TOWARDS THE DEVELOPMENT OF CAPITAL MARKET IN ETHIOPIA

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1. INTRODUCTION TO CAPITAL MARKET OPERATIONS

Capital formation or real investment is an essential ingredient for economic development and growth. Capital formation may take place for various reasons. Existing capital stock may need to be replaced due to normal wear and tear. Plants may have to be expanded from time to time in order to take advantage of economies of scale and to keep pace with growing market demand locally and abroad. The intensification of competition would dictate investments for incorporating latest technologies. Investment in inventories may be required where the supply of inputs or the market for end products exhibit a high degree of seasonality. Social facilities have to be upgraded and expanded in line with improving the standard of living of the population. And finally, infrastructures have to be laid in order to support productive investments, open up new areas or achieve a more balanced regional development.

No matter the motive, a real investment can only be realized if adequate funds could be put in place for its implementation. It is quite customary to identify two categories of funds - short term funds with maturities less than one year and long term funds with maturities longer than one year. Short term funds are raised in what are usually called money markets. The term capital market is normally used in connection with long term funds. In this paper, however, the term capital market shall be used to denote both capital market proper and money market.

It is also customary to divide capital markets into two types - primary and secondary markets. When new securities are issued, they are traded for the first time in what we call primary markets. In addition to other purposes, the proceeds from the sale of new securities on primary markets are used to finance real investment in physical structures, plant and equipment, and inventories. It is thus in primary markets that financial resources are actually mobilized for capital formation purposes.

After securities are issued and purchased in the primary market, secondary markets provide the medium for resale of these securities. Secondary markets may take the form of either organized stock exchanges or what are called over-the-counter markets. Organized stock exchanges are physical market places where securities are traded by open outcry or as in more modern exchanges by entering offers or bids into computer screens. Only the securities of companies meeting the listing requirements of a given stock exchange could be traded on that exchange. All other securities particularly those belonging to smaller companies and to companies with short track records are sold and purchased on over-the-counter markets.
The overall volume of trading activity in secondary markets is much larger than in primary markets. In the US, for example, the turnover in secondary markets is more than twenty times larger than the volume of initial public offerings in the primary markets.

Secondary markets perform a number of useful economic functions. As described above, they facilitate the trading of securities among investors. They enable securities to be sold on short notice hence rendering them highly liquid. Through continuous adjustment of securities prices upward and downward, secondary markets signal to the investing public which companies are being efficiently run and which ones are languishing in the hands of entrenched management. This way secondary markets facilitate the flow of capital to those companies with superior performance and hence play a crucial role in efficient allocation of resources. Also, secondary markets provide a very effective means for implementing monetary policies. Through open market operations, central banks may influence the amount of money supply in the economy by purchasing or selling securities on secondary markets.

Transactions in secondary markets do not necessarily lead to additionality in real investment or capital formation. However, secondary markets are essential for the successful operation of primary markets where resources are actually mobilized for capital formation purposes. The existence of an efficient secondary market means that financial assets or securities could readily be converted into cash. Potential investors fear that purchasing financial securities could lead to holding frozen assets indefinitely or at best until their maturity dates. The ability to liquidate financial instruments at will in secondary markets allays this fear. Thus the existence of secondary markets encourages savers to buy corporate securities issued for the first time in primary markets thereby facilitating the process of real investment or capital formation. Additionally, secondary markets provide benchmarks for terms under which new securities may be issued in primary markets.

After saying so much about primary and secondary capital markets, we now turn to the main actors in these markets. In primary markets, securities are issued by widely-held share companies, the central government usually represented by its treasury, and local governments and municipalities. Share companies may issue commercial papers to raise short term finance, different types and classes of shares to raise equity capital, and bonds to raise long term debt. Central and local governments as well as municipalities normally issue bills and bonds of varying maturities to finance budgetary shortfalls and the implementation of various infrastructural and social service projects.

The securities issued by the bodies mentioned above are by and large purchased by institutional investors, wealthy individuals, and small savers. Pension funds, insurance companies, credit and saving associations, foundations, cooperatives, banks, investment trusts and mutual funds (or unit trusts as they are called in the UK) are the major institutional investors. In many developed and developing countries, institutional investors account for the bulk of gross national investment. In the US, for example, more than two-thirds of total investment is made annually.
by institutional investors and only the remaining one-third by wealthy individuals and small savers.

In secondary markets, securities are resold by and change hands among and between institutional investors, wealthy individuals and small savers. Governments at central and local levels rarely enter secondary markets. Companies, whether private or publicly held, enter secondary markets frequently for cash management purposes and for adjusting their investment portfolio. As mentioned above, central banks also enter secondary markets from time to time in exercise of their mandate to formulate and implement a country’s monetary policies. Central banks normally trade in government securities and other securities of high credit rating.

Both in primary and secondary markets, financial intermediation plays an important role in many significant ways. Firstly, financial intermediaries operating in capital markets underwrite initial public offerings of shares and bonds issued by publicly held companies. In underwriting, a brokerage firm or a syndicate of such firms undertakes to sell to the public the securities of the issuing firm within a specified period, and to purchase for its own account whatever amount that may remain unsold at the end of the period. Thus underwriting gives assurance both to issuers and purchasers of securities that the subscription process would be completed promptly within a specified period. The subscription of issues not underwritten may take a protracted period before being completed meanwhile tying up the funds of early subscribers. Issues underwritten by a professional organization is also a big booster of confidence for the investing public. Additionally, the detailed prospectus to be prepared by the underwriter independently and in a professional manner will enable subscribers to make an informed decision as to whether or not they should buy the new issue. It will also avoid misunderstandings that may otherwise arise between subscribers and the promoters of the new issue.

Secondly, financial intermediaries bring together buyers and sellers of securities in secondary markets thereby facilitating a transaction to close as quickly as possible. When a buyer or a seller could not be located readily, a financial intermediary may act as a dealer and may sell from his stock of securities or purchase for his own account, respectively. This way intermediaries render securities highly liquid assets which could easily and quickly be converted into cash at the owner’s will. An intermediary may also act as a market maker in which capacity he strives to maintain an orderly market for the securities that may be assigned to him.

Capital markets are highly susceptible to frauds and manipulations. A company may deliberately mislead potential investors into buying its securities by painting a rosy picture about itself in the company prospectus and other publications. Investors may also be lured into a highly risky situation by companies which intentionally hide a vital piece of information on a certain aspect that may potentially have adverse consequences. Other than misrepresentation of facts or withholding information, securities markets may be manipulated in different ways for making unscrupulous profits at the expense of unwary investors. Also what is known as insider trading has been a chronic disease of capital markets. Major shareholders, board directors, and
management officers possess valuable non-public information which they may use to line their pockets. Very few countries have managed to bring insider trading under control.

In order to protect investors against frauds, misrepresentations, collusion between brokers, insider trading and the like many countries have enacted an elaborate set of legislation, rules and regulations. They have also established agencies with pervasive powers to control and regulate their capital markets. In this respect, one regulatory mechanism widely used is the mandatory requirement of full and fair disclosure of information. Companies are required to disclose information on forms prepared for the purpose not only at the time they issue securities but also regularly thereafter, say every quarter. They are also required by law to disclose, as and when necessary, any piece of information that may affect the prices of their securities. As may be appreciated, the purpose of the disclosure requirement is to enable the investing public make its investment decisions on the basis of complete and credible information.

Another important means of investors protection is the operation of credit rating agencies. These agencies evaluate independently the default risk associated with various bond issues. They regularly publish their credit ratings which investors may take into account in their considerations to invest in bonds.

2. THE INTERNATIONAL SCENE

Capital markets as described above are found in several countries. According to the International Stock Exchange Directory issued by the International Federation of Stock Exchanges there were by December 31st, 1991 109 stock exchanges in 72 countries. In more mature economies, stock exchanges are found in several major cities. Among the biggest stock exchanges in the world are New York, Tokyo, London, Paris, Frankfurt, Zurich, Amsterdam, and Toronto. Some of these stock exchanges have long history. The New York Stock Exchange, for example, celebrated its bicentennial last year.

But stock exchanges are no longer the monopolies of the developed world. Over the past decade, there has been a rapid growth of stock markets in the developing world. The growth has been more spectacular in Latin America, East European countries and countries in the Far East. In Africa as well several countries have set up nascent stock exchanges. In Sub-Saharan Africa, for example, Botswana, Ghana, Kenya, Mauritius, Nigeria, Namibia, Swaziland, and Zambia have set up stock exchanges.

According to a report by the International Finance Corporation (ICF), developing country stock markets or emerging markets as customarily called increased their aggregate market capitalization from US$ 67 billion in 1982 to US$ 740 billion in 1992. The number of listed companies in these emerging markets has also increased considerably over the same period. It is also interesting to note that, in the past decade, securities traded on those markets had
Generally yielded much higher returns than those traded in the stock exchanges of the more mature economies.

These international developments have had a profound impact on the way foreign investments are made. The traditional vehicle for foreign investment has been up until recently what is called direct investment. According to this modality of investment, a company identifies an investment opportunity in a foreign country, establishes the feasibility of the opportunity, makes the necessary legal arrangements, and invests its capital. This way of making foreign investments is increasingly giving way to other modalities thanks to the globalization of capital markets. These new modalities include portfolio investment through specialized country funds, direct purchase of foreign securities offered internationally, and investing in foreign companies by buying their shares in the respective stock exchange.

3. SHARE TRADING IN ETHIOPIA

Coming back to Ethiopia, the first share that was offered for public subscription was issued in 1956 by a company called Ethiopian Abattoirs. In the years that followed a number of other companies issued varying amounts of shares for public subscriptions. These companies included among others, the Bottling Company of Ethiopia (1957), Indo-Ethiopian Textiles (1958), HVA Ethiopia (1959), Societe du Tedj d’Ethiopie Saba and Tendaho Plantations (1961), and Addis Ababa Bank (1963). Total investment in major publicly issued shares during the period 1959-1963 was close to Birr 61 million. Of this amount, close to Birr 41 million (or 67% of the total) was invested by foreign companies the most significant of which was HVA of the Netherlands.

With the growth of share trading in Addis Ababa the then State Bank of Ethiopia formed a share exchange department in 1960 in order to encourage trading and holding of shares. The formation of the department was the first step in institutional arrangement for share trading in Ethiopia. Through this department, the Bank had acquired shares in many of the larger companies when they were formed and played an important role as their underwriter. Its portfolio of shares was adequate to support over-the-counter operations. The department was controlling the volume of transactions at its over-the-counter facilities through prices. It was setting prices by trial and error and by encouraging third parties willing to purchase or sell shares to quote their own bid or ask prices. The prices so set were posted regularly at the Bank’s main office in the Piazza. The Bank was also advancing loans against shares pledged as collateral by suitable borrowers. These loans were used for personal purposes or as margins to finance share purchases.

By 1965 the share market had expanded considerably. The quickening pace of economic development at the time led to an increase in the rate of formation of new companies. This resulted in an increasing number of new issues of shares made each year which in turn strained the department’s resources for underwriting. On the other hand, other financial institutions had
Problems and Prospects of Private Sector Development

by then initiated their own share brokerage and dealing operations. There had also developed fears of market dislocations when two large companies established by public subscriptions of shares started to experience financial difficulties.

At this point, an alternative institutional arrangement was called for. The National Bank of Ethiopia, the successor of the State Bank of Ethiopia, took the initiative to set up what was then called the Share Dealing Group. The Group consisted of six institutions which were represented by their respective General Managers or Managing Directors and one individual. The members of the Group were the National Bank of Ethiopia, Addis Ababa Bank, the Commercial Bank of Ethiopia, the Development Bank of Ethiopia, The Investment Bank of Ethiopia, Sabean Utility Corporation, and a certain individual called Mr. Alfred Abel.

The Group was regularly meeting every week under the chairmanship of the Governor of the National Bank of Ethiopia. The Bank was also providing secretarial and other support facilities to the Group’s activities. At their weekly meetings, the Group members were trading shares among themselves and executing orders for their clients. Dealing was conducted on open bidding basis, and the type of deals included spot transactions, forward transactions, and option transactions. Most of the members of the Share Dealing Group also had its own over-the-counter facilities which it used for public trading of shares at prices determined at the weekly sessions of the Group. All in all the Group accomplished its objectives in informing and educating the investing public about share holding and trading, fostering confidence in the market, and laying the necessary groundwork for an eventual launching of a full blown stock exchange. The Group formally ceased to exist in 1975 when financial institutions and large companies were nationalized and transferred into government ownership.

Another important landmark in the history of Ethiopian share trading is the enactment of the Commercial Code of Ethiopia in 1960. The Code consists of five books and over 80 chapters all in all, and covers, among others, such topics as business organizations, carriage and insurance, games and gambling, negotiable instruments, banking transactions, bankruptcy, and schemes of arrangement.

The Code is still valid almost in its entirety. It is in fact the governing law for the issuance and trading of financial securities. In this respect, the relevant part is Title VI of Book II of the Code dealing with Companies limited by shares. This part of the Code comprises of eight chapters dealing with formation of a share company, rights and duties of shareholders, management organs of a share company, issue of debentures or bonds, keeping of accounts, and dissolution of share companies. Of particular interest to the Ethiopian capital market operations are the articles of the Code specifying the conditions to be fulfilled before shares and debentures are issued for public distribution, and the manner in which these securities may be transferred from one person to another.
Since Ethiopia adopted free market economic policies, share companies have once again started to appear on the economic scene. So far a good number of share companies have already been formed or are under the process of formation. Hinjhat, Gosh Manufacturing and Trading, Eshet Food and Animal Feed Products, Chem-Tec Centre, Walta Ethiopia, Wabe Agricultural Development are but a few of the share companies established during the last two years. All the companies were formed or are being formed by Ethiopian investors, and their subscribed capital in most cases did not exceed Birr 20 million. The performance of these companies and whether they would be able to live up to the expectations of their shareholders are matters yet to be seen.

What is of interest to us here is that these Companies sold their own shares without involving outside underwriters. Unlike in the past where at least the banking sector showed active interest in share underwriting and trading, there seems to be a critical institutional gap at present regarding the provision of these services. The companies so far formed and their shareholders could not therefore reap the benefits of underwriting described above. Although no detailed research has been undertaken in this respect, it must have taken most of the companies quite a long time before they were able to raise the amount of paid-up capital required by law. Some may not even have managed to get sufficient subscription they envisaged in their draft memorandum of association.

In addition to the absence of intermediaries in the share market at present, there are also other problems which apparently stand on the way of an expanding share investment. The investing public has not yet fully regained the confidence it lost when its share holding in various enterprises was nationalized in 1975. What is more, active secondary markets have not yet emerged in the country enabling shareholders to trade their shares. Certainly this is another factor which currently acts as an impediment to investing in shares.

The Commercial Code of Ethiopia which still governs share issuing and trading activities creates, as it stands now, procedural inconveniences and considerable delays in completing registration formalities. On the other hand, the apparent lack of enforcement of certain provisions of the code may have detrimental effect on the confidence of the investing public, and the resulting confidence crisis may be difficult to overcome subsequently.

As described above, institutional investors account for a large proportion of gross investment in other countries. In as much as we could observe in Ethiopia so far, investing in shares has not yet been forthcoming from institutions having substantial financial resources at their disposal. Such institutions include provident funds, credit and saving associations, cooperatives and edirs. For some institutions it is a problem of legal or administrative restrictions on how they may utilize their funds. For others the problem is simply lack of awareness about the opportunities that exist in share investments. Still for others it is lack of confidence in the whole affair.
While the present situation surrounding share investment is as described briefly above, the future prospect seems to be bright given the deepening of free market policies in managing the national economy. Three developments are likely to make the above assertion to hold true. Firstly, the ongoing financial sector reform will create the basic conditions for a buoyant private sector investment in general and investment in share companies in particular.

Secondly, the launching of a large scale privatization programme by the government will give a big impetus to the development of the Ethiopian capital market. Presumably, the privatization of most government owned enterprises will be effected through public offering of their shares. This will increase the number of share companies thereby providing prospective intermediaries with a good size market that could support a profitable brokerage business.

Thirdly, as free market economic policies take root in the country foreign investment will increasingly be attracted which will give a further boost to the development of the Ethiopian Capital market.

4. POLICY RECOMMENDATIONS

By way of conclusion, the following policy recommendations are proposed:

1. It is recommended that the Commercial Code of Ethiopia be revised with the view of removing certain provisions that lead to a drawn out registration process and amending others so as to enhance investors protection afforded by law. The revision should take into account not only the primary issuance of securities but also the requirements of secondary markets.

2. It is suggested that a regulatory agency be established with broad and direct authority over the operation and further development of the Ethiopian capital market.

3. All share companies should be registered by this agency before their shares are sold to the public. The Agency should issue regulations regarding disclosure requirements that will ensure that investors have "full and fair" disclosure of pertinent information in connection with security offerings. The disclosure requirements should be designed in such a way to be able to prevent misrepresentation or fraud in the sale of securities.

4. Since financial information is the basis for securities analysis and for making investment decisions, it is proposed that the relevant government authorities and the Ethiopian Accountants and Auditors Association establish accounting and auditing standards.

5. In cognizance of the potentially large role institutional investors could play in the Ethiopian capital market, it is strongly recommended that legal and administrative impediments
restricting their ability to make investments in securities be removed, and that they be encouraged to make prudent investments in these instruments.

6. In view of the positive and favourable impact privatization would have on the development of the Ethiopian capital market, it is recommended that the privatization process be speeded up and that serious consideration be given to public offering of shares as a modality for privatization.

7. It is suggested that, in parallel with implementing the above recommendations, a detailed study be initiated covering all relevant macro and micro aspects not specifically mentioned above. The outcome of the study should be in the form of a plan of action for the further development of the Ethiopian capital market.

REFERENCES


