markets.

Therefore, prices on the securities market tend to be highly volatile and enable profits within short periods. Moreover, because the stock market undervalues long-term investment, managers are not encouraged to undertake long-term investments since their activities are judged by the performance of a company's financial assets, which may harm long run prospects of companies. In addition, empirical evidence shows that the takeover mechanism does not perform a disciplinary function and that competitive selection in the market for corporate control takes place much more on the basis of size rather than performance. Therefore, a large inefficient firm has a higher chance of survival than a small relatively efficient firm. These problems are further magnified in developing countries especially sub-Saharan African economies with their weaker regulatory institutions and greater macroeconomic volatility.

The higher degree of price volatility on stock markets in developing countries reduces the efficiency of the price signals in allocating investment

resources. These serious limitations of the stock market have led many analysts to question the importance of the system in promoting economic growth in African countries.

Supply and demand prospects for securities market

The Ethiopian finance sector is dominated by the commercial banks (private and public) whose focus is on mobilizing short-term liabilities and extending short term loans. These banks have limited capacity and are less reliable to support Project Financing. The banks, expected to extend loans for projects with long-term pay back have limited resources of their own to sustainably support long-term credit supply to the economy. This clearly shows that a securities market is a missing element in the financial structure of the country (Yishak, 2000). This part of the report shows the potential demand and supply sides of the financial market.

Demand side (investor base)

There is a growing demand for securities markets in Ethiopia. Among many others the following are identified by Yishak (2000).

Asset portfolio adjustment

Thus far Ethiopians used to hold their assets in the form of cash, bank deposits, physical assets in the form of land, buildings, livestock, precious metals (like gold, silver), vehicles, and hard currency. These are the traditional forms of asset holdings available to Ethiopians. Establishment of securities markets will create another form of asset holding and incentives to diversify asset portfolio for individuals and companies. Investors can buy securities of listed companies and diversify their investment in marketable

securities. Besides to portfolio adjustment, the securities market transforms resources from passive forms of asset holding to more active and productive activities and long-term investments.

Cope with inflation

If securities markets exist in Ethiopia, investors can put their assets into savings accounts, government bonds, corporate bonds, and stocks. As the inflation rate is much higher than the return of the savings account and the government bonds, local investors currently do not have an adequate investment possibility to achieve returns higher than the current inflation. This is a strong indicator for the theoretical demand of alternative investment opportunities such as equity securities.

Individuals and institutional savers

Under the current legal and policy environment, small savers have limited choice how to hold their savings. The main avenue for them is to put in the banks in the forms of saving and time deposits. The size of private companies and individual saving in the banking sector is surpassing the ongoing liberalization process. What does this imply? The savers are either motivated by the rate of return offered by the banks or the protection motive. If a well functioning and rewarding securities market is established, both of the motives will be satisfied with the securities market. The investment in securities generates more returns compared to the bank's interest.

Supply side (issuer base)

Issuer base refers to the potential number of issuers of securities and the amount of capital to be raised. The following are some of the identified potential issuers of securities in the Ethiopian context.

Government securities

Regarding debt securities, the only issuer is the Government of Ethiopia. The government is issuing short term (treasury bills) and long term debt securities to finance mega projects (bonds). There are not corporate bonds currently issued in the market. Even in the absence of the corporate bonds, there is a huge supply of government bonds to finance mega projects (e.g. the Great Renaissance Dam). Annual regular infrastructure needs for a country like Ethiopia (excluding the Great Renaissance Dam) are expected to be between ETB 41 billion (USD 2.4 billion) and Birr 53 billion (USD 3.1 billion), creating a potential for a remarkable and sustainable government bond supply (Ruecker, 2011). It is also noted that the Government of Ethiopia is heading to privatization except the big five state owned enterprises i.e., Commercial Bank of Ethiopia, Ethiopian Airlines, Ethiopian Electric Power Corporation, Ethiopian Insurance Corporation, and Ethiopian Telecommunications which are considered as the most profitable public enterprises.

Privatization

The Privatization and Public Services Agency (PPESA) has transferred 314 state owned enterprises through direct sales as of May 2012 and earned 12.8 billion birr (Elleni, 2012). Nine enterprises have been transferred through a joint venture agreement and five have been leased to private investors.

There are currently 48 enterprises left under the PPESA which are going to be privatized in the upcoming years. The government's commitment to privatize public enterprises will certainly increase the share of the private sector investment in the economy, which is an indicator of potential demand for financial markets as the private sector is the major stakeholder in the financial system. However, the privatization scheme of the government didn't contribute to the formation of private corporations/share companies as Government of Ethiopia transfers the public enterprises only via the open bid/tender to selected investors not to the general public on share basis. Therefore, the long term needs by private companies is the potential supply base for debt and equity instruments.

Existing share companies

The private sector involvement in the economy may take the form of share companies. It is undisputed that share companies play a significant role in today's economic world. A share company is a form of business organization where, in most instances, a large group of people invest cash or in-kind contributions in a company (administered by strangers) in return for units of ownership representing a proportion of the company's capital in the form of shares (Bahakal and Micael, 2013). Despite the vital role share companies play in the economy, the peculiar nature of shares in Ethiopia is their illiquidity. Rather than being an instrument frequently traded in the market, Ethiopian shares are mostly locked in the drawers praying for dividends which may or may not come and later inherited to successors if the company does not die earlier than the owner of the share. Where, to whom and at what price would a shareholder sell his/her shares? Some possibilities of disposing shares exist under the law, but the implementation is lacking. The present understanding of share companies in a global scale

acknowledges the importance of such business structure for a nation's economy. It is believed that share companies could be a strong arm of the nations' economy if properly regulated in order to attract shareholders, protect their interest and boost their confidence.

The environmental foundations to establish financial markets in Ethiopia

Financial managers, investors and investees don't operate in a vacuum—they make decisions within a large and complex environment.³ The prerequisite environmental factors for a well-functioning financial markets and system are macroeconomic stability, adequacy and independence of the judicial system, political stability, security, good corporate governance, accounting and auditing standards, transparency and availability of information, institutional framework, initiation and promotion of privatization, potential investor base, potential issuer base, financial literacy, technological factors, etc (Dahou, Omar and Pfister, 2009). An examination of the major environmental factors is presented in the following sections.

Legal, political and institutional environment

Over the last many years literature has emerged emphasizing the important role that legal and regulatory structures play in influencing financial institutions and markets. Developing countries have been continually searching for opportunities to transform their economic fortune. Among the central components for the envisioned transformation is the development

³ Environment in this article refers to the factors affecting the operations of the financial market in Ethiopian which are broadly classified as the Political, Economic, Socio-cultural and Technological (PEST).

of viable securities markets (Taylor, 1997). These countries envision that the increasing demand for domestic and foreign capital can be satisfied by robust and efficient securities markets. These countries also need to acknowledge that creating strong securities markets is hard. This is because it demands an assemblage of the necessary institutional infrastructure which takes time and sustained effort to develop. Aggregating the multifarious structures and mechanisms is a painstaking task and developing jurisdictions cannot leapfrog the process. One of the principal challenges a country must grapple with in the development of deep and vibrant securities markets is how to constitute an effective legal and institutional framework. Efficient and robust securities markets are dependent on institutional building blocks and the mainstream institution is the legal architecture (Gakeri, 2011).

Strong securities law presupposes substantive law on disclosure, transparency, prohibition of all forms of market abuse and minority protection against coercive takeover bids and expropriation (Gakeri, 2011). For instance, the groundwork of the United States and United Kingdom securities markets has been the robust legal and regulatory framework. The legal regime fosters certainty and continuity which is essential for investment (Rodriguez, 2009). To an increasing extent, the goal of the legal regime is protection of the securities markets. As exquisitely observed:

“... capital markets cannot flourish without an appropriate legal framework that reduces subjective decision making and encourages transparent and objective enforcement of laws and related regulatory framework. Certainty as to the working and fairness of the systems will attract more participation in financial markets and will curb interest groups that benefit from its weaknesses. Law should also build upon social and cultural factors that enjoy similar force or obedience such as customary law” (Ibrahim, 2007).

When it comes to Ethiopia, there is no institutional, legal and policy framework for any capital market activity in the country as financial markets are not yet established in Ethiopia. The absence of such framework will definitely be an obstacle for launching a capital market in Ethiopia. It is therefore crucial that this framework is put in place prior to the launching of a formalized capital market (Ruecker, 2011).

The issue of security

The security situation that prevails in a given nation determines the level of private sector involvement in the economy and financial market development. With regard to security factor for the operation of the private sector in the country, which has direct bearing on the financial markets, Ethiopia fares better compared to regional countries. Only a few firms (1.5 percent) report the existence of theft, robbery and the occurrence of vandalism. Despite that however, close to 92 percent of the firms do procure security services (Alemayehu, 2008). The figures tell us that the security situation is very conducive for the establishment of financial markets.

Table 1: Security

Crime	Ethiopia	Region	All
Percentage of firms paying for security	91.93	63.83	62.71
Losses due to theft, robbery, vandalism, and arson against the firm (% of sales)	1.44	3.28	1.8
Security costs (% of sales)	1.1	1.95	1.62
Products shipped to supply domestic markets lost due to theft (in %)	0	0.48	0.42
Percentage of firms identifying crime, theft and disorder as major constraints	11.64	26.56	21.15

Source: World Bank 2006 Cited in Alemayehu Geda (2008). The Road to Private Sector Led Economic Growth, A Strategy Document.

Corruption in Ethiopia

Myint (2000) defines corruption as the use of public office for private gain, or in other words, use of official position, rank or status by an office bearer for his/her own personal benefit. Examples of corrupt practices include bribery, extortion, fraud, embezzlement, nepotism, cronyism, appropriation of public assets and property for private use, and influence peddling. Despite countless policy diagnoses, public campaigns to raise awareness, and institutional and legal reforms to improve public administration, research shows that corruption continues to flourish and remained as a global challenge.

A wide ranging prevalence of corruption is considered as one of the direct challenges against nations overall growth. In the case of Ethiopia, the survey conducted by Alemayehu (2008) clearly indicates that a number of firms pay bribes either in kind or in cash to run their businesses. The degree of corruption is relatively lower in Ethiopia compared with both regional countries and the total sample average. But much more needs to be done to make the business environment free from corruption because a significant number of firms (23 percent) perceive corruption as a major constraint. In relative terms, Ethiopia is an attractive place for domestic and foreign investors who are presumed to be active players in the financial market if established in Ethiopia. As a result it is possible to deduce that the threat of corruption is less compared to the regional countries but a lot shall be done to improve the situation.

Table 2: Corrupt Practices

Percentage of firms expected to pay informal payments (to get things done)	12.42	45.54	36.23
Percentage of firms expected to give gifts to get an operating license	2.7	17.93	16.69
Percentage of firms expected to give gifts in meeting with tax inspectors	4.35	19.89	26.37
Percentage of firms expected to give fits to secure a government contract	11.8	42.87	26.9
Percentage of firms identifying corruption as a major constraint	23.08	34.39	32.7

Source: World Bank 2006 Cited in Alemayehu Geda, 2008. The Road to Private Sector Led Economic Growth, A Strategy Document.

Contrary to the above findings, other studies showed that there is popular corruption in Ethiopia though the country has taken very important steps to combat it. To mention some, Ethiopia has ratified the UN Convention against Corruption and the African Union Convention on the Prevention and Combating of Corruption. Ethiopia is ranked 113th of 174 nations in Transparency International's 2012 Corruption Perception Index. Ethiopia with a score of 33 falls in the fourth top category counted from Highly Corrupt. Of the 174 countries considered, 70% of them scored less than 50 out of 100 and 43 is the world average. Therefore Ethiopia's score is less than the world average indicating prevalence of corruption in the global context. Recently the Government of Ethiopia has taken tangible measures (arrested key government officials engaged in corrupt practices) as part of its move towards combating corruption in the country.

Figure 1: Perceived levels of public sector corruption



Source: Transparency International, 2012, Transparency International Corruption Perception Index 2012

The judicial system and private sector development

An independent judiciary is now a requirement of all modern political systems. Governments put several provisions in their constitutions that lay down the foundation of independent judiciary. What might be lacking is the political will to turn this lofty ideal into practice in the hard reality of governance. An independent judiciary implies “... a judiciary which dispenses justice according to law without regard to the policies and inclinations of the government of the day...” (Sir Ninan 1985, cited in Alemayehu 2008).

Regarding the Ethiopian judiciary system, Ruecker (2011) stated that the most important provision regarding share issuing and trading is the 1960 Commercial Code of Ethiopia which is outdated and needs significant revision. Addis Ababa Stock Exchange Rules and Regulations Manual (Volumes I and II) were prepared in 1999. However, it is at a working draft level and not up-to-date. There is no system of civil courts where securities cases can be prosecuted by a dedicated governmental authority. There are no specific training programs to educate prosecutors and judges on capital market regulation, including corporate governance. There are commercial courts that specialize in hearing commercial cases, but there are no courts that specialize in hearing only securities law and company law cases. There

are provisions in the jurisdiction's laws that may be used to prosecute securities violations.

An independent judiciary works free from the interference of the political forces through proper enforcement of law. If the government officials twist the judiciary system to their advantage, one can say that the judiciary system is partial - both in the sense of being biased and in the sense of encompassing less than the whole. Hence, adequate and independent judiciary system fosters the economic, social and political development of the nation.

Stock markets and corporate governance

The notion of 'corporate governance' refers to the overall legal, institutional and regulatory framework in which the interests of stakeholders surrounding companies are coordinated and protected (Fekadu, 2010). The quality of the corporate governance determines the confidence and willingness of investors to participate in investment and financial markets.

Empirical studies have found that investors are willing to pay a premium for the securities issued by a well governed company over a poorly governed company which is otherwise equivalent in terms of financial performance. If investors (domestic and foreign) lack confidence in corporate governance, they are likely to discount the shares that they hold, and that goes in the face of the company's ability to raise funds and grow (Lemma and Otchere, 2008).

According to Alemayehu (2008), in order to have good governance, it is mandatory to put in place governance institutions such as commercial codes, product market institutions (such as regulators responsible for competition),

labor market institutions, financial (capital) market institutions (such as financial intermediaries, and the judiciary). Corporate governance has a number of significances to various stakeholders. Among others, corporate governance can be considered as the basic prerequisite for raising capital from partners and shareholders. Secondly, when business conduct is reliable, stakeholders – particularly financiers – perceive lower risks for their participation by consequently lowering the “risk premium” and the cost of capital. Thirdly, corporate governance creates clear relations between key organs of the company i.e., the shareholders, the board of directors and the executive management. The fourth significance is that corporate governance is an important tool to create an efficient management climate in big as well as small companies. Finally, corporate governance increases the sensitivity of the corporation in relation to employees, suppliers and customers.

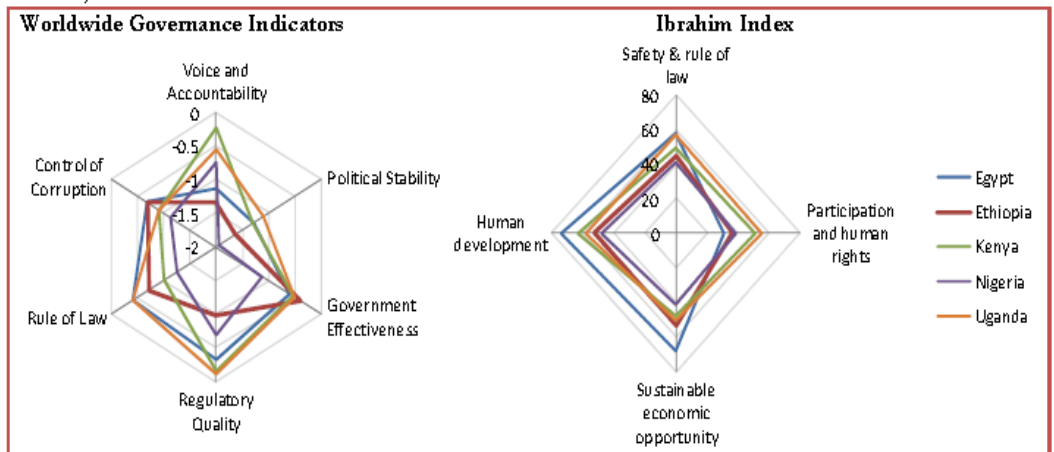
Corporate governance in Ethiopia

According to Ruecker (2011), the overall standard of corporate governance in Ethiopia is considered as low. More specifically, the legal and constitutional instruments do not provide an adequate regulative framework, key international conventions and standards are not ratified, investor and creditor protection laws are inadequate, and the absence of an organized capital market is a remarkable deficit and contributes to a lack in transparency. However, recent developments prove an emerging commitment to corporate governance standards and a corporate governance code is expected to be introduced in the near future. Among the governance institutions, a study conducted by the Private Sector Development (PSD) Hub Programme of AACCSA noted that the revision of the 1960 Commercial Code is underway by the Ministry of Justice. The revision of

the Commercial Code is a vital part of improving and upgrading of corporate governance standards in Ethiopia.

The following figure shows the governance in Ethiopia compared to selected African countries. Ethiopian overall governance is in the middle of the pack on most indicators, with the strongest suit being government effectiveness, an area where there has been marked improvement since 2000.

Figure 2: Worldwide Governance Indicators and Ibrahim Index – Ethiopia Vs Regional Peers, 2011



Source: Henock Assefa, Derk Bienen, Dan Ciuriak December 2012. Ethiopia Investment Prospects: A Sectoral Scan, BKP Development Research and Consultancy, Munich

Accounting and auditing standards

Financial information is the principal input for sound decision making by investors, borrowers, customers, employees, tax authorities, financial analysts, policy makers, researchers, etc. The quality of the decision made depends on the quality of the information. The quality of the information is,

in turn dependent on the accounting and auditing standards followed. A standardized accounting and auditing is a prerequisite for the establishment of financial markets. The situation in Ethiopia is that accounting and auditing standards are improving, yet they are not at an internationally accepted level (Ruecker 2011). However the AACCSA PSD-Hub, in cooperation with the Office of the Federal Auditor General (OFAG) and the Ethiopian Professional Association of Accountants and Auditors (EPAAA), is undertaking an important work to standardize the accounting and auditing practices in the country. The National Accounting and Audit Board is the body that governs the nation's accounting and audit practices and issues certificates and accreditations for audit and accountancy. The Association of Chartered Certified Accountants (ACCA) is focusing on International Financial Reporting Standards (IFRS) which is currently in use in more than 100 countries worldwide. The national bank, which is the regulatory body in the Ethiopian financial sector, has also developed a guideline for standard financial reporting. The practical work of the NBE which is at an inception stage now coupled with the commitment and will of the pertinent stakeholders indicates that Ethiopia may adopt standardized accounting and audit in the foreseeable future.

The market structure

The market structure within which the organized private sector operates is characterized by imperfection and lack of a level playing field which negatively impacts on its development (Alemayehu , 2008). Such market imperfections can be addressed through an intensive revision of the Ethiopian Commercial Code which has been used since 1960. As already stated in the preceding sections, the Private Sector Development (PSD) Hub of the Addis Ababa Chamber of Commerce and Sectoral Association

(AACCSA) has conducted a thorough revision on the commercial code of Ethiopia.⁴

Initiation and promotion of privatization

The Ethiopian government, in line with its commitment to the development of the private sector, has so far taken broad based economic reforms one of which is the privatization program. In order to implement this program, the government established and empowered the Privatization and Public Enterprises Supervising Agency (PPESA) under the Ministry of Trade. State owned enterprises are transferred to private investors through the Privatization and Public Enterprises Supervisory Agency (PPESA). The PPESA has transferred 314 enterprises through direct sales as of May 2012 and earned 12.8 billion birr (Elleni, 2012). The government's commitment to privatize public enterprises will certainly increase the share of the private sector in the economy, which is indicative of potential demand for financial markets as the private sector is the major stakeholder in the financial markets. However, the privatization scheme of the government didn't help the formation of share companies as the public enterprises are transferred to buyers – individuals and companies- but not for the general public in the form of shares.

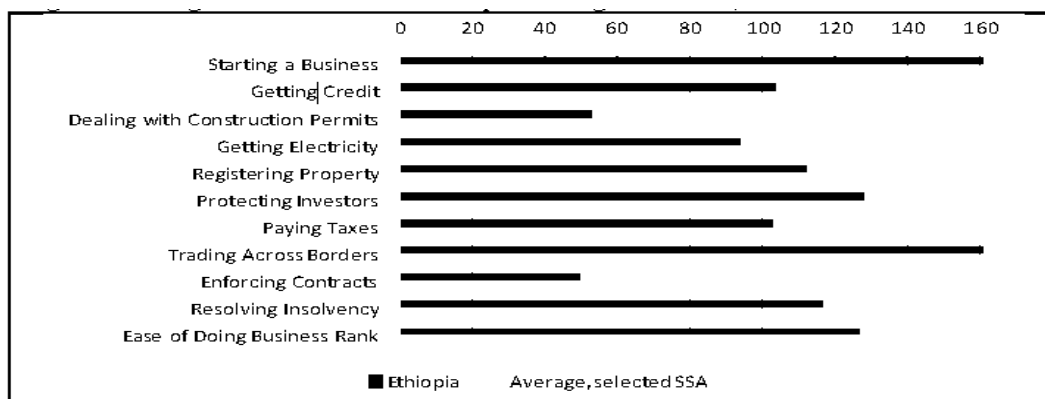
Business environment

Business environment can be understood as the suitability of the country in terms of ease of doing business, starting business, employing workers,

⁴ See Position of the Business Community on the Revision of the Commercial Code of Ethiopia, by Private Sector Development (PSD) Hub/Addis Ababa Chamber of Commerce and Sectoral Association (AACCSA), 2009, Addis Ababa.

getting credit and related issues. The 2013 edition of the World Bank's Doing Business ranks Ethiopia 127 out of 185 economies in terms of overall "Ease of Doing Business". This is roughly in line with the average score of regional peers. Ethiopia's relatively low rank is mainly the result of low scores in three sub-indices: getting credit, trading across borders, and protecting investors (Henock, Bienen and Ciuriak, 2012).

Figure 3: Doing business ranks Ethiopia Vs regional peers, 2012



Note: Selected SSA Is The Simple Average of Kenya, Nigeria, South Africa, Sudan And Uganda.

Source: Henock Assefa, Derk Bienen, Dan Ciuriak, December 2012. Ethiopia Investment Prospects: A Sectoral Scan, BKP Development Research and Consultancy, Munich

Macroeconomic Scan

This section of the article shows the macroeconomic situations of Ethiopia. Summary of the data on real growth rates by sector of the economy.

Table 3: Macroeconomic Conditions

Sector of Economy	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	Average
Real Growth Rates									
Real Growth Rates	11.7	12.6	11.5	11.8	11.2	10.0	10.4	-	
Agriculture	16.9	13.5	10.9	9.4	7.5	6.4	7.6	9.0	10.15
Industry	11.6	9.4	10.2	9.5	10.1	9.7	10.6	15.0	10.76
Services	6.3	12.8	13.3	15.3	16.0	14.0	13.0	12.5	12.90
Percentage Shares									
Agriculture	47.0	47.4	47.1	46.1	44.6	43.1	42.0	41.1	44.8
Industry	14.0	13.6	13.4	13.2	13.0	13.0	13.0	13.4	13.33
Services	39.7	39.7	40.4	41.7	43.5	45.0	46.1	46.6	42.84
GDP at Current Market Prices (Growth Rate)	18.0	22.9	23.6	30.6	44.4	35.1	14.3	-	

Source: Ethiopia: Macroeconomic Handbook 2011/12, Access Capital Research, December 30, 2011

In the fiscal year 2010/11 the largest sector of the economy was the service sector which accounted for 46.6 percent of the total, followed by agriculture and industry with 41.1 percent and 13.4 percent respectively. This is one of the highest growths when compared to the average performance of 4 percent in African economies.

Ethiopia ended the 2010/11 fiscal year with economic growth of 11.4 percent according to government statistics. The strong growth record stands out for taking place at a time when growth is faltering in most other regions of the world, at only 1.5 percent in the US, 2.1 percent in Europe, 4 percent in Africa, and 6.2 percent in Asia. Indeed the growth figure is among the highest in the world and marks—based on government data—the eighth consecutive year of double-digit growth. Looking at the sector-by-sector sources of growth, last year's outturns show Industry registering the highest growth of 15 percent, followed by services at 12.5 percent and agriculture at

9.0 percent. Slower growth rates in agriculture continue to result in its falling share of total GDP, which is now at 41.1 percent, compared to 46.6 percent for services and 13.4 percent for industry. With the fast growth of recent years, Ethiopia's GDP has now reached Birr 511 billion or about \$32 billion based on the FY 2010/11 year-average exchange rate of Birr 16.1 per USD. This aggregate GDP figure places Ethiopia as the sixth biggest economy in Africa in GDP at market prices (Access Capital, 2011/12).

Financial literacy

Financial literacy refers to the set of skills and knowledge that allows an individual to make informed and effective decisions through the understanding of finance. Securities markets work most efficiently when brokers, dealers and the like are knowledgeable, professional, skillful, honest, and have sufficient training and resources to perform these functions (Asrat, 2003). He further added that lack of a skilled labor force has been cited as one of the reasons why foreign investors are not attracted to developing countries like Ethiopia. Lack of such trained human resources as accountants, lawyers, financial analysts, economists, etc could be a serious obstacle for running and managing securities markets, and security market activities in particular. These obstacles for capital market operation should be overcome once a decision is reached to launch the market.

Use of technology

Currently use of state of the art technology is becoming a must to do efficient business in the world. However, a survey conducted by Alemayehu (2008) clearly shows that Ethiopian firms technology usage is poor compared to regional countries. To be specific Ethiopian firms seem

less inclined to use the World Wide Web, and are very limited in the use of licensed technology, both by regional and the total sample standards. The World Bank survey indicates that only about 4 percent of the firms have both ISO certification and employ licensed technology which is about threefold less than the sample and the region's average. This shows how weak Ethiopian firms are when it comes to use of technology and signify that it is one of the potential challenges of establishing financial markets.

Table 4: Use of technology

Technology	Ethiopia	Region	All Countries
Percentage of firms with ISO certification ownership	4.16	11.69	13.82
Percentage of firms using technology licensed from foreign companies	4.19	10.39	11.75
Percentage of firms using the Web to communicate with clients/suppliers	18.01	21.78	39.57

Source: World Bank 2006 Cited in Alemayehu Geda, 2008

Challenges and opportunities for establishing financial markets in Ethiopia

When it comes to challenges and prospects for establishing securities market in Ethiopia different parties and scholars accomplished different studies in different times and came up with different conclusions. For instance, Asrat (2003) identified such challenges as low level of public awareness about securities markets; lack of public confidence in share investment; lack of institutional capacity to facilitate securities trading; underdeveloped state of

the bond (debt) market; low level of private sector development and a low level of market orientation in the economy; easy access to loans by wealthy Ethiopians; problems with the supply and demand for securities at least initially. There is neither the tradition nor the trust in share companies; due to the historical prominence of bank financing; there is still government interference in the market; there is no mechanism in place to solicit input from the business community as a cause for the challenges stated above. In addition to this Abebe (2006) stated that the current state of affairs does not make the country ready for a full-fledged stock market. In addition the absence of accounting and auditing standards may become a challenge for the establishment of stock exchange. Ruecker (2011) has also identified that lack of adequate legal, regulatory, accounting, tax, supervisory systems, lack of awareness and willingness among Ethiopian policymakers, low implementation capacity on the part of the government as the major direct challenges in establishing financial markets in Ethiopia.

On the other side Asrat (2003) states that many prospects (opportunities) for developing securities markets exist in Ethiopia. The prospects are Ethiopia has considerable unexploited resources; one of the largest potential markets in Africa; the economic liberalization which has taking place in Ethiopia are quite encouraging; the privatization efforts going on would help with the supply problems (government is withdrawing from profit making activities and is transferring state owned enterprises into private ownership) particularly if a public offering of shares is used as the method of privatization; the existence of many profitable companies, which can potentially benefit from floating shares to the public; the existence of institutions like the country's Pension Fund, insurance companies, credit unions, etc., with large sums of money. If allowed to invest, they would

boost the demand for securities; the gradual improvements of the incentive packages in the successive investment proclamations help attract new investors including Ethiopians with foreign passports; the debate going on in academics, the business community at large and the government circle is encouraging. Similarly Abebe (2006) identified such prospects including the current scenario in share buying is a testimony of the existence of demand and supply sufficient to begin the long journey: the government has consistently maintained that the macroeconomic situation is reasonably stable and there are already some legal pronouncements, which can be reinforced a little more for a start. Such initiatives to develop accounting and auditing standards, enhancing the governance institutions, etc can also be considered as encouraging steps to launch financial markets in Ethiopia. Ruecker (2011) added that five years national growth and transformation plan (GTP), the double digit macro economic development and the ongoing and future privatization of state owned enterprises are opportunities for the establishment of stock markets in Ethiopia.

Conclusions and recommendations

The strength and performance of the financial system is an indicator of the strength and performance of the nation's economy. Financial markets, being an element of the financial system play a pivotal role in expediting the nation's economic growth through mobilization of domestic resources and attracting foreign direct investment. Existence of the financial markets encourages the private sector involvement in the economy which is usually described as "the engine of the national economic growth". Besides, financial markets help to mobilize local savings, enhance competition among financial institutions, increases remittances, lead to improved

corporate governance, reward sound economic policies, provide for sources of project financing on short and long term bases, allow deconcentration of ownership, improve accounting and auditing standard and help privatization efforts. Because of these tangible benefits, it is possible to recommend that financial markets need to be established in Ethiopia to further speed up the growth of the Ethiopian economy.

A well-functioning financial system requires strong institutions and a sound legal framework. Among others consumer and property rights protection, contract enforcement laws and corporate governance can be considered as the key elements for creating deep and vibrant financial markets and creating an enabling business environment. Establishing financial markets is not an easy task for the Ethiopian government. It is affected by several environmental factors emanating from different sources. For instance, the legal regime is the bedrock of robust securities markets. In Ethiopia, there is no institutional, legal and policy framework for any secondary financial market activity in the country. Regarding security issues, Ethiopia fares better compared to regional countries, implying conducive security situation to establish financial markets. Ethiopia has taken important steps to combat corruption such as ratifying convention Against Corruption and the African Union Convention on the Prevention and Combating of Corruption, and recently arrested and prosecuted key government officials as part of the corruption eradication campaign but still Ethiopia is known for popular corruption. Pertaining to the adequacy of the judiciary system, the 1960 commercial code is outdated and there is no system of civil courts where securities cases can be prosecuted by a dedicated governmental authority. Therefore, through adequate judiciary system and regulatory power, the government can reduce uncertainty, control unethical practices and enhance

investors' confidence in the financial markets. The missing laws, such as The Securities Laws can be enacted and used.

Regarding corporate governance, the overall standard in Ethiopia is low. The legal and constitutional instruments do not provide an adequate regulative framework, investor and creditor protection laws are inadequate, and the absence of an organized capital market is a remarkable deficit and contributes to a lack in transparency. However, recent developments prove an emerging commitment to corporate governance standards and a corporate governance code is expected to be introduced in the near future.

The accounting and auditing standards are improving in Ethiopia but still they are not yet at an internationally accepted level. However, the AACCSA PSD-Hub, in cooperation with the Office of the Federal Auditor General (OFAG) and the Ethiopian Professional Association of Accountants and Auditors (EPAAA), is undertaking an important work to standardize the accounting and auditing practices in the country. It is advisable for the government to grant full support for this endeavor.

With regards to adopting state of the art technology, the use of World Wide Web and licensed technology are very limited compared to regional standards. A lot has to be done to aware and support companies to use licensed technologies and World Wide Web as a competition tool. The government's commitment towards privatization of state owned enterprises is encouraging. However, the privatization scheme is not contributing to the formation of new share companies as the enterprises are transferred to highest bidders - individuals and companies- but not for the general public in the form of shares. Therefore, the government need to consider transferring state owned enterprises to the Public on share basis. The

Ethiopian government can help the process of share companies' formation by using public offering of shares in future privatizations of state enterprises. Such a process would give citizens a stake in the country's economy and reduces the resistance due to possible layoffs of employees.

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