

The Impact of Establishing Capital Market on Ethiopian Commercial Banks

Teferi Girma Bekele

Awash Bank Senior Research Development Officer, Ethiopia

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ABSTRACT

The paper analysed the implication of establishing the capital market on commercial banks operating in Ethiopia. The study aimed to identify its potential opportunities and main challenges to banks, to see how the capital market is operating in other African countries and to show the necessary preconditions to commercial banks to prepare themselves. The research method employed in the study had both qualitative and quantitative features, and the research was conducted using a mixed research method. Primary data was collected from focus group discussions with experts that have experience in the area, and, furthermore, secondary data were collected from literature and websites. The findings of the study identified the major risk of the capital market to the economy like economic risk to investments, inflationary/deflation risk, market value risk, being too conservative and political crisis by relating with the current situation of country regulation power. The study also investigated the major opportunities of the capital market to meet the financial need for the economy and how it can work with commercial banks. Besides, the study investigated its challenges to commercial banks working with security exchange companies. Many literature analyses confirmed the reputation of capital markets comparative to banks, which cannot explain across-countries deviation in economic growth. And it is better to establish a well-functioning legal framework, which plays a vital role in creating a healthy financial system. The study recommended that commercial banks should modify their business models and create products related to the investment bank and product differentiation that captures the mode of the capital market. And it is better for the commercial banks to empower their human resource, and they shall aggressively work on technology adaptation, work highly on awareness creation for all internal and external customers. Banks' capital increment should be made before the security market is established to minimise any risk that may come with it.

Keywords: Financial Market, Securities Market, Stock, Commercial Banks and Bond

Introduction

Even if the capital market had emerged in Ethiopia before the FDRE government, to this day, it is an impressive idea to many Ethiopians. It worked anywhere when a group of the market and exchange ordered activity of issuing share, transferring share from seller to buyer is openly held by companies taking the responsibility of security trade. The capital market is committed to working through legally established exchange or over the counter (OTC) market place which operates under a defined set of procedures. In a country, there can be many capital trading actors in regions that allow stocks and other forms of securities to be traded. These institutions trade stock, bonds and the like in a physical marketplace. In a developed nation, the capital market had a long history and was growing fast. As is really known, the capital market is working via online trade electronically. The buyer and seller purchase the security need using online stock traders or at the physical market. All trade provides security to the market separately, but overall stock prices are set by the market analysis brokers, who depend on news, political events, economic reports and other factors. Although the theory reveals the establishment of financial markets reduces the dependency of economics on banking industries, currently, for many African countries, the banks are the major sources of finance. Most of the African countries didn't have security markets till recent years, and a capital market existed in a few African countries where performances were stagnant for years' time relative to the developed nation markets. Ethiopia is among a few countries which did not have the capital market in Africa. But within a few periods, Ethiopia is expected to start the capital market, and like banks, it is being regulated by the National Bank of Ethiopia. It is expected to trade securities of the bank, agriculture investment, real estate, and insurance companies. The introduction of the stock exchange is expected to allow shareholders of any investment share in Ethiopia to sell their stock at any time and get their money or invest in other stocks, among others (New Business Ethiopia, 2020).

After the Addis Ababa stock exchange collapsed in the Derg regime, Ethiopia has no capital market. The market was malformed during the end of the Derg regime, it did not have the institutionalised, and the market does not have lawful backgrounds that make it workable to manage the market accordingly. The current establishment market has also developed the regulatory body before entering the market on stock trading activity. If the regulatory body didn't develop well, it would also grow into a largely unregulated space in which every person takes risks and plays for short-period gains. Maintaining the capital market within the explosion of investment entities in Ethiopia can improve the economy in several ways. The business characteristics of established companies and new companies under formation are based on transferring the shares to third parties giving rise to the availability of tradable shares in the market. The existing legal framework on stocks and tries to contrast relevant literature to give a picture of the legal aspects of stock market development.

This study tries to explain the party played in capital markets and its impact on the banking industry. The study also tries to analyse the precondition preparation by the bank before the capital market is introduced, how banks will work with key players of the capital market. Besides, it is relevant because there is a limited amount of research that has been dedicated to examining the link between capital market developments and banking services within the context

of Ethiopia. And the study also answered the probable challenges and opportunities of establishing a capital market for commercial banks were. How commercial banks are preparing themselves to work with the capital market? And to see how the capital market is operating in other African countries.

Objectives of the study

The overall objective of this study is to realise an understanding of the capital market and its impact on commercial banks and the overall economy. The specific objectives of the study are listed as follows:

- To assess how the capital market is operating in other African countries.
- To state probable challenges and opportunities of establishing a capital market to commercial banks.
- To identify the preconditions prepared by commercial banks before the capital market is established.

Methodology

Data collecting method and data sources

To analyse the study, it needs primary and secondary data, which are collected from diverse sources. Primary data were collected through focus group discussion with little expertise. From this expertise, the overview of the capital market and the impact of the capital market in the Ethiopian financial sector, especially banking industries and the overall economy, were assessed. Secondary data were also collected from different books and websites.

Method of data analysis

Analyses of the data need a qualitative research method was employed for the seeking of the nature of data. The qualitative research method is believed to be qualitative and to be helpful in obtaining pertinent and precise information that helps to draw a valid conclusion. The data for the study were analysed by categorising and sorting into meaningful patterns as the primary basis for organising and reporting the study findings.

Overview of Proclamation Issued on Capital Market Establishment

The new proclamation approved by the Ethiopian House of People Representative in December 2020 showed business operation and regulation of the capital market. As the country prepares its own capital markets establishment, the proclamation draft is assessed as having different value to market operation in the business entity and soon coming capital market maker. In addition to the proclamation draft, different literature also identified key players in the capital market—the proclamation document listed the potential key players to accelerate the establishment of a capital market in Ethiopia. The capital market proclamation draft explained how the business would establish, what is marketed by the firm and the regulatory framework of the business. It also specified regulatory bodies (members of the directory board members) with full duties and responsibilities. It explained that any private person, companies originated in the country or abroad, investors who have financial status, educational or other qualifications or experience

with respect to the nature of the application, ability to perform the proposed function efficiently, honestly and fairly; and reputation, character, financial integrity and reliability of that person can participate in the capital market.

The proclamation document said, any person who is employed by, or associated with, the applicant for the purposes of the applicant is a company, any substantial shareholder, director or officer of the company, proposed business to which the application relates, any person who will be acting as a representative in relation to such business can market makers. Besides, any other company in the same group of companies or to any director or officer of any such company and where the applicant is a foreign company, whether that company meets the minimum requirements for foreign investors stipulated under Investment Proclamation No. 1180/2020 can also be a market maker of capital trading. As the capital market proclamation draft explained, the Ethiopian Capital Market Authority is hereby established as an autonomous government regulatory authority. The authority planned to work with the country's regulatory organ and international capital market regulation. Furthermore, the authority is directly formed and governed under Ethiopian House of People Representative business law. The independent government organ 'Capital market authority' will have to regulate the activities within the capital market businesses. From many businesses, few of them are listed as; buying, selling and dealing in capital markets products, investment advice, underwriting, fund management, corporate finance advice relating to acquisitions, mergers, divestitures, combinations and other activities that involve buying, selling, and exchanging securities, custodial services, collective investment schemes, credit rating services, and any other activity deemed by the authority as a regulated activity pursuant to this proclamation.

Experience of another country

The recent data shows around 30 African countries have 38 capital markets/stock exchanges. From these countries, Egypt and South Africa have a very old capital market that passed above a century on the continent. Even if Africa's stock markets are in fast growth, it does not mean that they are mature and the most advanced. Many capital markets traders participate in only a few stocks. These account for a considerable part of the total market capitalisation, but the infant markets are suffering from the problem of low liquidity of the institutions (El Wassal, 2013). Odhiambo (2010) studies showed that for many African countries, the capital markets are an amazingly essential source of investment for capitalising on the growth of big companies. The study identifies the benefit of the capital market in South Africa, Ghana and Zimbabwe. It reveals that South Africa got several economic benefits from the capital market. In South Africa, due to capital market enhancement, new equity issues grew by 18 per cent of total assets growth between 1996 and 2016. This market is based on external debt that contributed 61 per cent of total financing, and retained earnings financed the remaining 21 per cent. The capital market in Ghana funded above 12 per cent of total assets growth of main corporations between the years 1995 and 2002. Zimbabwe equity finance had also underwritten 8 per cent to the funding of listed corporations between 1990 and 1999 fiscal years. In all of these countries, the capital

market is the most important source of long-term external finance and supports the economy by fulfilling the gap of the money market.

Since 1922, African countries under the British colony have established capital markets like the Nairobi stock exchange (NSE), which is an old security market in East Africa. The exchange comprises a world-class trading facility for both local traders and international companies observing to gain exposure to the country's economy rising. OlugBenga and Grace (2015) studies found that the effect of the Central Bank Rates on capital markets performance at the Nairobi Securities Exchange. The Central Bank Interest Rate has a negative effect on capital market performance. Therefore, an increase in the central bank rate will lead to declines in capital market performance as measured by Nairobi Securities Exchange in the all Share Index. Not only the interest rate but also the inflation rate has a negative influence on capital market performance at Nairobi Securities Exchange. In CRB adjustment, the minimal volatility should be retained so as to decline the instability of the capital market performance.

Importance of capital market to the economy

According to the focus group, interviewed expertise capital market has several roles in economic growth and development. Furthermore, authors like Singhal et al (2019) and Grout (2016) found that the economies of the world rely on the capital market to simplify the exchange of securities traders' companies. These organisations interconnect individuals who seek funds with those who can provide them. The capital market characteristically provides services as a centre of trading in securities, raised funds for investment in long-run assets to the financing freely. The other role of the capital market is summarised as follows:

I. Stimulating savings to investment: The capital market is not like the money market that activates only saving; it further converts the saved money to invest in other sectors. As societies draw savings and invest in shares, they are going to make more rational resource allocations because funds are transferred to moneymakers. The money invested in the capital market is deployed funds and forwarded to promote commercial banks and other industries.

II. Wealth Distribution: The capital market serves society by redistributing wealth to the communities and investors. The market issues the share to all communities, and anyone can get a chance to buy shares of scheduled corporations, and, therefore, everyone becomes part of the owners of profitable enterprises. The capital market has a significant role in reducing large income inequalities of developing nations because of this reason; many people get a chance to share the profit of businesses. The new investors may also use the capital market as a source of a fund that can expand their business.

III. Small investors get the investment opportunities: Unlike other financial sectors, the capital market provides finance to large and small businesses due to the fact that anyone can buy a number of shares that he or she can afford. This is through bonds and other securities traded are sold and bought by business entities. These activities result in; all small businesses can get finance to stimulate their business. Consequently, the security market provides an additional source of income to small investors.

IV. Create financing opportunities for public capital for development projects: The government bodies can easily get finance from the capital market. Public infrastructure projects constructed by the government are mainly dependent on a loanable budget. During government finance, when there is a budget deficit, it starts with selling bonds, another form of the capital market. In a country that has a capital market, bonds are marketable through the stock exchange. After the government collects money via tax, it starts to buy bonds from society. This shows the capital market is the main source of finance for government investments.

V. Used as an institution Governance: The capital market has the benefit of monitoring market exchange-traded as security. It works efficiently and fairly, and many decades ago, the stock exchange had been raising opportunities for a newly emerging corporation.

VI. Indicator of the economic growth: The capital market is used to measure the economic performance of the nation. The fluctuation price of the share, shares rise and fail to depend, largely, on market forces. Price share fluctuation to be rising or remain stable when companies and the economics are in general unstable. This up and down movement of share prices is the indicator of the economic performance of the country.

VII. Create job opportunities: As with any business capital market, the market helps the economy by creating jobs for the citizen. A capital market helps the economy by reducing unemployment. The market characteristics are a diversified business that can allow many actors in the business. Due to the fact that many actors come up with diversifying businesses and need technology and human capital, it is an opportunity for unemployment.

The Implication of Capital Market on Commercial Banks

Opportunities of capital market

The respondents who participated in the interviews indicated that the capital market has huge opportunities for commercial banks. The writers like Frederic and Mishkin (2016), book analysis, unlike the bank, the capital market is not the main finance for external business, and it has various opportunities for the banking sector. Besides, focus group discussion interview analysis and authors like LeBaron (2002), Chang et al. (2013), Teklehaimanot (2014) also suggested that the opportunities of capital market to the commercial banking as follows:

- I. The commercial bank can participate in the capital market as intermediaries, issuers and investors. It diversifies the earnings of the bank by collecting resources by the cost of others. Thus, capital markets have complemented service to the bank rather than substitute and have better opportunities for the development of the banking sector.
- II. Financial institutions can efficiently mobilise savings and clue to investment. The economy results in the smooth accumulation of capital, and the banking sector can boost profits by creating special credit products that may line with capital market products.
- III. If a company (which is a private company) or a newly incorporated public company want to raise capital and get listed on Stock Exchange, it will have to issue shares subscription forms (Initial Public Offer/IPO); these IPOs are sold to investors via forms available with banks. Consequently, commercial banks can enhance and automate its operation to provide excellent service.

- IV. The capital market always corrects proper stock valuation, and it predicts the forthcoming growth potential of the business. This economic accuracy results in being able commercial banks to make healthy loans, repayment of the principal as well as interest and fees on other accounts, and limiting counterparty risk business of the bank.
- V. The local capital markets allow the capital distribution of the national economy. The financial dependency of the monetary market enhanced by efficient capital market development
- VI. Financial markets liberalisation can also result in the local banks to interoperability of trade with international financial sectors. Hence, commercial banks may expand their services abroad or operate in foreign markets.
- VII. One of the main categories of the capital market, bond security exchange, allows safe delivery of bank loans and offers a relatively low cost of financing to large investments, trustworthy companies that have the scale and credentials to tap long-term capital markets. This makes banks safer and profitable.
- VIII. Investment Derivative: The capital market results in boosting investment in the country; this leads commercial banks to mobilise more resources. Investment and Reinvestment by the capital market have gained enough capital, customers and better goodwill to participate, and economic enhancement has direct relation to deposit mobilisation.
- IX. African intercontinental trade organisations and other international institutions may sustain the Ethiopian capital market, which may come with foreign new services of the financial market. They may come up with different financial technologies that may help domestic commercial banks.
- X. Financial technology derivatives: The capital market may emerge through new technologies. These technologies are interdependent with bank products that commercial banks may utilise. These financial technologies are derived from the capital market.

Challenges of capital market

The data collected from respondents show not only benefits in developing countries of the capital market can create several challenges to commercial banks. Author like Yartey and Adjasi (2007), Celebi and Hönig (2019) enlightens challenges of the capital market in developing countries. According to these authors, primarily capital markets have the challenge of market integration. The African market is highly detected by low liquidity problems, and there is an impossibility of integrating the market. Many analysts assessed in the empirical literature have said that the regional based on capital markets in Africa result in the problem of low liquidity. This may examine the newly developed Ethiopian capital market because of several reasons, like, continuous country inflation, monetary market interest rate and money market instability. The second challenge of the capital market is demutualisation to solve the governance and profitability problems. The demutualisation of African capital markets has been consolidated gains from technological and regulatory reforms. The third and most critical issue is the need to reduce existing weaknesses to develop in-dependable organisations. By its behaviour, the market needs to be highly regulated to regulate an institution. In addition to this, focus group discussions

and different author's like Chewaka (2014) found sets of overall capital market challenges on the commercial bank are listed below:

After the capital market is established, investments are usually financed through share and bond options rather than bank loans. The capital market will play an unlimited role in causal investment and occupations in market sharing. The price fluctuation in the capital market can have an insightful economic implication on the economy and individual consumer behaviour. Failure in share prices can result in bankruptcy and the possibility of being because of multiple economic disruptions which negatively influence commercial banks. Furthermore, investing in the capital market has riskier and has less liquidity than investing in the money market. Many investors may look only for liquidity rather than risk. Due to this, many investors may prefer the capital market to commercial banks. Additionally, when the capital market miscarries happen, investment activity of the country shall slow down, and commercial banks with brokerage occupations are unpleasantly affected. When the economy starts to rise, in reverse, the commercial banks start to be healthy. This shows failing capital markets is clearly hazardous for banks, but in some conditions, the economic and political inventiveness of economic recovery can also pose problems.

Many researchers argue that numerous government accomplishments shall plan to keep interest rates low to encourage economic recovery primarily because the capital market rises, but eventually weaken the recovery and contribute to rising interest rates. Both conditions are commonly bad for the banking industry. Foreign direct investment participation may have a cheap cost of investment on financial capital channels. The FDI flows partly to show the use of relatively low-cost capital available to overvalued parents in the country. This means when a capital market is established in the country money market may decide to decline interest rate to be continuing competently. This factor and the liberalised market may attract foreign investors who may create stiff competition on domestic commercial banks. African intercontinental trade may expand their market to Ethiopia and come up with different foreign direct investments like foreign banks that may make stiff competition. These banks have the huge capability of capital, technologies, very skilled professions and a large business experience. In addition to this, after the capital market is operated in the country, it may have a negative impact on the banking sector.

Major types of risks for capital market

According to the interview respondents, capital market investment has a big risk compared to other business activities. There are some risks that are controlled over and others that can't only be guarded against. However, other risks are inherent in investing, which the investor can't control over. These risks mostly affect the market, the economy and have to need investors to correct portfolios or ride out the storm. The following are major types of risks that investors face in capital market investment.

I. Economic Risk to Investments

Due to the fact that several reasons the economy fell in bank condition. Economic investment is one of the most and usually happening risks of investing that the economy can go in bad ways. For young investors, the risk is a big headache, and the best strategy to mitigate risk is often to

squat down and ride out the business downturns. When we compare the economic risk of foreign and domestic stock investors, the former has a bright spot, and the latter has the dumps business flow. In a collapse economy disaster, there may be no truly safe places to turn new businesses, and the mature investors are in a tighter bind.

II. Inflationary/deflation Risk

The capital market is badly influenced by economic fluctuation. Both inflation and deflation fluctuate in the economy, which is a risk factor of the capital market. Inflation destroys economies' value and results in economic downfalls. Although inflation in the economy may be under control, the higher interest rates may at some point be as bad as the problem to the market and need other remedial action to control.

III. Market Value Risk

Market value risk may happen when the market goes indifferent to an investment way. Sometimes the market goes on the wrong side of expected economic flows, and an existing company mainly declines with the market value downturns. The market value is chasing the "next hot thing" and leaves many good but unexciting companies left to the side.

IV. Being too Conservative

The investor may be risk-averse, which may be another risk to capital formation. More conservative or careful investors do their best, but they may have faced many problems to run the businesses in a healthy situation. As the investor becomes more conservative and never takes any risk, it may be difficult to grow as expected.

V. Political Crisis

The political crisis has resulted in economic shock and market price fluctuation. Measuring the implication of political instability on all economic activities is the biggest problem in developed nations. The major indicators of political crisis are any signal that the dominant return spread is dependable to the political situations of the nation and to augment the political risk-influenced project discount rate by increasing the cost of investment. The net present value of the project is greater than the net future values of the project. Although self-governance is dominated by others, it is influenced by political risk; it also reflects other risks that are likely included in the valuation analysis leading to the double-counting of risks. In addition to these risks, after the capital market is operated in the country, it may negatively harm the banking sector. Singhal et al. (2019) studies showed the capital market development indicators like market size, liquidity and volatility along with bank credit to GDP ratio as an indicator of banking sector development, and Industrial Production as the proxy for GDP. The study conducted in the Indian capital market showed that it does not affect the banking development, but the capital market growth has a close relationship with economic growth.

The implication of capital markets establishment on commercial banks

The capital market establishment has several opportunities and also has some challenges to the economy. Having a capital market in the nation creates additional financial alternatives for the investors. It also creates job opportunities for the citizens, and additionally, it makes the economy healthier. The capital market is a risky business compared to others and needs a strong regulatory body. The riskiness of the business may reduce by strong regulations and by having

skilled human capital in the area of its work. The derivative of economic influence by the capital market could also harm the money market. Even though both businesses can work in parallel, some customers of the bank may shift to the capital market that may negatively influence the commercial banks. Relatively, the positive weighing scale of the capital market to commercial banks makes both sectors work mutually.

Conclusions

The capital markets have contributed the visible finance for the growing economics of a large corporation in some African countries. But, to this day, African capital markets have faced the challenge of market integration, better technics and institutional sustain and develop it to overcome the problem of low liquidity. As it is a newly emerging business in Ethiopia, it has several opportunities and challenges for the economies. The preconditions to start the capital market may have been seen in different ways. It is limited to successful regional approaches, including the harmonisation of legislation such as regulations, accounting laws and a liberalised trade regime, the vital one. The robust electronic exchange systems and central depository systems have remarked important before the market inter to trade. Furthermore, financial liberalisation of the domestic economy, such as steps to improve the legal and accounting framework, private-sector credit evaluation capabilities, and public sector regulatory oversight, would also be seen as a pre-condition by concerned government bodies.

The listed opportunities and challenges of the capital market in the banking industry may be several types. This relationship between capital market return and liquidity management of commercial banks is seen both as an opportunity and challenge. The existence of a tradeoff between liquidity and profitability of banks affects the stock returns. This can be attributed to the fact that a stock price that affects the returns fully incorporates publicly available information according to efficiency market theory.

The coming new business idea, capital market the alternative investment possibility. As Ethiopia failed in a vicious circle of poverty, currently, it faces the problems of poor diseconomy of scale. The establishment of a capital market in Ethiopia is one of the major initiatives taken by the Ethiopian Government to improve national economic growth.

In general, the capital market and the banking industry have complementary markets that work together. Not only challenge/risk capital market has its own opportunity for the bank. It makes the banks strong bank financial industry providers by creating a better technology environment. Any financial transaction is done through a bank, according to some countries' experience. This study shows both have a positive impact on economics and are recommended for developing countries.

To minimise the capital market challenges and extract its opportunities, commercial banks should place in a good liquidity position. Their management frameworks shall remain viable to make returns for their investors. Banks should now the linkages between the financial and real sector composition effects of the financial could have a significant effect on banking industry development. Therefore, as a commercial bank to utilise those stated opportunities and minimise challenges, we have stated the following critical recommendations:

- ✓ The capital market works with domestic investment and foreign direct investment. Because of this, it is better for commercial banks to change their models and expand their products that link to the investment bank.
- ✓ The capital market is more structured than the money market, and the returns on investments are high on capital compared to investment in money markets, and the work on the transfer of funds from lenders to borrowers should also be more efficient and effective. The commercial bank shall assess and modify the strategy that can make them robust competent in the market.
- ✓ Intermediary institutions will expand their products and services that are dependable on more revenue from credit services. As an intermediary, commercial banks shall lead fin-tech that capital market and commercial bank use together.
- ✓ The commercial bank shall know major risk factors, work with the capital market and formulate risk mitigation strategy to minimise risk.
- ✓ The majority of banking industry income is generated from loans, and they are sensitive interest-rate. Any bank needs to maximise its revenue by increasing its price interest from loans and minimise the cost of funds that is interest paid out on depositors. Deposits are liabilities, loans and receivables are assets for banks. But the capital market may work in a reverse way that can cause a decline in bank base business demand. Therefore, commercial banks should revise their cost (interest paid to the depositor) and price (interest received from the borrower) strategy.
- ✓ The idea of the capital market is new in our country this year which needs knowledgeable, skilled and aware human capital to work together. So commercial banks shall have trained their human resource with new technology and theories.
- ✓ The capital market is a market to the banking sector. The commercial bank should have a strong strategy of banking market leadership strategy and should have a new strategy to work with the capital market. Commercial banks were expecting to see the capital market go to market, operating time and maturity period of the capital market return interest to companies and individuals.
- ✓ The capital market has an opportunity and challenges that management should see the impact when the market is opened or start implementation and modify the strategy to be competent enough. If the capital market opens in Ethiopia, commercial banks have many roles in the market. As listed above, commercial banks can collect many service charges by regular activities of banks (selling bonds, notes). Not only these activities, but the National Bank of Ethiopia may also modify the role of banking industries in capital market participation by (selling, buying) bonds, notes and other products in the capital market.
- ✓ Commercial banks expect to increase their capital before the capital market is operated. It is advisable to increase its capital to participate in various roles in economic activities, should invest in cutting-edge technological advances and the phenomenal speed of access to financial information. So commercial banks should have matured enough to compete in the market.

- ✓ Commercial banks shall aggressively deliver service through technological improvements, work highly on staff capacity building and awareness creation. This should be the vital decision of banks before the capital market is emerged to minimise all risk that may come with it. The technology derivative implication of commercial banks is big enough to work with the capital market.

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