POLICY Brief

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No. 05 / December 2022

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Values

Professionalism, integrity, independence, quality, efficiency, inclusiveness, teamwork, accountability and transparency.

Liberalizing Financial Sector in Ethiopia: Constraints, Consequences and Policy Issues

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1. Executive Summary

Ethiopia is at the verge of opening up its financial sector to foreign operators and revising its financial policy accordingly. Understanding financial liberalization and its consequences is vital for policy makers and practitioners to manage the change effectively and efficiently. This policy brief attempts to answer the question why, and how Ethiopia should open its financial sector to foreign operators with the goal of providing scientific evidence for existing financial firms and government bodies. It is suggested that before opening financial sectors to foreign operators, NBE shall articulate prudent but less bureaucratic policies and regulatory mechanisms to ensure the required supervision and leadership capacity to properly manage liberalization. In addition, it is recommended that liberalization of the financial sector to follow a gradual approach (first, liberalizing of the real sector; secondly, liberalization of the domestic financial sector; and thirdly liberalization of the external financial sector).

2. Introduction

Currently, the government of Ethiopia is on the verge of opening financial sector to the foreign operators. Thus, the consequences of financial sector liberalization policy and related issues need to be studied to provide the policy makers and government with evidence-based policy input. Therefore, following a scientific method, providing dependable and workable policy input is a very important and urgent issues for policy makers for appropriate decision making about financial sector liberalization. Cognizant of this, this study has been undertaken with the objective of examining the constraints, consequences, and policy issues associated with the liberalization of the Ethiopian financial sector.

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3. Rationale

It is widely believed that financial liberalization is an essential part of the financial sector development process, particularly in developing countries. Besides, scholars argue that financial sector liberalization has a double edge sword. On one hand, McKinnon's (1973) and Shaw's (1973) argue that government intervention in the financial sector distorts the financial market, depresses savings, and leads to inefficient investment. On the other hand, financial liberalization may trigger destabilization in the financial system and a financial crisis (Stieglitz, 2000; Yin, 2019) if handled inappropriately. However, unlike other East African neighbors (e.g., Kenya, Tanzania, Uganda) and many other developing countries, Ethiopia has not yet opened its financial sector to foreign participation. Recently, the Ethiopian government considered liberalizing its financial sector as part of its financial development strategy and opened the financial sector to Ethiopian-born foreigners. Given the unclear effects of financial liberalization from both empirical and theoretical perspectives, the move by the government of Ethiopia to liberalize its financial sector is a critical policy decision that needs to be supported by empirical evidence. However, little has been known about the possible consequence of opening the financial sector to foreign financial institutions. Therefore, this research aims to provide research evidence to policymakers and scholars by examining constraints, consequences, and policy issues associated with Ethiopia's financial sector's liberalization.

4. Issues Related to Liberalizing the financial sector in Ethiopia

4.1. How competitive is the financial institutions in Ethiopia?

The study finding shows that Ethiopian financial sector performance is lower compared to Sub Saharan African countries that has opened their financial sector to global operators. For instance, except for a few indicators (such as efficiency and profitability), Ethiopia's relative position in commonly used financial sector indicators such as depth, access, and competition were unsatisfactory, at least at SSA standard. SSA countries that has globalized financial sectors have better performance than non-globalized SSA countries except for profitability and stability. From empirical finding, we conclude that low depth, less access, less competition, and high profitability are opportunities that may attract many foreign operators to Ethiopia once financial sector is opened to foreign investors.

Moreover, the Ethiopian financial sector's overall competition is characterized as monopolistic competition (H-index 0.678, 0.474 and 0.211 for banking, insurance and MFI, respectively). But we need to take caution since foreign financial sector entry may not necessarily bring competition because entry through mergers or acquisitions may not do so. In all cases, factor prices have positive effects, indicating that increased factor prices lead to a higher revenue-to-asset ratio and H-statistic. Thus, it indicates that the financial institutions need to spend, for example, on labor with different incentives since higher financial benefit increases employees' morale, dedication, and loyalty to the organization and increases financial institutions' overall efficiency and performance.

4.2. Key success factors for financial firms in Ethiopia

Management efficiency, technology and liquidity have a positive and statistically significant effect on financial sector performance. Iinterest spread as a proxy to financial sector liberalization has a positive effect on the performance of both banking sector and MFI, but it is not statistically significant for the banking sector.

4.3. How do the domestic operators perceive the financial system in Ethiopia?

Most financial operators generally perceive the current status of the Ethiopian financial sector as inefficient, less competitive, unstable, less innovative, undiversified, not inclusive, and poorly capacitated. Similarly, the financial institutions' products are currently limited to basic financial products and they do not adopt innovations such as e -commerce, e-marketing, biometric identifications and remote data processing. The major reasons for the low level of financial inclusiveness, innovations and diversification are related to the absence of competition, highly scattered rural population, poor infrastructure (internet, power, and roads), low income and high level of inflation, insecurity in remote areas of the country, limited capacity of the financial institutions (technology and expertise), and poor strategic leadership. Morover, low financial literacy and awareness, collateral-based credit provision, unattractive saving rate and unpredictable directives from the supervision body and restrictive regulations of the government (National Bank of Ethiopia) are major constriants.

Additionally, about 39%, 50%, 82% and 74% perceived that the NBE lacks the supervision capability; its operations are not free from political interventions; if foreign entry is allowed, the share of foreign banks should be to a limited extent and agreed that strict supervision and regulation is essential, respectively. The major challenges in the process of regulation and supervision are related to the limited capability and lacks political independence to closely supervise and regulate the financial sector.

4.4. What are the possible consequences of financial sector liberalization?

The econometric model shows that both in the long and short run, financial liberalization has both costs and benefits. Foreign operators' entry into the financial sector may improve economic growth directly and indirectly by improving efficiency. However, the entry will reduce economic growth indirectly by increasing bank fragility. Based on operators' response the possible positive consequences on local financial institutions include: bringing new skills, technology, innovations and system (98%), enhancing competition (90%), development of financial markets (76%), improvement of the finance system's infrastructure (92%), more credit supply can be offered (71%), and transfer of good institutions practice (74%). They also indicated positive consequences on macro economy such as improved consumer and mortgage credit (83%), speeding up FDI (82%), increase in employment and wage rate (78%), possible economies of scale and scope (74%), and lower lending interest rate (63%).

In contrast, foreign financial operators' entry may have negative consequences as indicated by local financial institutions respondents. The consequences may be on domestic financial institutions and the macroeconomic conditions in general. On financial institutions, entry may lead to a fall in the market share of the domestic FS (80%), weakening of the local financial institutions (66%), sudden capital outflow (58%); and on macroeconomy, it may leads to loss of macroeconomic stability (35%), small firms will be suffered because of credit shortage (25%) and others.

4.5 Alternative approaches to liberalization and lessons learned

Our survey results and lessons learned from other countries suggest that opening up the secondary financial market in Ethiopia should precede other liberalization activities followed by liberalization of capital accounts (offshore borrowing and multiple exchange rate markets). Other activities such as liberalization of regulations on reserve ratio and interest rate, liberalization of the domestic financial sector to foreign investors, and privatization of existing public financial institutions will follow in the given order. Lesson from successful financial sector liberalization shows that maintaining macroeconomic stability and strengthening capability of regulators is a pre-condition for liberalization.

5. Conclusion

- The Ethiopian financial sector's current status can be characterized as less competitive, less innovative, less diversified, non-inclusive, poorly capacitated and monopolistic competition in nature.
- Financial sector liberalization (Interest rate spread as a proxy) has a positive effect on the performance of financial sector. In addition, improved management efficiency, technology, and liquidity are key success factors for the sector in Ethiopia.
- In both long run and short run, liberalizing the financial sector may improve economic growth directly and indirectly by improving efficiencyy. However, it may reduce economic growth indirectly by increasing bank fragility.
- The findings show that the current policy framework guiding the financial system needs to be customized to be able to meet the emerging needs of the financial sector in the country; and NBE may reduce its political dependence and increase its decision-making autonomy.
- Ethiopia's financial sector is characterized by low diversification and innovative products, and noninclusiveness becuse of population settlment, infrastructure (road, power, internet), leadership, technology, financial literacy and awareness.
- The finding shows that the liberalization of the financial sector shall follow a gradual approach with a stable macro economy and strong financial sector as a pre-condition.

6. Policy Recommendations

◊ ***Doable and functioning regulatory and supervisory framework***

Before opening up financial sectors to foreign operators, NBE shall articulate prudent but less bureaucratic policies and regulatory mechanisms to ensure the required supervision and leadership capacity to properly manage liberalization. Thus, NBE may revise its directives (foreign currency surrender, extent of share of foreign banks-less than 50%, policy on capital flight, extent of reinvestment) and ensure the merit-based appointment of management. In the pre-liberalization stage, NBE shall also closely supervise and work in supporting domestic financial institutions to build up their management and organizational capabilities. Similarly, in post-liberalization, NBE shall strictly supervise and monitor to ensure the effective implementation of policies and directives and implementation of liberalization in the right sequence, strict regulations on nonperforming loans, reserve ratio, interest rate spread, and capital adequacy.

◊ ***Capacity building***

Capacity development (staff, cyber security, technology, and finance) should be a priority task for both the incumbent firms and the supervisory body to reap the benefits and minimize the costs associated with financial liberalization. Hence, the concerned bodies should relentlessly work to upgrade their human capital and boost their investment in research and development activities.

◊ ***Sequence matters***

As an African proverb goes on "*Only a fool can test the depth of the water with both feet*". The lessons from successful countries and opinions from local financial operators show that the liberalization of the financial sector should follow a gradual approach (1st Liberalizing of the real sector; 2nd Liberalization of the domestic financial sector; and 3rd Liberalization of the external financial sector). Moreover, a stable economy needs to be a pre-condition to open up the financial sector, and it should not be considered a solution to macroeconomic instability.

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Conflict of Interest

There is no conflict of interest among researchers.

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