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.

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 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

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.

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.

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