A REVIEW OF POST-1974 MONETARY POLICY IN ETHIOPIA

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I. INTRODUCTION

Discussions of monetary policy often begin with a review of the objectives it is supposed to achieve and the institutions which execute the stated goals. It is within this framework that the choice and efficacy of instruments of policy are assessed. In this section, an attempt is made to define the concept of monetary policy and the objectives it is meant to attain as well as to outline the analytical basis of the workings of monetary policy in LDCs.

Monetary policy can succinctly be defined as "the deliberate use of the monetary system by the government and the central bank to regulate or influence the economy" [Livingston 1975:374]. It is in general supposed to help achieve "full employment non-inflationary level of total output" [McConnel 1984:293]. In other words, the usually stated objectives of monetary policy include full employment, high growth rate, price stability and balance of payments equilibrium [Chick 1973:2]. The monetary institutions responsible for the attainment of these objectives consist of the banking and financial institutions under the supervising lead of a central bank, also variously called as the Reserve Bank, the National Bank, etc., of a given country.

The literature on the role and scope of monetary policy in LDCs is varied, however. In some, the discussion is in terms of the appropriateness or otherwise of those instruments which we know as applied in developed countries.[1] And it has been concluded, not mistakenly, that the role of monetary policy is highly limited in an economic setting where the requisite institutional features are lacking.[2] In others, which consider the above perception as inadequate, monetary policy is taken as one instrument of policy for promoting development in LDCs.

The latter strand of thought argues that, given the right theoretical framework, there is an important role for 'developmental monetary policy'.[3] Views, however, diverge on how monetary policy is to be designed within this line of conception. Some base their views on what is called the 'prior-saving approach', a theoretical framework that follows from the conviction that it is shortage of savings that is the main bottleneck to development in LDCs, and therefore emphasize the need for an initial accumulation of saving before any meaningful investment is to take place. In relation to financial intermediation, monetary policy is to be designed, so goes the argument, in such a way that it is able to draw as much personal savings as possible into financial institutions; the high interest rate policy and discreet monetary expansion are reflections of the above view with respect to the development problems of LDCs. There is, on the other hand, a view that considers investment to be the most essential factor determining the pace of growth in LDCs and emphasizes

the need for a concerted effort to raise the level of investment in these countries. The policy prescription in the designing of monetary policy that follows from this view, called the 'investment-first approach', is low interest rate policy coupled with easy money expansion.[4]

These two approaches to monetary policy have, however, been criticized on the ground that they depict a "... partial view of what is really involved in the process of economic development" [Khatkhate 1972:534]. Saving and investment are considered, in the new approach called the 'flows-of-funds approach', to be equally important in the development process, so much so that "... what is at the center of things is not a mere act of saving or investment but the existence of a channel through which the surplus funds of some economic units can flow to those that need them" [Khathhate 1972:546].

This approach is assumed to capture the entire issues involved, for it underlines the role money plays in economic development as a 'conduit' of resources from surplus to deficit sectors. Given this conceptual framework in the designing of monetary policy in LDCs, discussion of techniques and instruments of policy become mere 'appendage to the relevant economic theory.'

It is, however, noted that in the initial stages of the development of an LDC, the task of promoting and strengthening financial intermediation can indeed be difficult for the simple reason that the task consists not only in accommodating whatever demand for financial intermediation there may exist but also in actively developing and strengthening the financial sector itself. Thus developmental monetary policy could begin with the mobilization of personal savings and channelling the funds so mobilized to sectors of the economy where investment demand is high. As development gets momentum and people start to part company with currency, however, provisions of alternative financial assets for the repositories of savings can constitute the objective of developmental monetary policy. This, in itself, can stimulate the development of markets in financial assets and the further deepening of the financial sector, which will eventually lead to the widening of policy instruments open to the authorities. In summary, the gist of the argument is that monetary policy should be designed with a view to the broad objective of the development of an LDC.

The above brief discussion, it is hoped, will provide a framework for the analysis of monetary policy in post-1974 Ethiopia, which period is characterized by the intensive, though unsuccessful, attempt to socialize the economy. The theme of this paper is to see to what extent monetary policy has been used towards the achievement of the development objectives of the previous regime.

II. THE FINANCIAL SECTOR OF ETHIOPIA: A REVIEW

The present structure of the Ethiopian financial sector is more or less shaped sometime in the past. The sector is led by a central bank, the National Bank of

Ethiopia (NBE), with powers and duties that central banks customarily have and perform [*Negarit Gazeta* No. 99/1976, Articles 3-10]. Within the sector, there is the Commercial Bank of Ethiopia (CBE), the Agricultural and Industrial Development Bank (AIDB) and the Housing and Savings Bank (HSB). Two contractual savings institutions can as well be viewed within the sector: the Ethiopian Insurance Corporation (EIC) and the Pensions and Social Security Authority (PSSA).

With the trend towards central administration of the sector, there has also been increasing specialization in the activities of banks and other financial institutions. The CBE is now the only bank that provides comprehensive commercial banking services[5]. The AIDB directs its lending activities to the long- term and medium-term credit needs of agriculture and industry, financing its activities from domestic and foreign resources. The HSB, on the other hand, provides loans for the long- and medium-term financing of the construction, purchase and maintenance of low-cost residential housing and commercial industry, funding its operations basically from savings accounts and time deposits it provides to the public.

In the case of the EIC and PSSA, their role in the financial sector consists in the provision of loanable funds, the former mobilizing finance through the provision of insurance services, while the latter from the public sector employees' pension contribution. In addition, the role played by the large number of institutions such as credit and savings co-operatives and, *'idir'* and *'equb'* cannot be underestimated. Furthermore, credit provided through service co-operatives as agents of CBE to rural areas is worth mentioning in this regard.

On the other hand, markets for financial assets are virtually non-existent, which is a reflection of the low level of development of the economy in general and the rudimentary state of the financial sector in particular. The rather less important market in government securities is institutionally administered, where the NBE, at the request of the Ministry of Finance, allocates treasury bills to banks.[6] Thus, it can safely be said that money and capital markets in the Ethiopian financial sector are underdeveloped.

III. FINANCIAL INTERMEDIATION

It seems highly germane to review the general set of objectives that are frames of references for the formulation of monetary policy before directly going into the discussion of the financial intermediation of the sector in expediting the overall objective of socializing the economy during the post-1974 period.

A. Monetary Policy Objectives

As part of the national economy, the financial sector within the framework of central planning was required to play an important role in the socialization process since the early days of the revolution. In the preamble to the Monetary and Banking Proclamation of 1976, it is stated that "the systematic mobilization and use

of financial and monetary resources is an essential component of overall planning in order to enhance the achievement of nationally desired goals" [*Negarit Gazeta* No. 99/1976]. This proclamation also underlines the necessity of "... reorganizing, coordinating, controlling and centralizing, the banking systems ..." [*Negarit Gazeta* No.99/1976]. It is thus clearly indicated in the legal foundation of the sector that the sector is to be an instrument in the building of socialism, itself undergoing a structural change towards centralized direction.

Within this general policy framework, the NBE is to:

1. foster balanced and accelerated economic development,
2. promote and maintain high level production, employment and real income,
3. encourage and promote the full development of the productive forces of Ethiopia [*Negarit Gazeta* No.99/1976].

Though the above objectives are so general and entertain overlapping goals[NBE 1986], they can nevertheless serve as reference to discussions of monetary regulations within the Ethiopian context.

B. Savings Mobilization.

The banking sector, within the policy framework of central planning, has been playing an important role in the mobilization of savings, though on a modest scale [NBE 1986]. The banking sector's ability to mobilize domestic savings is a function of many factors: the level and distribution of income, the public's habit of banking services and the legal and institutional framework within which banks operate are a few of them.

Given the level of income and people's habit of savings, the volume of savings the financial sector attracts in general depends on the return it provides (vis-a-vis other alternative savings instruments) to financial savings. In other words, the interest paid on different deposit instruments can affect the asset portfolio of the public. In the case of Ethiopia, banks and other financial institutions were made to operate within a legal framework that empowers the NBE to set the rates of interest payable on different classes of deposits [*Negarit Gazeta* No.99/1976, Article 32]. The rate structure was such that it enables small depositors to earn an interest of 6 per cent on savings deposits while no interest is paid on demand deposits and, given the term structure, the rate on time deposits ranges from 1 to 7 per cent (see Annex 1).

Although very general, the interest rate structure as of June 30, 1985 clearly reflects the general policy orientation referred to above. In 1986, however, a more comprehensive interest rate policy, both in terms of rate and term structure, was put into effect [NBE 1986]. In that regulation, not only is the term structure stated but also which institutions are allowed to hold which deposit accounts clearly indicated. Interest is not paid on demand deposits whereas time deposits of longer maturity offer interest payments as high as 5.5 to 7.5 per cent per annum. We see in the new policy a clear intention of promoting longer maturity time deposits, for the rate for

over one year has been raised from 6 per cent to 7.5 per cent per annum. Whereas the rate on savings deposits remains at the flat rate of 6 per cent with an additional provision that the rate is applicable to deposits not exceeding Birr 100,000, for amounts above this magnitude a 2 per cent rate is to be applied.

It is also interesting to note the types of deposit accounts allotted to different sectors and economic units in the new interest rate policy. Whereas savings deposits are reserved only to individuals, *idir*, savings and credit co-operatives, and private organizations, demand and time deposits can be held by any sector or institution.

In general, financial intermediation of the sector in savings mobilization is seen to be not unsatisfactory. From Table 1 we see that the total bank deposits grew, on average, at an annual rate of 7.5 per cent in the period 1982/83 - 1988/89. The picture is, however, quite different when we look at the various types of deposit instruments separately. While demand deposits, for which no interest is paid, more or less stagnated, although they accounted for the lion's share in absolute magnitude, saving deposits, with an interest rate of 6 per cent, have recently shown an increasing trend. Perhaps this might be due to the banking sector's effort to attract increasing amount of savings from such traditional savings institutions as *equb* and *idir*, as well as the generally positive real rate of return on these deposits. Time deposits, on the other hand, had the smallest share and, in addition, their share has been declining.

Table 1: Deposit Liabilities of the Banking Sector
(in million Birr)

	1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
Total deposits	2819.8	3026.4	3454.4	4018.3	3717.3	4082.1	4355.0
Demand deposits	1731.1 (61.4)*	1765.2 (58.3)	2029.3 (58.7)	2470.5 (61.5)	2029.3 (47.2)	2251.1 (55.1)	2255.8 (51.8)
Time deposits	458.3 (16.3)	509.6 (16.8)	576.1 (16.7)	574.2 (14.3)	602.4 (14.0)	564.2 (13.8)	666.4 (15.3)
Saving deposits	630.4 (22.4)	751.6 (24.8)	849.0 (24.6)	973.6 (24.2)	1085.6 (25.2)	1266.8 (31.0)	1432.8 (32.9)

Source: NBE, *Annual Report*, various issues.

* The figures in the parentheses are the deposits as percentages of the total.

From the above analysis, we can safely say that financial intermediation in terms of savings mobilization has been modest. Lack of other alternative ways of holding money due to, among other things, the unfavourable economic environment the modest inflation rate, which hasn't significantly eroded public confidence, and the branch expansion efforts of the sector are, to mention a few, the factors that encourage accumulation of financial savings. On the other hand, the excess liquidity

of government-owned undertakings, due to capacity underutilization, can be taken to account for the largest share of demand deposits.

More or less similar structure and trend can be observed by looking at the deposit liabilities of the CBE, which bank plays a significant role in savings mobilization. The annual rate of growth of deposits, on the average, was about 12 per cent in the period 1982/83-1988/89, with the rate of growth for demand and savings deposits being more or less equal, as can be seen from Table 2. On the other hand, time deposits have been low and, moreover, as a result of NBE's order to transfer time deposits of government-owned undertakings to either HSB or AIDB [NBE 1986a], their level declined significantly for the years following 1986.

Table 2: Deposit Liabilities of the CBE
(in million Birr)

	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
Total deposits	1800.0	2224.8	2095.9	2976.7	3211.9	3479.6	3691.8
1. Non-central gov't. deposits	1691.0	2112.5	2006.0	2869.5	3084.6	3355.1	3547.2
Demand deposits	930.8	1108.1	1349.1	1600.9	1839.4	2027.2	2017.1
Time deposits	251.1	286.1	842.9	328.3	190.6	118.2	161.1
Savings deposits	509.1	718.3	814.0	940.3	1054.6	1209.7	1369.0
2. Government deposits	109.0	112.3	89.9	107.2	127.3	124.5	144.6

Source: NBE, *Quarterly Bulletin*, various issues.

C. Credit Disbursements

The financial sector's role in financial intermediation can not be complete unless we see to what extent the funds so mobilized are used. For one thing, as reviewed in Section I, the role of the sector in the development process consists in channelling the mobilized fund to demanding sectors within the context of overall national policy; for another, being intermediaries, banks and other financial institutions are interested in financial savings not for its own sake.

Given this understanding, the demand for credit in an economy depends on the level of economic activity, the cost of credit (i.e., the rate of interest) and the state of expectations about the future economic environment. It also depends on the willingness and capacity of banks to provide credit, reflected in the banks' liquidity position, the rate of interest and the relative autonomy of banks.

During post-1974, policy regarding the lending operations of the financial sector has been part and parcel of the national goal of socializing the economy. In this

connection, the NBE was to devise a policy tuned to "... strengthening and expanding of the socialized sector and of encouraging the socialization of others ..." [NBE 1986e: 3-4]. This credit policy clearly discriminates against the private sector, which was to be superseded by the socialized sector.

The NBE, in its power to determine interest rates on bank lending [*Negarit Gazeta* 99/1976, Articles 30, 31 and 32], has set a selective interest rate structure. In particular, in 1986, a detailed interest rate structure was issued, which prescribes different rates to different sectors according to the degree of socialization [NBE 1986b]. The flat rate charged on the credits of different sectors ranges from as low as 4.5 per cent for co-operatives to as high as 10 per cent for personal loans. The borrowing rates of the central government have also been favourable, being 3.0 per cent for treasury bills and 5 per cent for bonds. The latter was 7 per cent before July 1986 (see Annex 1). In short, the structure of interest rates were concessionary for co-operatives and the central government and government- owned undertakings.

Given the credit and interest rate policy discussed above, Table 3 shows the distribution of bank credit on the basis of the degree of socialization. The distribution of credit is more or less consonant with the policy, so much so that the private sector, though large, has been squeezed out from the institutional credit by a set of policies that not only make investment unfavourable but also make institutional credit inaccessible by, for example, limiting the size of credit, requiring excessive collateral, charging relatively high interest rate, and so on.

Table 3: Loans and Advances by Sector
(in million Birr)

	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
1. Central gov't.	2322.2	2558.2	2961.2	3314.0	3716.7	4007.9	4452.6
2. Public enterprises	1482.0	1664.0	1806.5	2050.1	2317.3	2802.6	3021.6
3. Inter-bank lending	838.6	991.0	1116.8	1331.1	1491.8	1707.8	1883.7
4. Cooperatives	120.9	126.8	97.0	87.7	125.3	179.4	229.3
5. Private and individual	528.4	501.6	497.7	490.3	514.8	578.6	491.2
Total credit outstanding	5292.1	5841.9	6479.2	7273.5	8165.9	9276.3	10078.4
Total less inter-bank lending	4453.5	4850.6	5362.2	5942.1	6674.1	7568.5	8194.7

Source: NBE, *Annual Report*, various issues.

In terms of sectoral distribution of credit, one can see that the share of each sector in total credit disbursed is commensurate to its share in GDP, so that agriculture took the lead followed by industry and so on (see Table 4). However, a

careful look at the intra-sectoral distribution of credit reveals that, in line with the governments socialization policy, preferential treatment was given to socialized sectors; a point in case is the lion's share of credit allocated to state farms.

Credit disbursed by the banking sector is shown in Table 5. The share of NBE is the largest, whose credit is primarily to finance government deficit and AIDB financing of the rather unprofitable state farms. CBE lending, the second largest, which mainly consist of short-term lending, in particular to commercial activities, although it is required to cater credit for rural areas as well [NBE 1986e].

However, the rather modest savings mobilized through the financial sector were not fully utilized in the economy. The liquidity position of banks in Ethiopia reveals that banks, especially CBE, has remained underlent with mounting idle reserves. This is not so much due to the failure of financial intermediation on the part of the financial sector as to the dismal performance of the very sectors supposed to enhance the pace of socialization, and hence enjoy institutional credit.

Table 4: Loans and Advances by Economic Sector
(in million Birr)

	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
1. Gov't. Deficit Financing	2322.2	2588.2	2661.2	3314.0	3726.7	4007.9	4452.6
2. Agriculture	791.7	933.9	1058.3	1246.4	1427.0	1653.9	1744.1
3. Industry	241.8	245.7	263.6	271.2	296.3	345.4	470.8
4. Domestic Trade	181.3	155.4	275.0	134.6	180.1	247.4	172.5
5. Int'l Trade	390.2	373.5	389.6	341.8	398.1	486.0	513.8
a) Export	172.1	160.6	170.2	210.5	148.9	156.7	235.4
b) Import	(218.1)	212.9	212.4	131.3	249.8	329.3	278.4
6. Housing and construction	338.9	390.9	426.0	452.0	456.8	573.2	614.0
7. Transport and Communication	45.2	140.4	130.4	117.9	118.3	157.2	111.0
8. Hotel & Tourism	13.3	15.8	14.3	17.4	18.1	16.1	18.0
9. Mines, Power and Water Resource	12.8	18.8	17.7	19.0	36.9	55.3	75.4
10. Personal	9.7	9.1	10.9	10.1	10.6	11.0	10.8
11. Others	8.4	9.1	13.5	18.7	17.6	14.5	11.7
Total	4453.5	4850.6	5362.4	5942.1	6674.1	7568.5	8194.7

Source: NBE, *Annual Report*, various issues.

Table 5: Loans and Advances by Lender Banks
(in million Birr)

	1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
1. NBE	2224.6	2612.1	2597.3	3174.9	3788.3	4200.2	4443.9
2. CBE	1908.6	1879.6	2367.5	2372.1	2518.6	2810.2	3154.6
3. AIDB	966.1	1126.5	1261.0	1461.3	1628.4	1882.7	2072.2
4. HSB	192.5	223.6	253.2	265.2	280.5	375.5	408.0
Total	5292.1	5841.8	6479.4	7273.5	8165.8	9276.3	10078.7
Less inter-bank leading	4453.5	4850.6	5479.4	5942.1	6674.1	7568.5	8194.7

Source: NBE, *Annual Reports*, various issues.

Table 6: Reserves and Liquidity Position of Commercial Banks
(in million Birr)

	1976/77	1980/81	1986/87	1987/88	1988/89
1. Cash in hand	40.2	75.8	82.0	88.2	88.2
2. Deposits with NBE	241.2	339.9	1119.5	1092.2	1092.7
3. Reserve requirements	70.08	118.36	64.09	179.34	189.76
4. Actual reserves	281.4	415.7	1201.5	1180.9	1180.9
5. Excess reserves	211.32	297.34	1037.41	1001.57	853.54
6. Free reserves	171.12	221.54	955.41	916.36	902.94
7. Liquidity ratio*	100.41	87.23	75.89	67.49	63.12
8. Ratio of loans and advances to deposits**	70.21	74.15	77.60	79.30	83.91

Source: NBE, *Quarterly Bulletin*, various issues.

* Actual reserves plus foreign assets, net of short-term liabilities, divided by demand deposits (net).
** Gross loans and discounts plus credit to central Government divided by gross deposits (of private and others) plus demand deposits of domestic banks plus time and savings deposits.

For example, since 1974 CBE's liquidity position has been well above the minimum reserve requirement, which, until 1986, was 10 per cent of demand deposit and 5 per cent of saving and time deposits and was changed to 5 per cent of all types of deposits after 1986 [NBE 1986c]. This can be seen by looking at the high liquidity

ratio, the low credit/deposit ratio and virtually no borrowing from the NBE, as shown in Table 6. This was the result of many factors, the credit policy playing the leading role in preventing the would-have-been large demand for institutional credit from the private sector. The decelerating economic activity, especially during the 1980s, has reduced credit demand from public sector enterprises, whose problems has been compounded by the foreign exchange inadquacy.

Thus the monetary policy of post-1974 has hardly succeeded in enhancing the pace of socialization; and, in fact, the move towards general instruments of policy has become a far cry. The excess liquidity of the banking sector, for instance, denied the NBE potential instruments of policy such as the reserve requirement and the bank rate, if at all the bank ever thinks of using these instruments. In general, therefore, it can be concluded that the post-1974 performance of the financial sector has not been up to the expectations even of the government, for the pace of socialization has not created a 'favoured sector' large enough to mop up the institutional credit.

IV. FINANCIAL SECTOR PERFORMANCE

Though less successful, the financial sector was required to play an active role in expediting the overall objectives of socializing the economy. In other words, developmental monetary policy was so designed as to achieve the channelling of as much financial resources as possible to socialized sectors.

Looking at the macroeconomic performance of the economy for the last decade, one may safely conclude that it was disappointing: GDP grew, on average, at an annual rate of 2.1 per cent; gross domestic savings were low, which meant financing the rather low level of investment from external sources; the commodity sectors, particularly agriculture, were performing poorly, etc., to mention a few macroeconomic indicators. This poor macroeconomic performance notwithstanding, there has been relative internal balance during the decade: the rate of inflation averaged only 5 per cent per annum and the overall fiscal deficit has been somewhere between 5-13 per cent of GDP. Although this balance was achieved by the cumulative effect of policies on the economy[7], the less inflationary impact of monetary expansion and monetization of the fiscal deficit played no less a significant role.

Growth of money supply, defined broadly , averaged about 11.3 per cent during the 1980s, as can been seen from Table 7. This growth has largely been a reflection of domestic credit expansion, in particular credit to the central government to finance its fiscal deficit. That is, monetization of the rather low level of fiscal deficit significantly determined the expansion of domestic credit (see Table 7). Although it is known from economic theory that resort to bank credit to finance fiscal deficit can impinge upon domestic inflation, in addition to crowding out non-central government credit(especially the private sector), it nevertheless was not fraught with an inflationary impact in the case of Ethiopia. This was primarily due to the 'monetary deepening', i.e., the steady rise in the ratio of broad money to GDP that

has taken place during the 1980s. That there has been unfavourable investment policies to the private sector (not to mention the stifling credit policy) and the limited menu of choice in financial assets has meant that there has been a sort of 'forced savings' where the public held a large amount of its savings in currency and savings deposits [World Bank 1990]. These phenomena have increased the reserve balance of the economy and made it possible for the banking sector to finance the increased demands of the central government deficit from this reserve, without having to impinge upon inflation. As a World Bank report succinctly put it, "the control of inflation has thus been a cause, as well as a consequence of monetary deepening" [World Bank 1990: 59].

Table 7: Developments In Broad Money
(in million Birr)

	1980/81	1984/85	1986/87	1987/88	1988/89
A. Components Broad Money Money Supply	1715.3	2692.1	3563.5	3910.8	4174.4
Currency in circulation	1027.1	1358.5	1743.5	1908.3	2181.8
Demand deposits (net)	688.2	1333.6	1820.0	2002.5	1992.6
Quasi Money	662.3	1156.9	1245.2	1327.9	1530.6
Broad Money	2377.6	3449.0	4808.7	5238.7	5705.0
B. Determinants of Broad Money External assets(net)	230.1	232.1	536.4	152.3	410.8
Domestic credit (net)	2629.6	4477.6	5554.2	6044.8	6835.2
Claims on cent. Gov't	1167.9	2620.7	3206.6	3502.3	3886.8
Claims on non-cent.Gov't	1521.7	1856.9	2347.6	2903.8	2948.4
Other Items (net)	-482.1	-860.7	-1281.0	-958.4	-1548.2
Broad Money	2377.6	3849.0	4808.7	5238.7	5705.0

Source: NBE, *Annual Report*, various issues.

V. CONCLUSION

Though there has been a clear policy statement that financial intermediation is primarily to help achieve the socialization of the economy, the result has been far from satisfactory, not so much because there has been a failure to accord preferential treatment to priority sectors as to the poor performance of the very sectors -- state-owned undertakings, state farms, etc., -- thought to be the means of achieving the overall objectives of the past regime. The excess liquidity in the vaults of banks clearly indicates that not only was institutional savings sterilized due to wrong credit policy but was also misallocated for the policy denied credit to the private sector, a

sector whose role in the economy was not less significant to the last days of the regime.

Now that the policy intent is towards a private-sector-led market economy, there is a pressing need to redefine the whole set of policies in relation to financial intermediation. Indeed, the relative internal balance hitherto achieved will no longer be enjoyed in the face of a changing economic environment -- a move from a command to a market economy. The potential demand for institutional credit from the private sector can safely be expected to increase, and monetization of the fiscal deficit can no longer be less inflationary. It is thus hardly debatable that reforms in the financial sector are essential, although the design and timing of the reforms invite discussions.

A central issue in financial sector reform is the interest rate and credit policy. No one gainsay that money interest rates have been in general repressed in Ethiopia, which may be taken as a justification for immediate liberalization.[8] However, great caution should be exercised in the design and pace of interest rate liberalization. For one thing, interest rate liberalization should not be construed as its steady rise, which is most likely to happen in the period immediately after liberalization for economies where financial repression is typical. This can destablize the undergoing reforms, and can make the policy change unsustainable. For another thing, since it would take some time before the real sector begin to respond to market forces, it seems unwarranted to immediately leave interest rate determination to market forces. This type of orientation can do more harm than good. Indeed, the literature is abounding emphasizing the need for measured pace of interest rate liberalization, for the issue involved is not whether the rate is 'high' or 'low', but to what extent it is flexible to accommodate changes in the economy, in particular whether or not the rate is, in real terms, at least as rewarding as the return on other alternative assets [Chandavarkar 1971; Park 1973; Rodrik 1990; Roe 1982].

Secondly, the financial sector must itself undertake reforms so as to be able to implement new set of policies as well as help facilitate real sector reforms. In this regard, the sector should be freed from central control which could consist of giving more autonomy to banks and other financial institutions, and permission to banks to engage in a wide range of banking services. This could possibly lead to competition among them which has hitherto been virtually non-existent.

The other component of financial sector reform is the active promotion of markets in financial assets. This task could begin with the issuance of government securities, which so far has been administratively managed, with a remunerative return. As the financial intermediation deepens, the financial sector could stimulate the issuance of financial assets by other institutions, both financial and non-financial. This will eventually culminate in a well-developed and integrated financial market, which will widen the range of instruments at the disposal of the bank.

But it should not be assumed that reforms in the financial sector are independent of reforms in other policy areas. In fact, the success of reforms in the financial sectors depends much on the pace of reforms in the real sector. The need for a reform in fiscal policy is, for example, uncontestable in order that the need for domestic financing of fiscal deficit be maintained as low as possible.[9] Thus, the reforms in the financial sector are to be viewed within the context of national economic policy reforms, and in fact have to follow than precede reforms in the real sector.

NOTES

1. The instruments of mnnetary policy referred to include: the discount rate, which the hank in its role as a lender of last resort uses; open market nperations; variation in reserve requirement and special deposits; direct credit control, which consist nf selective credit control and quantitative and mnral suasion [Furness 1975: 217-233; Ghatak 1981: 107-113; and Livingston 1975: 374-377].

2. Low level of monetization; lack of appreciable banking habit by the public, reflected in high currency/income ratio; and rudimentary financial sector, with limited financial assets and undeveloped markets for financial assets are some the institutional characteristics of a typical LDC [Coats and Khatkhate 1984: 330-331].

3. Although it is recognized that there could be contradictions between the stabilizatinn and develnpment nbjectives of monetary policy, what matters most is the 'harmony between these sets of objectives.' Moreover, it is well-recognized that macroeconomic stability is a necessary condition for a successful development programme [Cnats and Khatkhate 1984: 331-334].

4. For a good exposition nf lhese two approaches mnnetary policy, see [Coats and Khatkhate 1984 and Khatkhate 1972].

5. Proclamation No.184/1980 shaped the present structure of CBE. The basic objectives of CBE is to prnvide commercial hanking services tn public enterprises, private companies and individuals. These services include saving accounts, checking accounts, short-term loans, overdrafts, import and export change, dnmestic and foreign remittances, and safe deposit boxes.

6. See the prnvision of article 26(3b) in the Monetary and Banking Proclamation No, 99/1976.

7. The low rate of inflation cannot be attributed snlely to monetary factors. Though credit restraint contrnlled the expansion of money supply and prudent mnnetary management has played a great role, policies such as the freezing of wages should not be ignored.

8. The immediate liberalization of interest rates could severely harm public enterprises, which are financially staggering. In other words, it could make restructuring in these structurally distnrted enterprises very difficult.

9. One can clearly ascertain the tendency for greater bank financing of the fiscal deficit by noting Proclamation No. 22/1990, which relaxes the ceiling on government credit from the hanking sector set in the 1976 Monetary and Banking Proclamation (see Article 26).

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Annex 1

Deposit and Lending Rates of Banks
(Through June 30, 1985)

1. **Deposit Rates**	**Rates Per Annum**
a) Time Deposits (one year and above)	
- Financial Institutions	6.0
- Government-owned Undertakings	6.0
- Private Organizations, Co-operatives (except Savings & Credit Co-operatives Urban Dwellers & Peasant Associations Other Mass Organizations & Professional Associations, Joint Ventures & partly State-owned Companies	6.0
b) Savings Deposits	
- Financial Institutions, State Organizations, Co-operatives (except Savings & Credit Co-operatives), Urban Dwellers & Peasant Associations, Other Mass Organizations & Professional Associations, Joint Ventures, Foreign & Partly State-owned Companies	6.0
- Individuals, Savings & Credit Co-operatives, Private & Self-help Organizations	
- Upto Birr 100,00	6.0
- In excess of Birr 100,00	6.0
- Others	6.0
1. **Lending Rates**	
Agriculture	9.0 - 10.5
Industry, Mining, Power & Water Resources	9.5
Domestic Trade	9.5
Transport & Communication	9.5
Export Trade	9.5
Import Trade (agricultural inputs)	9.5
Import Trade (others)	9.5
Hotels & Tourism	9.5
Construction	9.5
Housing	
1) Purchase	10.0
2) Construction	9.0
Central Government	3.0 - 7.0
Banks & Financial Institutions	5.0 - 6.5
Personal Loans	10.0

Annex 2

Natioaal Bank of Ethiopia
Credit Regulatioa NBE/CR/1
Interest Rates on Deposits and Loans and Advances

Pursuant to the provisions of Article 30, 31, 32 of the Monetary and Banking Proclamation, No. 99 of 1976, the National Bank of Ethiopia has established rates of interest on deposits, loans and advances as follows:

Interest Rates on Deposits

		Percent Per Annum
Demand Deposits (Current Account)		Nil
Time Deposits:		
-Financial Institutions	1 Year	1.0
-Government-owned Undertakings	1 Year	1.0
-Private Organizations, Co-operatives, (except Savings and Credits Co-operatives) Urban Dwellers Associations, other Mass Organizations and Professional Associations	1 Year	4.0
	2 Years	4.5
	3 Years	5.0
	5 Years	5.5
-Individuals, Savings and Credit Co-operatives, *Idir, Equb*	1 Year	6.0
	2 Years	6.5
	3 Years	7.0
	5 Years	7.5
Savings Deposits:-		
-Financial Institutions, Government-owned undertakings, Co-operatives (except Savings and Credit Co-operatives), Urban Dwellers Associations, and other Mass Organizations and Professional Associations not allowed to maintain savings deposit accounts		
-Individuals, *Idir*, Savings and Credit Co-operatives and Private Organizations:		
-upto Birr 100,000		6.0
-in excess of Birr 100,000		2.0
Others to be determined hy the Bank		

Source: *Birritu*.

Annex 3

Interest Rates on Long- and Short-term Loans and Advances
(per annum)

	Co-operatives per cent	Government-owned undertakings per cent	Individuals and private organizations	Financial institutions per cent
Agriculture	5.0	6.0	7.0	--
Industry, Mining, Power and Water Resources	6.0	8.0	9.0	--
Domestic Trade	6.0	8.0	9.5 (existing)	--
Transport and Communication	6.0	8.0	8.0	--
Export trade	6.0	6.0	6.0	--
Import trade: Fertilizers, Seeds and Pesticides	5.0	6.0	7.0	--
All other Imports	6.0	8.0	9.5 (existing)	--
Hotel and Tourism	6.0	8.0	9.0	--
Construction	6.0	8.0	9.0	--
Housing: Construction	4.5	4.5	7.0	--
Purchase	6.0	6.0	8.0	--
Central Gov't: Short-term Long-term	-- --	3.0 5.0	-- --	-- --
National Bank of Ethiopia	--	--	--	2.5 - 4.0
Personal	--	--	10.0	--
Others	to be determined by the Bank	2.0 - 5.0	2.0 - 5.0	--

Annex 4

Summary of Central Government Finance
(io millions of Birr)

		1982/83	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89
1	Revenue and Grants	2201.4	2407.6	2626.9	3066.4	3119.9	3666.4	4077.8
2	Revenue	2058.1	2243.0	2318.9	2778.6	2858.6	3392.0	3732.6
3	Total Expenditure	3517.1	3020.9	3428.0	3714.7	3819.3	4481.9	5189.1
4	Overall Deficit	-1305.7	-613.3	-801.1	-648.3	-699.4	-815.5	-1,111.3
5	External Borrowing (net)	450.7	215.3	344.4	484.6	396.1	371.9	559.1
6	Domestic Financing (net) Banking System	855.0 (821.3)	379.4 (333.7)	456.7 (369.4)	163.7 (381.3)	303.3 (445.8)	443.6 (379.3)	552.2 (451.0)
7	Total Financing	1305.7	613.3	801.1	648.3	699.4	815.5	1,111.3

Source: NBE, *Annual Report,* various issues.