

Establishing secondary market in ethiopia finance essay



**ASSIGN
BUSTER**

\n[[toc title="Table of Contents"](#)]\n

\n \t

1. [Key Words:](#) \n \t
2. [Introduction](#) \n \t
3. [Statement of the Problem](#) \n \t
4. [Objectives and Methodology](#) \n \t
5. [Capital Markets and Economic Growth](#) \n \t
6. [Fig. 1 showing Capital-Market-Induced-Growth Cycle](#) \n \t
7. [Benefits of Securities Markets:](#) \n \t
8. [Costs of operating Securities Markets:](#) \n \t
9. [Conclusion](#) \n

\n[/toc]\n \n

Review of the existing literature indicates that securities markets contribute to economic growth by mobilizing saving and channeling it to productive investment. Ethiopia, though having growing markets for primary issues of equity and debt securities, does not have a secondary market and as a result is not reaping the benefits. The purpose of this study is to assess the benefits and costs of operating secondary market for equity and debt securities in the light of extant literature. In order to achieve this objective, the literature available on securities markets has been critically studied and summarized. The result of the research shows that Ethiopia should pave the way for secondary markets development in the medium term as their benefits exceed costs. The study concludes that the policymakers must seriously consider the launching of secondary market in Ethiopia.

Key Words:

Secondary Market, Benefits and Costs, Ethiopia, Extant Literature Review

Introduction

Financial Markets channel savings to those individuals and institutions that need more funds for spending than that are provided by their current incomes. The financial system consists of many players like financial institutions, financial markets, regulators, market participants and others having stake on it. Money and Capital Markets operating within the financial system make possible the exchange of current income for future income and the transformation of savings into investment which result in increased production, employment, income, and living standards. (Rose, 2001) The size of the world stock market was estimated at about \$36. 6 trillion at the beginning of October 2008. (seekingalpha. com). The total world derivatives market has been estimated at about \$791 trillion face or nominal value, 11 times the size of the entire world economy (BIS, 2008).

With the exception of South Africa, African stock markets are extremely small by world standards. Together, the fifteen markets apart from South Africa accounted for only 0. 2 per cent of world stock market capitalization at the end of 2003, and 2. 0 per cent of emerging market capitalization. In contrast, South Africa - which accounts for 80 per cent of African stock market capitalization - is quite large by world standards. With a capitalization of US \$267 billion at the end of 2003, South Africa was then the fifth largest emerging market (after China, Taiwan, South Korea and India), and the 18th largest equity market in the world. All African markets (including South Africa) tend to lack liquidity, however, and therefore when <https://assignbuster.com/establishing-secondary-market-in-ethiopia-finance-essay/>

ranked by turnover rather than market capitalization their relative position is diminished. Five of the African markets are included in the S&P Global Emerging Market Index (S&P/IFCG) (South Africa, Egypt, Morocco, Nigeria, and Zimbabwe) although, apart from South Africa, they have very small weights in the S&P index. (Jefferis & Smith, 2005)

Ethiopia, with a population of about 81 million, is the second most populous country in Sub-Saharan Africa (SSA). One of the world's oldest civilizations, Ethiopia is also one of the world's poorest countries. At USD of 350 per year, Ethiopia's per capita income is much lower than the SSA average of USD 1,077 in the financial year 2009 (World Bank, 2011). In Ethiopia, two components of money market, viz., treasury bills market and inter-bank loan market are operating on a limited scale. On the capital market side, the primary market does exist but in rudimentary form and there is no secondary market.

Statement of the Problem

In traditional economic theory the inputs used in a production process to create value are land, labor, capital and entrepreneurship. Now the trend is that finance is given the necessary attention among researchers as a basic input for accelerating economic growth of countries. Many least developed countries including Ethiopia face huge challenges in access to finance to the many economic actors. Lack of finance was one of the reasons for lower economic growth of these countries in the past. Such countries have bank denominated financial system whereby access to finance for firms, government and households is limited by banks capacity to mobilize savings and their conservative lending policies. Hence the various market

<https://assignbuster.com/establishing-secondary-market-in-ethiopia-finance-essay/>

participants' needs for quality financial service are not satisfied by the existing bank-dominated financial system. This calls for capital market development that can satisfy their needs with financial products tailored to their needs.

When it comes to the Ethiopian context, the country has rudimentary primary market and no secondary capital market. The Daily Monitor (cited in allafrica.com) reported that the Managing Director of New York Stockbroker Auer Bach Grayson and Company said Ethiopia - the continent's second most populated and one of the biggest import markets - could boost the current high economic growth, if capital market started soon. Grayson further stated: " Ethiopia would be the most attractive investment destination in Africa, if it had a stock market and one could invest in Ethiopian businesses as cheaply as people are now investing through private transactions. Letting the private sector develop the capital market would lead to more transparency and more capital allocated to fuel Ethiopia's rapid growth."

The Capital Ethiopia Newspaper reported (under the caption: Ethiopia's Struggle for a Capital Market)the following news item:

For more than fifty years Ethiopia has been trying to have its own capital market and in June 2011 the Addis Ababa Chamber of Commerce and Sectoral Association (AACSA) held a workshop to help make this dream a reality. In what seems to be a fresh attempt to use its Private Sector Development (PSD) Hub to bring the issue to the public's attention, capital market consultants such as RuedigerRuecker, from Sweden, spoke in June

<https://assignbuster.com/establishing-secondary-market-in-ethiopia-finance-essay/>

2011 at the Intercontinental Hotel. Ruecker said that in order to create a capital market there needs to be an institutional, legal and policy framework. (edited by researchers for brevity)

In its “ Africa Market Entry Intelligence: Ethiopia Market Entry Brief”, the Africa Group (which offers ground market intelligence and a unique perspective on investing and doing business across the African Continent) identified the following “ Growth Hurdles” in Ethiopia:

Access to capital remains the largest single limiting factor for Ethiopian industry. Banks only lend on collateralized based loans, and many Small and Medium Enterprises (SMEs) lack sufficient collateral to secure the type of credit they need.

Capital markets in Ethiopia are at a nascent stage and lacking in strong legal and institutional framework. The treasury bills market is the only actively functioning market.

There had been a few studies focusing on the development of securities markets in Ethiopia in the last 15 years. Ruecker and Shiferaw, (2011) conducted the most recent study and other older studies, cited in Ruecker and Shiferaw (2011) include Tessema (2003); Mekelle University (2001) Conference on “ Promoting Capital Market in Ethiopia”; Haregework and Debessay (1995); East African Security Company (1995 & 1999); Ernst and Young (1999); and Maxwell (2010). These studies recommended the careful development of security market in Ethiopia. Based on the studies recommendations, many actors such as the Addis Ababa Chamber of

Commerce and Sectoral Association (AACCSA) tried to procure the <https://assignbuster.com/establishing-secondary-market-in-ethiopia-finance-essay/>

government's permission for security market development. Yet such efforts did not succeed. Thus, the development of organized and vibrant securities markets in Ethiopia is still a dream to be realized.

Objectives and Methodology

The objective of the study is to assess the benefits and costs of operating secondary market for equity and debt securities in the light of extant literature available. In order to achieve this objective, the literature available on securities markets has been critically studied and summarized.

Capital Markets and Economic Growth

It is an accepted view among researchers that there is a close relationship between capital markets and economic growth. Researchers such as Bencivenga et al. (1996), Levine (1991), and Obstfeld (1994) argued that stock markets provide services that boost economic growth and contribute to the achievement of these goals.

A capital market with greater breadth and depth will be able to attract domestic savings. Small investors would be wooed to pool their savings and invest in capital market instruments as they provide greater returns particularly in the long run. The domestic savings mobilized in turn will be channelized into investment, paving the way for greater and quicker capital formation.

Fig. 1 showing Capital-Market-Induced-Growth Cycle

Higher capital formation in industrial sector will enhance the capacity to produce capital and consumption goods. This will gradually reduce the

import burden of the country. Import substitution has multiple effects on the economy, such as enhancement of employment potential, enthusing agricultural and domestic production, reducing balance of payments deficit, improving the productivity of agricultural and industrial sector and their contribution to the GDP of the country, and the like.

Higher GDP in turn will improve the individual disposable income, enhance the standards of living, and increase the saving potential. The increased saving potential will be met with higher opportunities to invest in capital market instruments, and that is how the “ Capital-Market-Induced-Growth-Cycle” will operate. (Kannan, 2011)

Benefits of Securities Markets:

Securities markets offer a number of benefits to the country and the surveyed literature prove this emphatically. The salient benefits of having securities markets are summarized in the following paragraphs:

Enhanced saving mobilization and risk management:

Stock and bond issues serve to increase the national savings rate by creating incentives to invest. Since securities are risky investments, they generally earn higher returns than more secure instruments such as bank savings deposits. They also offer investors the option to diversify across industries, thus improving their risk/return tradeoff. (Tessema, 2003)

Offering Liquidity to Investments:

Securities markets provide comparatively higher returns without losing the liquidity of an investment desired most by investors. Liquidity in turn affects economic growth positively by increasing incentive to invest and save.

Levine (1996) found that countries with well-developed financial sector and a liquid capital market experience faster rates of capital accumulation and greater productivity gains. As liquidity increases, firms gain increased assurance that they will be able to exit from long term investments. They therefore become more willing to make the permanent investments critical to development. Simultaneously, local consumers are more willing to mobilize domestic savings. However, Yartey and Adjasi (2007) say, increased stock market liquidity may have an adverse effect on the rate of economic growth by reducing the need for precautionary savings.

Redistribution of wealth facilitated by diffused ownership:

Securities markets give many people (especially the poor) a chance to buy shares of listed companies and become part-owners of profitable enterprises. Many people sharing the profits of businesses in turn help to reduce large income inequalities. (Etienne and Vincent, 2008) Wider distribution of corporate profits develops a general sense of ownership and an assumption of responsibility on the part of the citizen. People will be united by their common defense of their business interests and ethnic and religious differences would gradually dissipate. (Tessema, 2003)

Improved Corporate Governance:

Self and external regulation of the stock exchange help to ensure that the market is working efficiently, fairly and transparently. Over the decades, the <https://assignbuster.com/establishing-secondary-market-in-ethiopia-finance-essay/>

stock exchange has been raising requirements for new corporations seeking listing. These requirements relate to the submission of all financial information regarding companies whose securities are sold on the stock exchange. Such requirements exercise a control on a company management; keep its malpractice in check; and improve corporate governance. (Etienne and Vincent, 2008)

Efficient 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. Thus, efficient enterprise management is rewarded by access to investment funds. (Tessema, 2003) Without securities markets, companies must rely on internal resources (retained earnings) for investment funds, on bank financing or on government grants or subsidies. Such forced reliance on self-finance penalizes young companies whose products may have greater future demand. These new and growing enterprises often have little in the way of retained earnings. Bank lending to certain specified sectors (referred as priority sectors) leads to inefficient resource allocation and widespread loan delinquencies. The prevalence of these problems reduces the level of investments, productivity of capital and the volume of savings. Even if government grants and subsidies are available, they tend to introduce market imperfections that contribute to the distortion of financial prices. These imperfections subvert the positive allocation role of securities markets. Securities markets create better opportunities for small emerging companies to raise funds in the venture capital market since venture

<https://assignbuster.com/establishing-secondary-market-in-ethiopia-finance-essay/>

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.

Competent and vibrant Financial System:

Securities markets break the oligopoly that would be enjoyed by the banks in the absence of securities markets. 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. (Tessema, 2003)

Investor Education:

Capital markets through the brokerage community, investment advisers, security analysts, and well developed financial journalists serve to educate the investing public. Such institutions are critical to an economy. (Etienne and Vincent, 2008) Such educated investors will help in reducing unfair trade practices in securities markets. Efforts of stock brokers to accumulate wealth by speculation and short selling can be mitigated through investor education.

Barometer of the Economy:

At the stock exchange, shares rise and fall depending, largely, on market forces. Share prices tend to rise or remain stable when companies and the economy in general show sign of stability. Therefore, the movement of share
<https://assignbuster.com/establishing-secondary-market-in-ethiopia-finance-essay/>

prices can be an indicator of the general trend in the economy. (Etienne and Vincent, 2008)

Alternative to Taxation:

The Government and even local authorities may decide to borrow money in order to finance huge infrastructure projects by selling another category of securities known as bonds. These bonds can be raised through the bond markets whereby members of the public buy them. When the Government or the local authority gets this alternative source of funds, it no longer has the need to overtax the people in order to finance development. (Etienne and Vincent, 2008)

Costs of operating Securities Markets:

Security markets are not without costs. Significant costs of operating securities markets can be briefed in the following paragraphs:

Profiteering Behavior of Intermediaries:

The strategic position that financial intermediaries hold in the market system in terms of access to information and control over transactions can lead to profiteering behavior that decreases the benefits accruing from the mobilizing and allocating functions of the securities markets system as a whole. (Tessema, 2003)

Speculations:

Stock market prices do not accurately reflect the underlying fundamentals when speculative bubbles emerge in the market (Binswanger, 1999). In such

<https://assignbuster.com/establishing-secondary-market-in-ethiopia-finance-essay/>

situations, prices on the stock market are not simply determined by discounting the expected future cash flows, which should reflect all currently available information about fundamentals. Under this condition, the stock 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 as it is in danger of becoming the by-product of a casino.

Higher Costs to Intermediaries and Regulatory Agencies:

The specialized services of financial intermediaries in securities markets are costly, yet indispensable. Expenses related to the organization and function of regulatory agencies as securities commissions, stock exchanges and administrative organs represent monitoring costs associated with the control of securities markets abuses. (Tessema, 2003)

Cumbersome Reporting Requirements:

The demanding reporting requirements represent costs to participating companies. In addition, companies have incentives to falsify such reports, which result in distorted investment decisions on the part of securities purchasers that may lead to decreased government tax revenues. (Tessema, 2003)

While the first two costs, viz., profiteering behavior and speculative acts of intermediaries can be regulated by appropriate measures by regulatory agencies, the last two costs, viz., costs involved in intermediation and regulation and reporting requirements are necessary for the effective

operations of the system itself. In the long run these costs would be more than offset by the benefits derived to the participants and to the economy as a whole.

Conclusion

Establishing Securities Markets in a country is not a task that can be achieved over-night. It requires careful planning and long-term orientation. By drawing information from primary and secondary sources, this study points out the various issues to be considered for the development of securities markets. Further the study weighs the benefits and costs of these markets to the economy as a whole and to market participants, and assesses Ethiopian-specific opportunities and challenges. It lays out institutions and infrastructures needed for security market development. Considering (i) current growth in the number of share companies, (ii) need for infusing higher capital to various economic sectors, and (iii) increased capacity to save due to higher economic growth, the researchers conclude that the policymakers must seriously consider the launching of securities markets in Ethiopia.