CHAPTER – I
INTRODUCTION

Over the past few decades, the world stock market has surged forward and emerging equity markets have experienced more rapid growth, taking on an increasingly larger share of this global boom. Stock exchanges play a great role in the investment process by providing mobilization of domestic savings and international capital. Stock markets encourage economic growth by providing an avenue for growing companies to raise capital at lower cost. The stock market provides easy access to long term financing capital for financing new projects, and allocating long-term capital to the private sector for growth and poverty alleviation. The stock exchange provides aggregating information about firm's prospects, thereby directing capital to investment with returns. Stock markets have also become very important in recent years as a major channel for foreign capital flows to emerging economies. The creation of a stock market will compliment commercial banks in term of investments. Stock exchange may play the role of a market monitor to ensure that the said market is working efficiently, fairly and transparently. Securities markets enable firms to improve their gearing ratios. Formal capital markets promote high standards of financial reporting and provide minimum standards of disclosure. Privatization through stock exchanges facilitates the public flotation of shares and transparent as well as supporting a narrowing of the income gap.

However, while most economists agree that stock markets help countries develop, many would agree it’s not a first priority. Setting up a stock exchange becomes in a necessity only when a country is at an “advanced stage of industrialization. One of the disadvantages of the stock market is that it develops its own speculative growth dynamics, which may be guided by irrational behavior. Also a very liquid stock market may encourage investor myopia. Liquid markets may weaken commitment of the investors and reduce their incentives to exert corporate control by overseeing managers and monitoring performance and potential of the company. These problems are further magnified in emerging market economies with their weaker regulatory institutions and greater macroeconomic volatility.
To take advantage of stock markets benefits, some less developed countries are now working on plans to launch a stock market. Yemen is one of these countries. The World Bank and Arab Monetary Fund (AMF) generally view stock markets as important and urge countries to set them up.

Therefore, an understanding of the critical prerequisites to the proper functioning of a stock market is very important. For example, political and macroeconomic stability, growth prospects of local business, a certain level of savings with a relatively large distribution, institutional quality and financial intermediary development. In addition, creating a successful stock market is not likely to be easy. Its implementation will face many challenges and obstacles that need to be addressed such as a low savings rate, lack of resources, a complex tax regime, lack of awareness, a small economy and the structure of companies that are family owned, absence of financial intermediaries, low level of protection, poor performance of the judicial system and so on. Obviously, there are many studies both theoretical and empirical which have concentrated on the importance of stock market development, prerequisites of development stock exchange in small countries and the factors that impede and facilitate the development and/or creation of less developed economies’ stock market.

Yemen is the only country in the Asian Arab region, which has no stock exchange so far. The economic reform program of the government emphasizes the need for setting up a stock market in Yemen. Therefore, the study attempts to focus on the feasibility of stock exchange in Yemen by identifying mandatory requirements for setting up stock exchange and exploration the prevalence of these requirements. In addition, the study is to focus on the major obstacles in setting up stock exchange in Yemen. Furthermore, the study looks at the outlook of companies and financial institution attitudes in Yemen towards investment in the stock exchange, the appropriate trading system, institutional structure and best of the alternatives of financial intermediation.
1.1 Statement of the Problem

The establishment of a stock market in Yemen is essential for economic growth and development, particularly, for mobilizing savings for investment and industrial development. When people accumulate their savings and invest in shares, it leads to a more rational allocation of resources.

Yemen, like any other developing countries, is facing problems of poor economic growth. The financial system in Yemen is primarily bank based and thus suffers from the usual bias of bank financing towards short-term credit requirements. The non-bank sources of medium and long-term financing are generally underdeveloped. Securities markets are seen as an alternative to bank finance as a means of addressing the shortage of long-term finance. The Yemeni government has an initiative to encourage establishment of stock exchange. Experts also have confirmed the importance of establishing a stock exchange in Yemen which would help mobilize savings, enhance economic growth and spur development. Starting a stock exchange is a new issue in Yemen. The government is facing several challenges and obstacles in this regard. In addition to these obstacles, creating a stock exchange in Yemen is not in itself sufficient to promote full development of the capital market unless the essential requirements of establishment are to be taken into consideration and satisfied. By using the research problem stated above several questions arise concerning the success of these initiatives.

1) What are the mandatory requirements and essential conditions for setting up of a stock exchange?

2) Are these mandatory requirements for setting up of a stock exchange prevalent in Yemen?

3) What are the major obstacles in setting up stock exchange in Yemen?

4) What is the attitude of the Yemeni companies towards listing themselves in the stock exchange?

5) What is the attitude of the financial institutions and private sector towards investment in equity?

6) What are the appropriate institutional structure and trading system for development of an equity market?

7) What are the possible alternatives of financial intermediation?
1.2 Significance of the Study

In tune with a global pattern of rapid development in the equity market and following recommendations of the World Bank and International Finance Corporation, the number of stock markets in developing countries has increased dramatically over the last fifteen years.

The idea of creating a stock market in Yemen was born at the beginning of the structural adjustment program (SAP) in 1995 sponsored by the International Monetary Fund and the World Bank. The World Bank and Arab Monetary Fund (AMF) pointed out that the establishment of a stock market is very essential for the Yemen's economy. The government of Yemen has recently decided to open a stock market in 2011. Therefore, the present study attempts to identify and examine the mandatory requirements, their prevalence and investigate the major obstacles faced in setting up a stock exchange in Yemen. Also, it examines the attitude of Yemen financial institution in Yemen towards investment in the stock exchange. The study also attempts to explore the appropriate trading system, institutional structure and best alternatives of financial intermediation to ensure a sound and stable development of the securities market in the future.

The study would be an addition to the existing literature on the stock markets. The findings of the study would be helpful to the formation and operationalization of the upcoming stock exchange in Yemen. It would provide a better understanding of the importance of stock market to individuals in business and other fields. This study is timely because it addresses many of the important research questions that have been raised by the World Bank, many government officials, and policy makers in Yemen. Furthermore, studies on this issue are very extremely limited in Yemen and no previous has seriously and sufficiently examined the feasibility of stock market.

A systematic investigation of the research questions would help the formulation of policy recommendations toward the development of stock markets in Yemen. Additionally, the policy lessons from this study may be applicable to other smaller countries that share similar features and problems with Yemen. Furthermore, this study, it is hoped, would provide a substantial and significant contribution on this area which would pave the way for further research and studies.
1.3 Objectives of the Study

So far, there has been a severe dearth of studies on feasibility of stock exchange in Yemen. Therefore the present study is an attempt to provide a significant contribution to this field. The present study is undertaken with the following objectives:-

1. To identify the mandatory requirements and essential conditions for setting up of a stock exchange in Yemen.

2. To examine the prevalence of these mandatory requirements for setting up of a stock exchange.

3. To study the major obstacles in setting up stock exchange in Yemen.

4. To explore the attitude of Yemen's financial institutions and the private sector towards investment in the stock exchange.

5. To explore the appropriate trading system, institutional structure and best alternatives of financial intermediation to ensure a sound and stable development of the securities market in the future.

6. To develop some policy recommendations based on the results of the study.

1.4 Scope of the Study

As a background, the study presents a general overview of the development of the stock market in the various countries in the world, including the Arab World. Analysis of the development of stock exchange in Sudan, a neighboring country with similar economic and social conditions as an implication for setting up stock exchange in Yemen is studied. The primary focus of this study is to explore the feasibility of stock exchange in Yemen. The study covers the economic and financial system and the important factors that affect the development of stock exchange in Yemen. Quantitative data on macroeconomic, financial and socio-economic variables for the period 1990-2007 is analyzed to examine the need for stock exchange. Analysis of primary data is carried out with the help of questionnaire to explore the feasibility of stock exchange in Yemen. Questionnaires were distributed to top managers in large business companies and concerned government bodies in Yemen. The collected data is analyzed using appropriate statistical tools.
1.5 Methodology of the Study

1.5.1 Research Design

The present study is exploratory as well as descriptive in design. The exploratory technique is used in this research to provide insights into and comprehension of the issues as well as map the problem environment. Descriptive research is involved in collection and analysis of primary and secondary data. In this study, data pertaining to the pertinent aspects of the Yemen economy is presented in detail in order to answer questions concerning the current status of the economy. Descriptive data and characteristics of the population or phenomenon are studied.

The study draws data from different sources and uses a multimethod approach. The first method analyzes the data on other stock markets, their experiences and the factors that gave birth to their stock markets and development. The second method collects and analyzes the economic and financial data in Yemen over the period 1990-2007. Data collected through questionnaires supported the secondary data. Questionnaires were distributed to the top managers in large corporate sector in Yemen and government bodies to ascertain their opinions on the need for and feasibility of a stock market in Yemen.

1.5.1.1 Source of Data

(a) Primary Data

Primary data was collected through field survey questionnaires. Closed structured questionnaires were distributed to top managers in both companies and government institutions. In this survey, one respondent was selected from each company. Respondents were presumably having sufficient knowledge to answer questions relating to stock exchange. Questionnaires were collected from the respondents themselves. Respondents’ profiles, geographical locations, characteristics of business, size and ownership structure of the companies were identified in this survey in order to achieve the maximum representation of the population. The questionnaires were in a closed form, which permitted only pre-specified related questions. Respondents were asked to answer the questions pertaining to general and stock exchange-related issues. Interviews were held to explain the intention of the survey and to clarify if there were any unclear questions and to comprehend incomplete answer.
(b) Secondary Data

Secondary data was obtained from various annual reports, National Account Statistics, reports and publications of the Central Bank of Yemen, International Financial Statistics and World Development Reports. Quantitative data (1990-2007) on macroeconomic and financial variables was collected. Macroeconomic and financial development variables were analyzed, which may include the level of income, average rate of economic growth, inflation rate, domestic saving and investment, size of the capital market and financial development indicators and so on.

1.5.1.2 Sampling Design

The research sample size constitutes fifty large companies and nine government bodies. Top managers were considered as the most appropriate respondents because they are familiar with stock exchange and are involved in the business decision making. A structured questionnaire was administered to 10 Partnership Companies (PC), 12 Limited Liability Companies (LLC), 20 Closed Joint Stock Companies (CJSC), 8 Open Joint Stock Companies (OJSC) and 9 Government Institutions (GI).

These questionnaires consisted of both closed –end questions and one open – ended question, in order to ensure that respondents had the full opportunity to express their comments and suggestion for the survey. Since, all the respondents were Yemenis, the questionnaire was translated from English into Arabic language by an expert who is fluent in both Arabic and English languages to ensure the consistency of the questionnaire.

The survey population included large sized firms, banking institutions, insurance companies and government institutions. Large size firms were chosen because the smaller ones are less likely to be listed in the stock exchange. Large firms are more likely to list themselves and more likely to be eligible for listing in the stock market and are willing to fill up the questionnaires. The sample selected at the organization level consisted of chairman, board member, general director, owner and financial manager. The subjects for the study were business companies operating in Yemen with a focus on large companies as well as concerned government bodies. The population of the companies was classified into Partnership Company (PC), Limited Liability Company (LLC), Closed Joint Stock Companies (CJSC) and Open Joint Stock Companies (OJSC).
At the beginning of July 2009, the questionnaire was pre-tested on five Yemeni large business principals in order to evaluate its appropriateness. The field work was conducted during the period from July 10th to 31 October 2009. Majority of the responding companies were distributed in the capital city where headquarters of companies are located. The list of companies was obtained from the Chamber of Commerce in Sana’a, the Ministry of Industry and Trade, Businessmen's Club, and private sources. Worthy of note is that no relevant government or nongovernment body has a comprehensive list of medium and large scale firms that can be used solely. The questionnaire was administered by the researcher to the respondents by hand. To reduce non-response bias, one to five reminders were given and the cut-off date for responding was October 31th 2009. Data analysis was started in November 2009.

1.5.1.3 Pilot Study

Pilot study was tested twice. The first test involved 2 experts and practitioners in the stock market, and the second one five firms among the selected companies. The objective was to evaluate the survey's questions and to provide suggestions for improving the survey in both form and content. The suggestions from the pilot survey were evaluated and used to improve the questionnaire. The final questionnaire was divided into six sections. The first one focused on respondents' and companies' profile. The second section designed to explore the awareness and the attitude of the Yemen's financial institutions and the private sector towards listing and investment in the stock exchange as well as the views of respondents on the expected performance of the stock market in Yemen. The third section included 15 questions to identify essential conditions for setting up of a stock exchange in Yemen. The fourth section consisted of 15 questions to examine the prevalence of these mandatory requirements for setting up of a stock exchange. The fifth section had 17 questions meant to study the major obstacles in setting up stock exchange in Yemen. The final section consisted of 5 questions to explore the appropriate trading system, institutional structure and best alternatives of financial intermediation.
1.5.2 Data Analysis

After getting all responses from the participants, the researcher developed a database structure which integrated the data for this study. The researcher has kept all the information that participants provided completely confidential. The statistical techniques used for data analysis included descriptive methods like percentage, frequency table, cross tabulation etc, one sample t-test and Friedman test. Results on continuous measurements are presented on Mean ± SD (Min-Max) and results on categorical measurements are presented in Number (%). Significance is assessed at 5% level of significance. 4x2, 4x3, 4x4, 5x3, 5x4, 5x5 and 5x6 Fisher Exact test has been used to find the significance of study parameters on categorical scale between two or more groups. Chi-square test and 95% Confidence Interval have been computed to find the significant features. The Statistical software namely SPSS 15.0, Stata 8.0, MedCalc 9.0.1 and Systat 11.0 were used for the analysis of the data and Microsoft word and Excel have been used to generate graphs, tables etc. Finally, the researcher has interpreted and discussed the results of the data analyses, and drew conclusions and made recommendations from the study.

1.6 Limitations of the Study

The study was conducted with the help of a structured questionnaire as well as economic and financial data in time series during 1990-2007. Hence, the following are the specific factors that may have influenced the outcome of the research.

1. The number of cases was rather limited for arriving broad generalizations. The sample size consisted of 59 managers in top management in both very large companies and government institutions in Yemen. Therefore, the results may not be generalized to all companies without additional research efforts.

2. Sensitivity of the questionnaire may also influence the results of this study. Thus, it is possible that participants who have responded do not accurately reflect their behavior.

3. The study is also constrained by the information provided by the respondents. A few respondents were not quite aware of the nuances of stock exchange and have responded rather vaguely.

4. Respondents were asked based on their current outlook and their attitude may change over time.
1.7 Organization of Thesis

For analytical convenience the thesis has been organized into eight chapters. The first chapter covers introduction, the statement of the problem and the background of the study. It also deals with research methodology, objectives of the study and the scope and limitations of the study.

The second chapter gives an overview of the concept of stock market. It also discusses the evolution of stock exchanges in various countries of the world, including the Arab World. The Chapter concludes with a case study of the development of stock exchange in Sudan. The third chapter presents a review of the existing literature on financial development and economic growth, stock market development and economic growth. It also exposes the determinants of stock market development, hurdles to the development of a stock market, and the past studies on establishing a stock exchange in Yemen. The fourth chapter presents an overview of the economy of Yemen. It reviews the trends in macroeconomic determinants of stock market development in Yemen. The fifth chapter reviews the financial development, the resource mobilization and credit allocation of banking sector in Yemen. The fifth chapter analyses the state of Yemen’s capital market. The sixth chapter interprets the results of the data analysis made with the help of appropriate statistical tools and techniques. The seventh chapter, the last one, presents the summary of the findings of the study. It also brings out the policy implications and conclusions of the study.