PROBLEMS AND PROSPECTS FOR THE EMERGENCE OF A STOCK MARKET IN ETHIOPIA

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1. INTRODUCTION

The Ethiopian economy has recorded steadily deteriorating performance over the past two decades. Among the explanatory factors advanced, the adoption of distorted economic policy and economic management stand out as central. Economic policy was designed to grant an exclusive priority to the public sector in terms of ownership, production and employment of resources. This has resulted in a weak and marginalized private sector and a level of economic growth and development far below the country's considerable potential. Thus the current change in approach and economic reform measures are long overdue.

Although the key policy orientation is to institute a market economy, the state has an essential role in setting appropriate economic policies and in facilitating the development of market institutions as well. Ethiopia's new approach is, in fact, part of the larger trend in development thinking and policy orientation recently observed in Africa, Latin America and Eastern Europe. This shift is clearly toward a restricted government role in economic activities and toward the promotion of the private sector; however, shrinking the public sector is not an objective in and of itself. Rather, a properly organized and efficient public sector which can actively promote the private sector and bridge the gap between the actual capacity of that sector and the resource requirements for investment and economic growth is necessary (World Bank, 1991:131). Thus the issue becomes in essence what the optimal size and role of the reformed public sector should be to create a conducive environment for economic development (Israel, 1990:3). It is therefore the quality not the size of the state in economic affairs that matters.

One of the areas in which the realization of private sector's potential requires policy reform is the financial sector. Without an efficient financial system the improvement in resource mobilization and its efficient allocation towards economically viable investment can be only partial. Most developing nations, including Ethiopia, have undermined the growth of the financial sector by controlling interest rates, directing credit to priority areas regardless of their economic viability, and securing inexpensive funding that is biased for the public sector alone (World Bank, 1989: 4; TGE, 1992a: 5). The objective of financial liberalization in the reforming economies is thus to eliminate this distortion within the general framework of macroeconomic adjustment.

In order to spur a market economy and unleash private productive potential, the Transitional Government of Ethiopia has launched an economic reform programme. Within the framework of the new approach to economic management, three interrelated measures that are intended to stabilize, reform and restructure the Ethiopian economy have been announced, and some of these measures have already been taken (TGE, 1992b: 3). Creation of an enabling environment requires the implementation of policies favouring market activity, including investment incentives, the development of physical infrastructure and market institutions, and measures to ensure macroeconomic stability. This would open the opportunity for the 'birth' of a strong private sector and the achievement of faster economic growth and development. The structural reform measures which began to lay the legal, institutional and regulatory groundwork were taken with the issuance of Investment, Credit and Interest rate, Exchange rate, Public Enterprise and Tax Codes (TGE, 1992b: p.3-5; annex). Measures related to the privatization of public enterprises and the revision of the Commercial Code are now being undertaken as well.

This paper investigates the economic rationale and options for the emergence of a stock market in Ethiopia in light of this general policy framework. In the first section, it will discuss the economic rationale for share market development. The next section concentrates on the operation of the infant share market in Ethiopia in the 1960s until it ceased operation in 1975. In section three, the specific problems and possible options for not only reincarnating Ethiopia's former stock exchange, but also paving the way for a larger, more active stock market will be examined. In the last section, some conclusions and recommendations are set forth.

2. THE RATIONALE FOR SHARE MARKETS

The achievement of sustainable economic growth demands, among other factors, considerable resources for investment and the efficient utilization of those resources. These may be generated either domestically or externally. The domestic side can be broken into two components: the public and the private sectors. Experience reveals that the public sector alone could hardly be able to generate revenues and distribute resources in an efficient way, and therefore can't finance these resource requirements by itself. External sources of funding are also problematic and cannot be channelled without domestic institutions, and are limited in size and scope. Thus the active involvement of the domestic private sector in saving and investment is critical to achieving desired levels of economic growth.

For this, not only are favourable economic policies needed, but actual institutional capacity must also be developed in order to overcome the obstacles to the generation and flow of investible resources. The mobilization of economic resources from various economic agents is a problem general to developing countries, and in fact one of their main challenges. In most cases, there is a persistent gap between the actual monetary saving and the targeted investment requirements of these countries. This phenomenal investment gap has only increased in recent years, ultimately leading many to resort to external borrowing.

Ethiopia is not an exception to this general picture of the developing countries. The problem of resource mobilization in the Ethiopian economy is at least as serious as that of most other developing countries. The level of national saving is far below the domestic investment requirement, so the system has been compelled to resort to external borrowing particularly to finance large development projects. The details of this serious and long-standing situation are depicted in Annex I. This table also points out the need for specific adjustment measures to redress this growing gap. In this respect a strong mechanism for the efficient mobilisation of resources should be put in place so as to channel resources from disparate sources toward the investment levels required to a sustainable economic growth.

In the face of this critical disparity, most developing countries probably have actual saving rates far below their socially optimal rates (Baran, 1976: 132-134). One reason for this is undoubtedly the lack of effective and efficient institutions for attracting savings and directing investible resources to their most profitable use. The existence of such institutions could, in theory at least, boost saving and investment levels by increasing the return on small investments, thus altering agents' current consumption-future consumption decision. That is, if postponing current consumption could mean much higher wealth and consumption in the future, many may opt to postpone consumption of a larger share of their current wealth, and save and invest more of their current income.

In encouraging agents to raise their savings and investment rates, however, a stable and sound policy environment and the existence of effective institutions for channelling these resources is crucial. This is most likely to be realised through the private financial sector. The problem of bridging the gap between the saving potential and investment requirements is a long-standing and persistent one for developing countries and requires countervailing measures. Encouraging potential savers for higher monetary saving demands improving the relative attractiveness of this opportunity. For instance, this include conditions which favour subsistence production and discourage market exchange as well as non-monetary forms of saving like real estates, livestock investment, construction and the like. The most beneficial decisions for vast sectors of the population are also conditions which tend to reproduce themselves, resulting in low monetary savings rates. In particular, weak productivity levels, slow technological advancement, low levels of real income and demand, and an unreliable policy environment are part of this vicious circle. They also make a shift to alternative forms of saving and investment unlikely without deliberate and well-conceived countervailing measures. In particular, boosting monetary saving, which can be channelled into viable investment opportunities, will require new financial institutions and a great deal of confidence in those institutions. One form of financial intermediation which could be highly effective, given the right institutional design and economic environment, is a stock market. There is a recent discussion in policy making circles in Ethiopia which involves the establishment of a reliable capital market in the system through different options.

If the country is successful in building the institutions necessary for facilitating efficient resource allocation and in inspiring investors confidence in such an exchange, investible funds could be thereby mobilized from both domestic and external sources. However, there are a number of major economic and political challenges to be confronted before this is possible.

The stock exchange can be important to corporate -- and therefore economic -- health and viability for a variety of reasons. Its main function is, of course, to serve as the nexus between disparate sources of saving and various investment outlets in the economy. In so doing, it provides a market place for the purchase and sale of securities, and the opportunity for constantly adjusting signals of corporate value and prospects as well as the economy's health. An active stock market primarily benefits the companies themselves by supplying readily large amounts of capital, and the assurance that if their own management and prospects are good, they will face a less stringent capital constraint. In theory, then, corporations would invest up to the optimal level, and funds would be allocated more in line with efficiency considerations throughout the system. Moreover, the advantages to investors of tradeable securities usually translate into a lower cost of capital to the corporation itself.

Thus one major attraction of a stock market to potential holders of securities is that stocks are reasonably liquid (Khan, 1982:234-5). That is, no investment is completely irreversible, and investors would be more likely to assume corporate risk.

The functions of providing liquidity and signalling overall investor confidence would thus allow the stock exchange to act as a barometer of the national economy and of the prospects of various corporations themselves. It is in fact the need for these functions, which is at the root of the goal to promote such exchanges.

Of course, the extent of real transferability and liquidity of shares would depend on the capacity of the market to absorb a fairly large volume of shares within a certain time span and price. That is, if a large investor wishes to disinvest quickly, then the price of those shares is most likely to fall. In an active share market with diverse shareholders, these holders could convert their shares into cash easily and quickly thereby reducing the uncertainty and difficulty of holding shares. An additional advantage is that the transferability of shares makes them a convenient form of collateral for borrowing from financial institutions. In this manner, an active market increases the attractiveness of investment in corporate forms of business organizations with fairly convertible assets for economic agents.

The emergence of this important type of market and its ongoing development, however, would require corresponding policy measures which would encourage private sector risk taking and entrepreneurial decision-making. Thus economic, political and social variables are intricately linked to the evolution of this type of enterprise and hence market.

Share-markets and companies especially in the earlier stage of their life have usually been viewed with scepticism, when actually a leap of faith is required. These are obstacles to the development of public confidence in share investment and hence in share markets which ultimately limit their ability to solve the problem of under-capacity operation in the economy. The development of stock exchanges in economies like that of Ethiopia would face a number of challenges which include: the new and unknown nature of the market, the low level of real

The corporate form of enterprise ownership was established in Ethiopia beginning in the 1960s and continued until the early 1970s. During this short period, a number of obstacles impeded existed to the successful development of the stock exchange, which served as the medium of share ownership transfer in the system. First, the corporate form of enterprise organization was a new phenomenon and potential investors at the beginning were reluctant to actively participate in share investment.

The government gave the responsibility to the Central Bank of Ethiopia for administering the exchange. The intention was to stimulate trading and investment in shares of the newly established corporations through a Department of Share Exchange, which formed the basis for the establishment of the new share market in Ethiopia in 1959. The objective was to encourage widespread public investment in shares and other securities. To achieve this, the unit was governed by rules and regulations which basically emphasised the requirements that a company should meet in order to participate in the market. These requirements included legal establishment and reporting on the operation of the company to the group and to the shareholders on a regular basis. Only listed shares and bonds of companies which fulfilled certain minimum requirements were traded at the weekly meeting of the Department.

By the mid-1960s, the department found it difficult to effectively accommodate the growing needs of the share transactions for the period. The demand of the economy for additional investment greatly improved and the department which was assigned to the operation and dealing of shares became a stumbling block for its expansion. To this effect, the National Bank of Ethiopia formed a group of the main financial institutions and a few private share dealers entitled Share Dealing Group. The Group was established to facilitate the transaction of shares and other securities in the market by involving the shares of those companies which fulfilled the requirement set by the National Bank. The Group was also involved in the transfer and delivery of traded shares, which had to take place within three days after the trade. To implement the share transfer objectives, Addis Ababa Bank, the Commercial Bank of Ethiopia and the Ethiopian Investment Corporations provided over-the-counter share dealing services in Addis Ababa.

Options for investing in shares grew and the investing community developed the needed confidence in these institutions to invest in the newly established share companies. This institutional framework encouraged the investing community to take the risk of such stock investments.

The share-holding public was expanding at a fast rate, from a trading volume of Birr 852,300 in 1959 to Birr 1,159,090 in 1963 (SBE,1963:15). There was a general trend of excess of sales to the public over purchases from the public indicating the growing interest of private savers to invest in shares. The potential buyer of shares began to develop confidence in share investment. This fast growth, coupled with the provision of a number of new share issues, raised the need

The role of the government in share companies ownership was significant in most cases. The approach pursued by the Imperial Government was to create a conducive environment and confidence of the private sector to make investment in share and eventually take over the share of the government (Paschke, 1968: 3).

The serious impact of nationalization of share companies was reflected on foreign investors and the private domestic investors. These shareholders entirely lost their investment in shares. The reaction of the government and the investing community in this broad grouping could be treated separately. The foreign investors managed to have at least partial compensation of their share investment. Even for the remainder, they make every effort to put on the agenda for any negotiation between the Ethiopian government and their government. Some of them considered the issue of compensation within the framework of technical assistance to Ethiopia and paid their nationals out of the fund allotted for this purpose.

The remainder of the confiscated shares of the public were held by the domestic private investors. Even if relatively weak in share-holding at that period, the potential of the private sector in share investment was promising and significant. At the rate of growth of the purchase of shares by the investing community, one can tell the possible strength of the sector in the absence of that unfortunate measure of confiscation of share companies. Unlike the beginning period when the community looked share investment with scepticism, an encouraging development of public confidence in making investment in share companies was observed. The middle class and the trading community was the potential and some people from the low income strata were also participating in this investment opportunity. The development of confidence in the public for investment in shares was exhibited by the fact that the Share Dealing Group turned out to be the net seller of shares to the community (SBE, 1963: 9; Pischke, 1968: 6-7). The nationalisation measure was taken just before the share market reached a take-off stage and that destroyed the infant development potential of the system. Then on wards, the private sector became the victim of a number of policies adopted by the Dergue regime and nowadays one can hardly consider the existence of the private sector in the economy.

4. OPTIONS FOR SHARE-MARKET REINCARNATION

Having explored the operation of the infant share market in Ethiopia in the 1960s and the unfortunate and abrupt end of its operation in 1975, the next issues that demand closer investigation are: Is there a conducive environment for the re-emergence of the share market in the foreseeable future in the economy? Is reincarnation a visible possibility in the present economic policy environment of Ethiopia? What challenges and options are available for the reincarnation of the stock exchange in Ethiopia?

The emergence of stock exchange is a necessity in the present economic policy environment of Ethiopia for financing business organizations. This is so because of a number of reasons the earlier period. Nonetheless, a lot remains to be desired in this exercise so as to ease the investment efforts of potential investors.

In addition to this, the investors could form different forms of business organizations including share companies provided that some conditionalities are fulfilled. These conditionalities mainly include factors like a minimum amount of Birr 50,000 of capital, making a deposit of at least a quarter of the stated capital under blocked account, the submission of project appraisal document to the Office and confinement in areas which are allowed to the private sector involvement (TGE, 1992c). The restriction of the areas of operation for the private sector would have its own side effects on the magnitude and form of private sector participation in the economy.

The responsiveness of the private sector so far in terms of making investment in the productive sectors has been far below expectation. The records of the Central Register of companies reveals that a total of 127 companies were formed with a capital of Birr 72.4 million worth of capital after the issuance of the new investment code. Of these enterprises, 119 are formed as private limited companies. These companies have small capital investment which on average is Birr 440,630.70. The main form of ownership in these companies is confined within a family or friendship circle to ensure the close follow-up of the operation of the enterprise. In the form of Partnership, only two companies with capital investment of Birr 525,652 were established. These companies have no direct impact on the formation of share markets because they have shares with restricted circulation in the economy. They have non- transferable shares and are relatively less risky because the controlling hand of the owner on the business is strong. These are activities which are concentrated in trading and hotel service with little involvement in the productive sectors of the economy.

The formation of share companies so far has been very limited for various reasons. The common justification for forming corporate forms of business organization is the need to have huge amount of capital for the undertaking. This implies the scale of activities of the investment project demands the contribution of investment resources from a wide range of sources. This has partial limitation in Ethiopia for the government has identified these types of companies to be run and owned by the state. Since the reorganization of the investment code, for instance, it is only 6 share companies until October 1993 which were formed and registered in the Central Commercial Register. These companies had an initial registered capital of Birr 19.4 million and most of them are operating in areas of commercial agriculture and trading activities which are not within the domain of activities of the government.

Recently, the government announced the possibility of private nationals to involve in commercial banking and insurance companies. The conditionalities for the involvement include company form of organization, minimum capital and the level of maximum share-holding ceiling of share holders. This means that the form of business organization in these industries is going to be the pool for the emergence of share markets through which investment in shares is to be effected. This is therefore indicative of the optimal time to put in place the institutional and policy framework for the emergence of stock exchange in the system as soon as possible.

4.2 The Formation of Share Companies through Privatization

The recent economic reform measures of most of the former socialist countries and the underdeveloped nations emphasized the promotion of the private sector in economic activities and the limitation of the public sector to its areas of relative efficiency. One of the forms to improve the efficiency of the enterprises is supposed to be through privatization of public enterprises. A number of the reforming economies have adopted the policy of privatization though the pace is different in different economies (Sachs, 1991: 17). Privatization itself has different modalities including public offering of shares, management contract, sales of shares to the employees of the enterprise, or even divestiture. The actual course of action depends, nonetheless, on economic, political and social variables that prevail in the system under consideration.

One of the forms of privatization is disposing public enterprises through initial public offering. This approach demands the existence of an institutional arrangement in which the identification and valuation of the enterprises to be privatized is made. The valuation of public enterprises is one of the prerequisites in this method of privatization. Those economies which adopt this method of privatization confronted the same problem of timely and realistic valuation of the firms. This raises the need to have accountable and competent valuation groups in the system which is in short supply in most of the reforming economies. This approach might lead to unfair expropriation of public assets in favour of those who manage to buy shares of these companies (Sachs, 1991:26-27).

The issue of privatization is widely discussed in the community and the policy making circle. The government has set up a Privatization Agency whose main task is to carry out the process of privatizing public enterprises in an orderly and efficient manner (TGE, 1994c). The Agency has the responsibility of screening out, in light of the New Economic Policy of the Transitional Period, those enterprises which are going to be privatized and which are to remain under public ownership. The committee has forwarded some proposals as to the status of enterprises in terms of their ultimate fate. Out of the enterprises which are going to be privatized, one of the modalities of privatization is the conversion of organizations into share companies.

The conversion process demands proper valuation of these companies, getting an institution which would under-write the values of the companies and issue share to the public for sale, keeping share registration of share-holders and forming an institutional set up which would report on the overall operation of the companies under consideration.

These two aforementioned options of forming share companies would open the door for the

The private sector in Ethiopia could improve its actual saving provided that the necessary policy and institutional measures are taken. The present state of operation exhibits the prevalence of a phenomenal saving-investment gap. This urges the need to encourage the private sector through sound economic policies and incentives to save and invest more in the system.

This in turn demands the use of various mechanisms and modalities of mobilising investable resources from different economic agents. One of the widely used mechanisms in this regard is the formation of share companies by selling shares to the investing community. This would allow even the low-income group to opt for investment in shares out of their limited income. The nexus between the saving and investing economic agents would be assumed by share markets.

In Ethiopia, this share market has been effective at least for a decade in the 1960s and 1970s. This was the period in which the economy was relatively performing well and achieving growth. This infant share market came to an end with the nationalization of private establishments in 1975. This was made without any compensation measure to the bulk of shareholders. The whole effort came to an end with the confiscation of investment in shares and no counteracting measures have been taken so far.

In the context of the present economic environment of Ethiopia, some measures have to be taken in due time to develop companies in order to realise the potential of the private sector at a higher level. In this endeavour, the role of the stock market is evident. In this connection, however, one cannot escape the issue of compensation and should be considered seriously to nurture public confidence in shares investment and markets. Schemes of full or at least partial compensation could be developed and international financial institutions could be approached for financing contribution.

Since the market is not familiar in our economy, educating the potential investors through communication media about the essence, importance, workings, and characteristics of share companies and markets is important. In addition to this, the training of experts to properly screen the enterprises, whose shares to float in the market, is required. Public awareness, coupled with proper screening mechanism of companies whose shares are to freely float in the market, would foster involvement in share investment.

The development of sound legal framework for the formation and proper operation of the newly established companies or the would be converted state enterprises is important. The progress of operation of these companies should be reported to the investing public so as to attract the investment in these organizations. Mechanisms to control fraudulent acts should be developed and implemented in the new system.

To involve a larger sector the population in the purchase of shares, various schemes should be developed especially for government employees through long-term loan and other attractive

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Annex II

Ethiopia: Profile of Share Companies whose shares were floating in the market by ownership, capital, and par share value by 1968

Year of Estab.	Name of the Company	Percentage Share Portfolio by Ownership			Capital (Mil.Birr)	Par Value of Shares (in Birr)
		Gov't	Prtiv. Nat.	Foreign		
1963	Addis Ababa Bank Share Company	0	51.0	49.0	15.40	25
1957	The Bottling Company of Ethio. S.Co.	2.7	96.3	0	0.99	100
1960	Cottonoficio Barrtollo	0	na	na	20.80	1,000
1963	Cotton Company of Ethiopia S.Co.	na	25.0	75.0	12.00	100
1963	The Ethiopian Drug Manufact. S.Co.	68.8	31.2	8.0	1.25	100
1942	The Sabean Utility Corporation S.Co.	47.0	na	na	18.00	100
1966	Ethiopian fabrics Share Company	0	27.2	72.8	2.60	100
1950	General Ethiopian Transport S.Co.	0	100	0	5.00	100
1958	HVA-Ethiopia	11.1	8.9	0.8	28.00	100
1957	Indio-Ethiopian Textiles S. Company	43.9	31.4	24.7	4.46	100
1962	Manifattura Sacchi Asmara	na	na	na	3.50	1,000
1962	National Meat Corp. of Ethio. S.Co.	55.6	15.0	18.1	4.50	100
1948	Ras Hotels Share Company	na	na	na	4.00	100
1964	The Rubber and Canvas Shoe S.Co.	80.5	3.9	na	4.35	100
1942	Sabean Utility Corporation S.Co.	47.0	25.0	28.0	18.00	100
1961	Societie du Tedj d'Ethiopia Saba	0	100.0	0	1.50	100
1961	Tendaho Plantations Share Company	6.7	31.1	62.2	11.50	100
1963	Imperial Ethiopian Government 6-12 % Saving Bonds					
1963	Imperial Ethiopian Government 4% Premium Bonds					

Source: Author's computation from different documents of share companies in Ethiopia during the 1960s and 1970s.