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FINANCIAL LIBERALIZATION

IN THIS ISSUE

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FROM THE EDITOR

The Ethiopian Economic Association (EEA) held its Eighth General Assembly on July 15, 2000. In addition to the usual business session, a panel discussion was organized for the occasion on 'Financial Liberalization in Ethiopia'. The Governor of the National Bank of Ethiopia delivered an opening speech, which is published in this issue of the *Economic Focus*. There were three presentations in the panel relating to financial sector liberalization in general as well as policies and measures undertaken by the country to liberalize the sector. We present two of these presentations now; the third one will be come out in our forthcoming issue. Moreover, two additional pieces have been contributed by scholars, which we are delighted to present to our readers.

As you may be aware, the general assembly elected a new executive committee. Taking this opportunity, I would like to thank the outgoing members for their dedicated and fruitful efforts and their strive to fulfill the objectives of our Association. This, I believe, has resulted in substantial progress in the activities of our Association.

Moreover, I would like to inform our readers that the *Ethiopian Journal of Economics* has become *reputable* as per the standards of the Addis Ababa University. Continuation of such recognition depends on the ability to continue, as it has been doing so far, publishing outstanding academic articles. I would like to take this opportunity again to thank all those who have contributed articles for the Journal and I encourage new contributors.

Thank you.

OPENING SPEECH BY THE PRESIDENT OF EEA AT THE 8TH GENERAL ASSEMBLY OF THE ETHIOPIAN ECONOMIC ASSOCIATION

Invited Guests
Members of the Ethiopian Economic Association
Ladies and Gentlemen:

In the name of the Executive Committee of the EEA, and for the last time as the president of the Association, let me start by formally welcoming you to the 8th General Assembly of the Ethiopian Economic Association and the panel discussion on the timely issue of "Financial Sector Liberalization in Ethiopia."

I said a timely issue because we are discussing the issue at a time when talk about a new international financial architecture is abound. The existing international financial architecture has revealed its deep flaws during the financial crises of Asia with reverberations all over the global economy. The only countries that were affected the least from this crises were those countries, mostly in Africa, with the weakest link to this international financial system and are pushed to join it at a much rapid pace than most of them really wish.

A consensus seem to be emerging in the developed countries that this financial architecture must either be thoroughly reformed or scrapped and be replaced by a new financial architecture. Although far fetched and premature, and with all the apologies to the resident representative of the IMF here, there is even talk among quite powerful circles, about doing away with the IMF and replace it with regional institutions. The envisioned financial architecture is expected to be more transparent and ensure more participation in decision-making and norm-setting. For this international system to support development, it should enhance financial mobility, improve early warning and response quickly or even help prevent financial crises.

But what is damaged by the Asian financial crisis is not only the reputation of institutions but more importantly, it is the financial orthodoxy that was pushed on developing countries by these institutions that was seriously scarred. Probably the most damaging accusation leveled on the monetarist orthodoxy is its confusion of means with ends. The calls for policy reforms, including financial liberalization were supposed to be a means to a larger end. The larger end, for developing countries, being achieving rapid growth and development and alleviation of poverty. In a normal state, it makes a lot of sense to scrap the means if it was found that it could do damage to the intended objective. But these reforms were pushed on countries with such zeal, and without ensuring the existence of the institutional and regulatory mechanisms in place, that their negative effects have ended up wiping out decades of economic and social gains in some of the worst affected countries. For those countries such as Ethiopia, that are in the fringes of this rapidly changing international financial system, moving cautiously, gradually and with the appropriate institutional capacity in place, towards financial liberalization might indeed be the important lesson of this crisis.

Obviously, this is not a call against reforms, in fact, I do believe that some reforms are quite necessary. It is not even designed to join the debate about financial sector reforms in general and its status in Ethiopia in particular. It is rather to draw the most important lesson from the Asian financial crisis–i.e. the need for strong regulatory institutions to make reforms work–as a prelude to talk about our own association as an institution whose strength and dynamism could play an important part in the economic development of our country.

As you all know, the EEA was formed with a few modest objectives in mind. Like all professional associations, it is concerned with the well-being and development of its members as professionals. This means, creating the conditions for the professional development of its members by encouraging research in economics and related subjects, networking among members to exchange research ideas and outcomes by organizing annual conferences on the Ethiopian economy and publishing our bi-annual *Journal of Ethiopian Economics* and in general creating a conducive atmosphere for members to talk about and discuss various issues in economics in general and the Ethiopian economy in particular.

Our association is also interested in the quality and spread of economic education in the various educational institutions of the country. In this regard, the association's first conference, in cooperation with the Economics Department of Addis Ababa University, has prepared a book on the Ethiopian economy that is currently being used as the only reference book on the Ethiopian economy at AAU and other higher education institutions. This reference material is currently being updated following last year's conference that assessed the performance of the Ethiopian economy in the previous seven years. The various conferences that were held since 1992 and the articles published in the journal are also hoped to improve the quality of teaching by making new research findings available to instructors in economics.

Another clearly stated objective of the association is the objective of "contributing towards the development of the Ethiopian economy." This follows the concerns that most of us have as economists that, as our late president Dr. Eshetu Chole stated in the inaugural meeting of our association, the availability of so many capable Ethiopian economists at home and abroad is simply not matched by the miserable state of our country's economy. In this area, the hope is that the various researches on the Ethiopian economy, conducted by our members via the various forums organized by the association, will find their way to policy-makers and the general public to better inform public discussion on economic issues in general and the policy making process in particular. In the last two years, the association took a number of initiatives to directly contribute towards this objective. Our bi-monthly economic round tables which brings policy-makers, academicians and the business community to discuss contemporary economic policy issues and our bi-monthly bulletin, *Economic Focus* were both designed with this objective in mind. The annual report on the Ethiopian economy, which appeared this year for the first time, is also intended to inform the public on the state of the Ethiopian economy and hence broaden and deepen the debate on economic issues in our country.

It is now four years since the current executive committee (with some changes in its composition) took over the leadership of the association and, at least for me, it is my last year as a president. It is indeed the mark of our democratic constitution that it has a binding and effective term limit. Since this is an important period of transition, I would like to briefly talk about what we have achieved and the challenges we faced in the past four years and identify some of the unfinished tasks ahead that would require the attention of the new executive committee. Let me say in general, however, that the current executive committee sincerely believes that we have at least laid the groundwork for the coming executive committee to take the association to the next level of institutional growth and development.

The best way to asses performance, as economists love to point out, is to establish the initial conditions. I will therefore start by stating the condition of the association when we took over. It is important to note that our association is a very young association both in terms of the actual number of years since its existence and relative to other professional associations in the country. When we took over, the EEA was only five years young and it has achieved quite a bit for its age even at that time. It has conducted unfailingly its annual conference on the Ethiopian economy, it was publishing the proceedings of these conferences, The *Ethiopian Journal of Economics*, its flagship journal, was coming out more or less regularly.

There were also expected weaknesses in the young organization. Membership, particularly active membership was decreasing. There were delays in the journal. It was getting difficult to recruit executive committee members and the enthusiasm of its formation was waning and its financial position was relatively weak. Because the association's secretariat was manned by one half-time secretary, the burden of the Association's day to day work was carried by a few active and committed members. There were no new initiatives to generate excitement in the association and there was no regular contact with members and the larger population. Fatigue was slowly setting in.

The association was formed by 173 founding members in November 1991 and its active members grew to 377 the following year. By 1996, when the new executive committee was elected, there were 519 total registered members only 108 of which were active, due paying, members. By June 30, 1996, the association had a total fixed asset worth 87,258 birr and a current asset of 54,393 birr. Its annual budget was about 200,000 birr that covers all its activities which comprises of one annual conference and a proceeding and the bi-annual journal. As I said earlier, it had one half time secretary running the office.

Four years later, we are happy to say that the association is in a much stronger position than ever in its short history. We have now

984 registered members of which 519 are active, due paying members (a five fold increase in active membership). We have registered 468 new members since 1996. We are also in a stronger financial position with our net current asset rising to more than a quarter of a million birr and our fixed asset has increased by 240%. Our annual budget for the year 2000 will be about a million birr, indicating a significant increase in the association's activities. We have now five full time employees and two part-time workers.

The increase in our membership and budget, we believe, is a result of the increase in our activities and our ability to reach more and more of our members although there is still a lot to be done in that front. Our activities grew because we introduced three new initiatives that we believed will energize the association and enhance its presence. The first and reasonably more successful of our initiatives was the round table discussions we organize every two months. Using this forum, the association has been successful in bringing important government officials to its functions for direct participation in discussions. Although it is difficult to tell how much of these discussions have found their way in policy debates among official circles, there is no denying the fact that we were able to closely look at the rational behind government thinking about policy, and hopefully, the government was able to look at the thinking of academicians and the private sector on policy matters. In short, this is a good beginning that need to be strengthened and the next leadership has the challenge and responsibility to pursue this cooperation with the government.

The second initiative, to publish the policy discussions of the round table and other related material in Amharic and English through our bi-monthly magazine, *Economic Focus* or Lisane Economics have helped us reach the wider public. This and our activities related to the elections, I believe, have succeeded in emphasizing the importance of economic policy in the life of our people and to a certain degree de-mystified economic policy in the eye of the public so that the public can participate in economic policy discussions.

Our third initiative, to publish an annual report on the Ethiopian economy was both the most difficult to do and surely the most rewarding. It was the first report of its kind published by a civil society institution in Ethiopia. Whatever weaknesses it might have, and I am sure there are quite a bit of them, the report has been well received by the public and has helped the public understand the depth of our economic problems. We are certain that when the Amharic version comes out in a few weeks, it would even reach a larger audience.

Putting out the report was part of a larger project we envisioned in the association to provide a continuous policy relevant research to the public and policy-makers and through it enrich the overall policy-making process. The idea was to create a research and publication wing of the association in the form of an economic policy research institute. After over a year of negotiations with donors, I am happy to formally announce today that we have now the resources to form the institute. I would like to use this opportunity to thank our partners, the NORAD of Norway, SIDA of Sweden, the Embassy of the United Kingdom, our usual partner the Fredriech Ebert Stiftung and the African Capacity Building Foundation. We have now rented a larger place for the association and the institute and as soon as we complete the furnishings and other arrangements we will be in business.

The challenge for the coming executive committee is to build on what was achieved up to now. Our membership drive still needs improvement and vigor. Our relationship with relevant government institutions while good, can use a boost. The biggest challenge, and one that we have not done as much, is to create contact with other civil society institutions and other associations in other countries to share experiences. We also need to work more towards attracting Ethiopian economists abroad to be part of our association and contribute professionally towards helping our country prosper.

Invited guests, members of the Association, Ladies and Gentlemen

Four years ago two people pushed me very hard to join the association. They were very worried that the association was losing its momentum and they were terrified that the institution they struggled hard to form and put quite a lot of their time in, could lose its value in the life of this society. These two people, Dr. Eshetu Chole and Ato Mekonen Tadesse, are no longer with us. I hope they can see where our association is now. I am sure they will rest in peace knowing that what they have built is an institution. What we have done in the last four years is strengthen this institution. It is now an institution that is anchored in a firm ground. It does not depend on individuals. It is poised to do a lot more for this profession and above all for our society. We, the current executive committee, think we have done our part. We are certain that the next group that is about to take the leadership of our association will take it to an even higher level. After all that is what institution building is all about.

Thank You. ■
Berhanu Nega

HIGHLIGHTS OF SOME CONSIDERATIONS IN LIBERALIZING THE FINANCIAL SECTOR

Teklewold Atnafu
Governor of National Bank of Ethiopia

GENERAL

Financial sector liberalization is an extension, albeit a crucial one, of overall economic liberalization which derives from the free-market economic development paradigm, now almost universally accepted as unrivalled in creating material wealth. Liberal economic thinking argues creditably that the true scarcity price of financial capital, the main stock-in-trade of the financial sector, can only be approximated through the forces of demand and supply. Such a price would ensure that capital is channeled into sectors where returns are relatively high, thus, in principle, automatically guaranteeing the most efficient possible use of scarce capital resources. Hence, restrictive practices with respect to both deposit and lending rates of interest are said to run counter to the objective of utilizing capital resources efficiently. Likewise, administratively set rates of exchange are generally anathema to the liberal school of economic thought. In the same vein, free and fair competition among financial institutions progressively improves the quality of financial intermediation, in the process instilling in the financial sector the imperative of remaining competitive at all times. Simultaneously, financial sector liberalization enables the central bank to perform its crucial function of monetary management through indirect, rather than direct, instruments of monetary policy. Hence, the rationale for financial sector liberalization may be succinctly said to be composed of four major elements: determination of the scarcity price of capital, efficient use of capital resources, improved financial intermediation and risk-minimizing prudential regulation and supervision.

ETHIOPIAN CONTEXT

The main policy objectives of financial sector liberalization in the Ethiopian context are:

a) to foster a competitive, diversified and sound financial system fully supportive of the objective of accelerated overall economic development and modernization; and

b) b) to create an inclusive financial system that is accessible to the all-important rural community as well as to urban-based micro and small-scale enterprises.

It is well-nigh impossible to conceive of a worthy development policy objective or strategy in Ethiopia that does not somehow address the country's fundamental problem of mass poverty. Therefore, financial sector liberalization in Ethiopia is, as indicated above, aimed at actively supporting the objective of accelerated overall economic growth and development, and this is expected to contribute to the reduction of poverty. Secondly, financial sector liberalization in Ethiopia gives particular emphasis to the creation, development and expansion of micro-finance institutions in order to be able to effectively address the needs of farmers and micro and small-scale businesses. It also promotes mutually profitable links between these micro financial institutions and traditional banks and non-bank financial institutions. This policy emanates from the belief that providing the opportunity for small savings and credits would significantly enhance the entrepreneurial and productive capacities of micro and small-scale economic operators.

One of the preconditions for a successful financial sector liberalization is *a conducive macroeconomic environment.* An unstable macroeconomic environment characterized by high and variable inflation, booms and busts in economic activity and unsustainable fiscal and external imbalances can only frustrate attempts at financial sector reform by creating volatility in the prices of financial assets and the allocation of financial resources.

Another area of concern when liberalizing the financial sector is *the choice of approach and the sequencing of reform measures.* Broadly speaking, there are two approaches. One is the 'big bang' approach where everything is liberalized at one go. The other is the gradualist approach where reforms are introduced in a graduated manner. The prevailing conditions in a given country, of course, determine the preferred choice. If gradualism is the chosen approach, then the subsequent reform measures have to be sequenced both vis-à-vis the real sector and within the financial system itself if an orderly transition is to be made.

Institution of an *appropriate regulatory and supervisory mechanism* is another prerequisite for a successful financial sector liberalization. Where liberalization is undertaken without having in place such a mechanism, unqualified operators can enter the sector and existing institutions can engage in excessive risk-taking. When a crisis situation is created because of the absence of regulation, another round of intervention will be required or the confidence in the financial sector can be seriously damaged.

When the liberalization of the Ethiopian financial sector was being contemplated, the significance of the above considerations was well recognized. Consequently, the first measure taken by the Ethiopian Government before embarking on financial sector liberalization was to create a stable macroeconomic environment. At the close of the *Derg* era, inflation was running at around 21%; the overall fiscal deficit (excluding grants) constituted 9.6% of GDP and the current account deficit (excluding official transfers) stood at 9.9% of GDP. To correct this situation, tight fiscal and monetary policies were introduced and the Birr was devalued.

As far as the choice of approach is concerned, Ethiopia opted for gradualism. This choice was dictated by the fact that since the Ethiopian financial sector was emerging from a socialist-oriented system (where there was no competition, no managerial autonomy and no entrepreneurial spirit), there was no regulatory and supervisory expertise and the foreign exchange earning capacity of the Ethiopian economy did not warrant the immediate scrapping of all exchange restrictions. By adopting this approach and by carefully sequencing the reform measures, it was possible to avoid the confusion and, more importantly, the destabilizing effects of one-shot liberalization programs experienced by some countries.

It is worth highlighting some of the noticeable policy measures taken to liberalize Ethiopia's financial sector during the last seven years. First and foremost, in recognition of the vital role of financial sector regulation and supervision, the Ethiopian Government gave the necessary legal and regulatory powers to the National Bank of Ethiopia prior to opening up the sector for private participation and competition. And the National Bank of Ethiopia, in its turn, has created a new regulatory and supervisory unit to discharge this responsibility.

The Ethiopian Birr was devalued by 59 percent in October, 1992 against the US dollar, and adjusted there after through the auction system with the objective of improving the country's international competitiveness which had been depressed due to the overvaluation of the currency which was pegged to the US dollar for decades. Interest rates which were administratively fixed and differentiated by sector and ownership type, were liberalized, (except minimum deposit rate set at 6 percent) to give a correct signal to market forces with respect to cost of capital and resource allocation.

The financial sector was opened to domestic private sector participation with the view of enhancing competition within the financial sector, expanding and diversifying financial services, and increasing financial deepening.

Commercial banks are allowed to open foreign exchange bureaus to conduct all approved current account transactions. Treasury bills auction was introduced and its modalities improved with the intention of mitigating the crowding out effect of the private sector by the government in credit appropriation from banks, and of reducing inflationary pressure.

In order to further improve the environment within which banks operate, a foreclosure law has been enacted and an effort is going on to establish a mechanism for sharing information on borrowers, training programs for bankers, etc. Moreover, existing public banks were recapitalized and new capital level was set for new banks so as to make banks financially strong.

Micro-finance institutions have been established to cater for the credit needs of small and micro enterprises both in urban and rural areas which, as you know, are not particularly suited to the cost-sensitive business strategies of traditional financial institutions.

An export credit guarantee scheme has been introduced to encourage exporters to diversify their exports and to enhance the country's foreign exchange earnings. Exporters are also allowed to deposit 10 percent of their export proceeds in foreign currency in domestic banks and convert the remaining balance through the formal banking system at freely negotiated rates.

Another important policy measure was the introduction of the foreign exchange auction system to determine, through market forces, the exchange rate applicable to most transactions. Inter-bank money and foreign exchange markets have also been established to facilitate the proper utilization of liquidity in the banking system and to further consolidate exchange rate and interest rate liberalization.

At this juncture it is appropriate to ask the question "What are the major outcomes attained and difficulties encountered as a result of the policy measures enumerated above?"

There were only three specialized banks, fully owned by the Government, before the reforms. Today there are nine banks, out of which six are privately owned. There was only one state-owned insurance company before the liberalization of the financial sector was set in motion. To date, there are nine insurance companies, out of which eight are under private ownership. Competition, which was totally absent in the sector in the pre-reform period, is well underway among the banks and the insurance companies. The liberalization process has also been accompanied by the emergence of micro-finance institutions, which are new to Ethiopia. These institutions, whose targets are small farmers and micro businesses, are filling the gap left by big banks and are playing an important role in poverty reduction. At present, sixteen such institutions have been established.

As a result of financial sector liberalization it has been possible, to a certain extent, to improve financial intermediation and resource allocation through the banking system. The financial sector liberalization has revitalized the financial system. The level of competition within the financial sector has also moved a step ahead, albeit at a low pace, as new private banks and insurance companies have been established. Encouraging results have been attained in ensuring the viability and stability of the financial system. The sector's contribution towards the promotion of trade, savings and investment as well as real sector development has also shown some improvement. There are better results in the international competitiveness of the Ethiopian exports, and the premium between foreign exchange auction market and parallel market rates has significantly narrowed down. Interest rates are also keeping up in accordance with the principles of market forces.

Yet, in the face of such encouraging results, there have been, and still are, a number of challenges. Have we created, through financial sector liberalization, a diversified and deep financial system? Obviously, there is still a long way to go in this respect. We still do not have active money and capital markets. The types of financial instruments remain limited. The sector is not well diversified in terms of financial institutions. Competition in the sector is far from being fierce. This situation, however, should not come as a surprise, partly because the development of diversified and deep financial markets is an evolutionary process and partly because we are following a gradualist approach. Nevertheless, the liberalization process should be sustained through appropriate policy measures and would like to highlight some of the outstanding issues in financial sector liberalization in Ethiopia that we would have to address in the coming months and years

- Further liberalization of the foreign exchange market,
- Promotion and expansion of money and bond (security) markets,
- Deepening competition in the financial sector, and
- Improving the country's payments system. ■

TOWARDS A DEVELOPED AND AN EFFICIENT FINANCIAL SECTOR IN ETHIOPIA[1]

Ali Abdi
Senior Resident Representative, IMF

1. INTRODUCTION

An efficient and well-functioning financial sector is essential for the development of any economy, and the achievement of high and sustainable economic growth. A growing body of economic literature affirms the importance of financial development to economic growth, and the association of efficient and mature financial systems with economic development[2]. The empirical evidence is overwhelmingly in support of the financial deepening paradigm, although debate still continues on the direction of the causality. Some contend that in the early stages of development, financial development leads growth, while in later stages growth may determine the speed of financial development[3].

A developed and efficient financial system is necessary to mobilize domestic savings and foreign resources and to allocate them to high return investments. In addition, financial intermediaries provide savers a channel to diversify the risk of holding financial assets and permit investors to access financial resources that would otherwise be unavailable. In this process, a developed financial sector facilitates economic competition, integrates commodity markets, and facilitates growth. Moreover, once financial services are extended to rural and poor producers, a developed financial system is a strong tool to reduce poverty.

2. THE DEVELOPMENT OF THE FINANCIAL SECTOR IN ETHIOPIA

The use of money and coins in Ethiopia has a long history, and the introduction of modern banking is nearly a century old. The original bank of Abyssinia started operations in February 1905 and its activities included keeping government accounts and financing exports[4]. Despite the long history, which precedes the advent of modern banking throughout most of Africa, the Ethiopian financial system has not progressed much. The development of the financial sector was constrained by the government takeover of the existing private banks in 1975. In this period of a shift from a mixed to a state-managed economy, the development of the financial sector was stunted. Although the financial sector of Ethiopia has grown in the 1990s, compared to its state during the preceding decades, it is still in its infancy.

To assess the developments in the financial sector of Ethiopia, we have examined a number of indicators that have traditionally been used to measure financial deepening and development across countries. We have assessed four principal monetary and credit aggregates to measure financial development. None of the aggregates is an adequate parameter of financial development by itself; each is indicative but in combination they are highly reliable. We examined (i) the ratio of narrow to broad money (M_1 to M_2), (ii) the ratio of broad money to GDP, (iii) the share of bank credit to the private sector to total bank credit, and (iv) the ratio of credit to the private sector to GDP. In addition, we assessed the density of bank branches or the number of people per bank branch in Ethiopia and selected African countries as an indicator of financial sector maturity.

Figure 1 shows the evolution of the selected financial development indicators for Ethiopia in 1991-2000. Financial deepening is associated with a relatively higher increase in term deposits than in M_1 and hence a decline in the ratio of narrow to broad money. Such development has, in fact, occurred in Ethiopia in the last 10 years, as the share of currency and demand deposits in broad money declined from 77 percent to 59 percent between 1991 and 2000. Financial deepening is also associated with an increase in the ratio of broad money to GDP; in the case of Ethiopia this ratio remained broadly unchanged in the 1990s. There was a moderate increase in some years, but broad money as a percent of GDP did not show a consistent trend in 1991-2000. An increase in bank credit to the private sector as a proportion of total bank credit, and in relation to GDP also indicates financial deepening and development. The share of private sector credit in total bank credit rose from 4 percent in 1991 to 45 percent at end-1999, while the ratio of credit to the private sector to GDP rose by 16 percentage points in the ten years through 2000. In general, the results of financial indicators do not show an unambiguous financial deepening and development in the period. There have been positive developments in the growth of savings deposits (as compared to currency and demand deposits), and the share of bank credit to the private sector in total credit, and in relation to GDP. However, the growth in broad money was in line with the growth in nominal GDP (Figure 1 and Table 1).

To put the state of financial development in Ethiopia in perspective, we compared its recent development with that of three African countries (Egypt, Kenya, and South Africa), and three industrial economies (France, Italy and the United Kingdom). The current population of the three African countries ranges from 30 million for Kenya to 63 million for Egypt, and each of the three industrial countries has a population in the range of 56-60 million, while Ethiopia's is estimated at about 63 million. The level of development of the selected African and industrial countries, in terms of per capita income levels, is much higher than Ethiopia's, and accordingly the assessments point to the level of financial development Ethiopia should aim for Ethiopia's financial sector development, as measured by the relationship of monetary aggregates and economic output, is well below that of the selected African countries, and is even more starkly rudimentary in comparison to the financial systems of the industrial countries (Figures $2_a - 2_d$, and Table 2). More importantly, in recent years, Ethiopia has fallen further behind the developments in the comparator countries, instead of closing the gap as would be expected for late starters. Narrow money accounted for the highest share of broad money in Ethiopia and was more than double the ratio prevailing in the industrial countries. Broad money as a percent of GDP in Ethiopia was at about 40 percent, compared to 60 percent for the African countries and about 73 percent for the industrial countries. Per-capita deposits in Ethiopia were on average US$31 in 1998, as compared to Kenya with US$128, Egypt with US$865, and South Africa with US$1,624. Per-capita deposits at end-1997 in France, Italy and the United Kingdom were US$16,772, US$9,979, and US$25,081, respectively.

All other indicators of financial development also demonstrate a nascent financial system in Ethiopia. The share of private sector in total bank credit in Ethiopia was much lower than in all the six comparator countries in the 1990s. Such share in Ethiopia was under 50 percent, and ranged from 60 to 80 percent in the selected African and industrial countries. The maximum attained during the period in Ethiopia was 50 percent in 1999. This evidently reflects the undeveloped state of the financial sector and the private sector in general in Ethiopia. Policy changes that facilitated private sector economic activity since 1993 have contributed to narrowing the differences between Ethiopia and the comparators. Bank claims on the private sector as a percent of GDP were consistently lower in Ethiopia than in all the selected countries in 1991-99. Such claims averaged 11 percent of GDP in Ethiopia, but were in the range of 20-48 percent in the selected African countries and nearly 90 percent on average for the industrial countries. In Ethiopia, when priorities were given to the public sector and in the early 1990s, bank claims on the private sector in percent of GDP were in the low single digits. It was only after 1995 that bank claims on the private sector in percent of GDP were at 10 percent or higher.

At present, there are a very limited number of banks in Ethiopia, comprising 8 commercial banks and 1 development bank (all domestically owned), as compared to 54 banks in Kenya out of which 8 are subsidiaries of foreign banks, and 51 banks in South Africa out of which 8 branches and 11 subsidiaries are foreign banks. Given a population of about 63 million and 299 bank branches at end-June 2000, there was one branch for each 211,000 inhabitants in Ethiopia. This is extremely low even by the standards of African countries; inhabitants by bank branch in South Africa were 16,000 in 1998, and the ratio may be lower this year[5].

3. FINANCIAL SECTOR REFORMS IN ETHIOPIA

In a short period, the Ethiopian financial sector has been transformed from a classically repressed to a domestically liberalized financial system. Since the mid 1970's and through the 1980's, the unitary state-owned banks operated under selective credit controls, and administered interest rates that often were negative (Table 3). The NBE utilized pre-established annual credit guidelines to ration credit extended by the Commercial Bank of Ethiopia. These guidelines were not revised throughout the fiscal year, regardless of economic developments.

In 1976, the National Bank's authority was significantly enhanced with regard to the formulation of credit policy, imposition of exchange controls, and determination of interest and exchange rates. The National

Bank was given regulatory power to monitor credit to all non-government sectors, including lending conditions, maturities, security requirements, and the activities to be financed. Overall domestic credit extension was subject to central planing, but the principle of legal ceilings on credit from the banking system was also retained. The state of nationalized private banks, administered interest rates for savings and lending, and restricted allocation of credit reflected the classical manifestations of a repressed financial system. Predictably, under these conditions, the financial system did not develop. In the ten years through 1990, the annual growth of time and saving deposits averaged about 11 percent, indicating that the mobilization of domestic financial saving was limited.

After the change of government in 1991, a series of policy reforms were launched to move towards a market-based economy. Among these reforms were measures to decontrol prices and markets, including in the financial sector. The following principal reforms in the financial sector were gradually introduced:

(I) The government issued a proclamation (no. 84/94) that allowed for the introduction of privately-owned domestic banks. These private banks, now numbering six, were intended to provide competition to the state-owned banks and to improve the provision of financial services in the country.
(ii) The state-owned banks were reorganized (proclamation 86/94).
(iii) In July1996, a proclamation (no. 40/96) to provide for the licensing and supervision of microfinance institutions was issued. As of end-1999, 12 microfinance institutions have been registered.
(iv) The legal framework and instruments for bank foreclosure on the collateral on non-performing loans was introduced in September 1997.
(v) The National Bank issued a directive, (no. NBE/INT/7/98) to decontrol commercial banks' deposit and lending rates in January 1998. The National Bank has maintained since then a floor on bank deposits rates, at 6 percent.
(vi) The National Bank introduced in September 1998 (directive no IBM/02/98) a framework for the conduct of interbank money market operations.
(vii) Government also introduced significant reforms in the exchange and trade regime, particularly in September 1998, that considerably liberalized foreign exchange operations. These measures included the market determination of exchange rates through frequent auctions (bi-weekly initially and then weekly); the elimination of foreign exchange surrender; the decontrol of most external current account transactions; and the introduction of an interbank foreign exchange market.
(viii) The National Bank issued a directive that set a higher capital standard: a minimum capital requirement for new banks of birr 75 million, and that requires all existing banks to attain the higher capital base by June 2002.
(ix) The National Bank started upgrading its supervision capacity and has conducted frequent examinations of the soundness of private banks.

The recent financial sector reforms eased direct controls on the determination of interest rates (except for the floor on deposit rates) including the elimination of preferential treatment of selected sectors. The scope for market-based credit extension was enhanced. A number of significant institutional reforms were introduced. Private domestically-owned commercial banks, and non-bank financial institutions were licensed. Microfinance institutions were established, and efforts were made to improve bank supervision. The financial sector reforms implemented in the 1990s improved the operations of the Ethiopian financial system, but significant short comings of the sector remain intact.

4. THE CHALLENGES AHEAD

Developing an adequate financial structure is no less important to facilitating investments and economic growth than improving the rest of the economic infrastructure, such as telecommunications, electric power generation, and the transport network. The current undeveloped and inadequate financial structure of Ethiopia imposes heavy costs on potential investors and traders alike. If a large distance of an economic agent from a tertiary or secondary road is of concern, then the distance from a branch bank could well be as burdensome. A broad reform of the financial sector needs to be pursed in order to further promote growth and eliminate stark weaknesses. The following comments point to the most pressing issues and challenges that need to be addressed.

a. Deepening and Broadening Access to Financial Services

The current number of banks and branch network would need to be augmented to improve the financial structure, while ensuring that all new entrants in the financial market are prudentially sound. The current network of 8 commercial banks is concentrated in Addis Ababa, which accounts for 30 percent of the total branches, and, in all, a dozen towns account for 49 percent of the total branch network. Steps are necessary to reduce the overwhelming reliance of economic agents in Ethiopia on cash transactions, which results from a lack of automated banking operations and efficient check clearing arrangements for banks. Moreover, other modest improvements such as the introduction of debit and credit cards, which are common place in this region and else where, could facilitate transactions.

Increasing access to basic financial services is key to reducing poverty in Ethiopia.

The inadequacy of the financial structure is particularly evident in the rural areas, where an overwhelming majority of Ethiopians reside. As noted above, a forceful attempt is underway to develop alternative sources of finance for rural communities, through microfinance institutions. However, the current capacity of these institutions is clearly limited. The total assets of the microfinance institutions, for which data are available, amounted to birr 239 million in mid-1999, equivalent to 1 percent of the assets of commercial banks at the time. More significantly, the microfinance and commercial bank markets are totally segmented, and hence there is an imperative need to integrate the financial markets.

The recent development of microfinance institutions is encouraging as these units focus on poverty alleviation by serving exclusively the poor, particularly the rural poor. Microfinance institutions provide savings and credit facilities to the poor that are not served by commercial banks, and at lower costs than informal money lenders. Also, the high repayment rates in microfinance institutions in Ethiopia are encouraging. Nevertheless, the sources of income for microfinance institutions depends mainly on crop harvest, which are subject to frequent droughts and unstable commodity prices. In these circumstances, there is a need to diversify risks by varying the mix of clients, in particular by including small artisans and urban traders in the portfolios of microfinance institutions. Crop finance insurance, when available, could also reduce overall risks[6].

b. Enhancing Competition in the Financial Sector

The inadequate performance of the financial system has reflected a lack of progress in enhancing competition. In a short period of time, the small private banks that were established have increased access to financial services by raising the number of branches, provided extended hours of operations, and offered clients a limited choice. However, the new private banks have not measurably increased the menu of financial assets and have failed, as yet, to trigger competition in the financial sector.

The Commercial Bank of Ethiopia (CBE) may no longer enjoy monopoly power in the commercial banking sector, but it maintains a dominant influence in the financial sector that continues to limit competition in the money and exchange markets. As of end-1999, the CBE accounted for 87 percent of deposits held with, and 81 percent of the loans extended by the commercial banks. Together with the other state-owned commercial bank, the public banks accounted for 90 percent of deposits and 88 of loans outstanding at the end of last year. In this context, the small and undercapitalized private banks have not improved competition in the financial sector. Evidence available indicates that most pricing decisions in the financial sector are dictated by the CBE, and the private banks are price takers. A number of structural constraints, including the state of excess liquidity in the financial system, the paucity of bankable projects, and the lack of an operative interbank money market, contribute to the dominance of the CBE in the money and exchange markets. The lack of competition is marked by the prevailing interest and exchange rates in these markets. National policy encourages market determination of interest and exchange rates, but the CBE established rates have proven almost invariant and have acted as ceilings on interest and exchange rates.

Enhancing competition by enlarging the menu of financial assets and services, and introducing banking innovations requires new technologies and banking skills. Accordingly, there is a need to introduce such innovations through acquisition of the required technologies by the existing institutions or by the introduction of new banks that can inject in the system the needed modern and efficient financial techniques. Introduction of traditional foreign banks would not resolve all difficulties faced by the Ethiopian banking system, least of all improving access of the rural community to financial services. However, foreign banks will provide know-how, improve the range of financial assets and services available in the Ethiopian financial market, and could well
enhance the stability and the soundness of the financial system provided the foreign banks are well chosen.

c. Removing structural constraints on the operations of the financial system

A number of structural deficiencies contribute to the poor functioning of the financial markets: (i) inadequate risk assessment and lack of information by individual banks on prospective clients, (ii) low levels of entrepreneurship and limited "bankable" projects, and (iii) lack of assets that can be used as collateral. The money and capital markets are extremely underdeveloped;

the only financial assets available to investors other than bank deposits are treasury bills of a short-term maturity. These structural deficiencies would need to be corrected if the financial sector is to perform its functions efficiently.

Lack of risk assessment capacities is a predominant feature of the Ethiopian commercial banking system that leads to limited or no differentiation in interest rates among borrowers, regardless of risks. Under the current system, a flat rate of interest is charged across borrowers, without distinction to type of business and credit worthiness of the clients. No meaningful risk assessment takes place, and variations in the value of the collateral serve in place of interest rates differentiation and appropriate risk analysis. Consequently, the lack of credit rating mechanisms should be fully addressed.

Limited information on borrowers and prospective clients constrains the ability of banks to develop new and relatively high-risk business. A dynamic financial institution that wishes to extend loans to new clients and develop longer term relationship with untested entrepreneurs, often without collateral, needs information on potential customers and specifically on less credible and problem cases. In this context, information sharing among the banks, could serve to meet the immediate requirement for more adequate assessment of clients, while risk analysis and credit agencies are to be developed.

Paucity of bankable projects and limited availability of collaterable assets have constrained the performance of the financial sector. A high and sustainable growth in Ethiopia demands augmentation of domestic financial savings and the efficient allocation of such savings. An indication of the structural constraints confronting the financial system is the large and persistent amounts of unremunerated excess reserves and liquid assets which are held by the banking system. These excess reserves/liquidity manifest limited availability of bankable projects. Alternatively, the commercial banks may not be lending to potentially high return projects, owing to lack of sufficient collateral by the borrowers. The limited availability of collaterable assets is accentuated by the country's land ownership policies and the very limited commercialization, if at all, of land leases. There could be objective reasons for a bank to maintain high liquidity as a prudential measure, particularly if a sizeable share of its portfolio is of a questionable quality. Unregulated excess liquidity could endanger financial stability and weaken the external accounts. In addition, excess liquidity in banks is inimical to mobilization of financial savings and impedes financial deepening.

d. Ensuring Adequate Regulations and Supervision

Recent efforts to improve regulatory and supervisory capacity need to be further strengthened. Banking problems and failures are widely perceived to have adverse effects on an economy, as they tend to spread quickly throughout the system, affecting solvent as well as insolvent banks. Ensuring sound banking is necessary to reduce the adverse effects on macro-economic performance and to avoid a heavy fiscal burden. Detailed supervision and frequent examinations of the condition of banks, with prompt corrective actions, as necessary, is required. A comprehensive approach to address the immediate balance sheet and income problems of weak banks is also important. The success of dealing with problem banks is related to the urgency and speed with which corrective measures are undertaken. In addition, adequate supervision is needed to correct forthwith any shortcomings in the accounting, legal and regulatory framework and to ensure sound banking. Prudential regulations, based on increasing transparency, accountability and the adoption of internationally accepted standards of good practices help promote confidence and soundness in the banking sector[7].

e. Developing Instruments for Monetary Policy Management

The National Bank of Ethiopia has made progress in its modernization and development of its institutional capacities in a number of areas. It remains, however, quite passive in the conduct of monetary policy and there is an urgent need to build from scratch a market-based monetary system, where indirect instruments of monetary policy are used as the principal tool of intervention. Currently, even the most basic tools to conduct open market operations are not developed, and the interbank money market has not become fully operational. The main constraint relates to the lack of appropriate instruments, such as National Bank or government securities, that can underpin open market operations. Liquidity management in the financial system is likely to become more imperative as the financial system develops and the monetary authorities move away, definitively, from direct interventions and the application of blunt instruments, including the active use of changes in the statutory reserve and liquidity requirements.

The National Bank should promote the development of an efficient payments system in the country, and facilitate the emergence of debt instruments and private securities markets. Evidently, the National Bank needs to focus its skills and resources on its first line responsibilities of maintaining financial and macroeconomic stability, management of the country's reserves, and supervision of financial institutions. Also, the National Bank ought to consciously pursue the development of tools and instruments that will enable it to perform the larger menu of responsibilities entrusted to autonomous central banks in financially mature economies.

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[2] Raymond Goldsmith, 1966; Ronald Mckinnon, 1973 and Edward Shaw, 1973

[3] Hugh Patrick, 1966

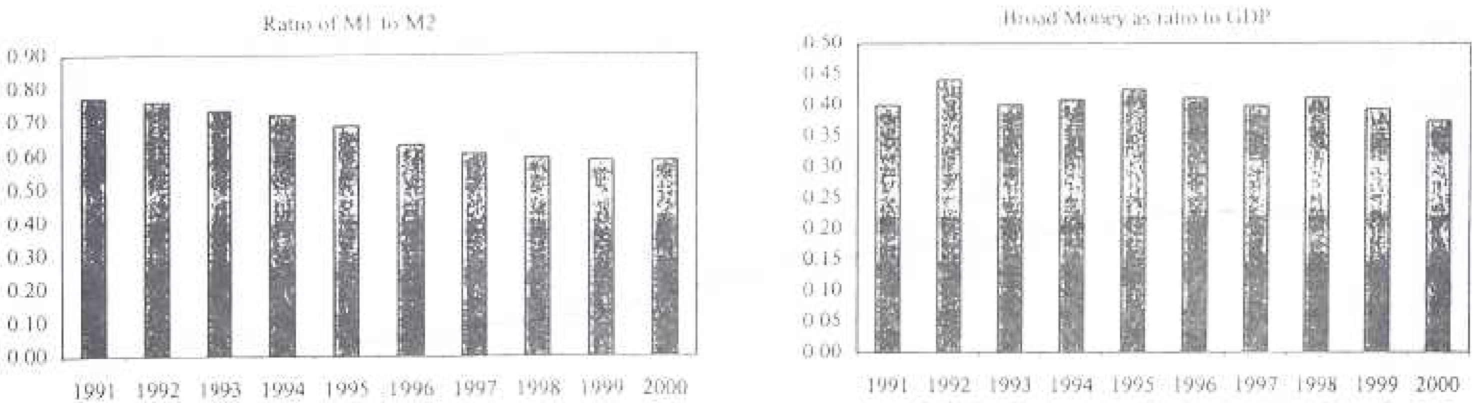
[4] Belay Gidey, 1987.

[5] Mehran, Hassanali and others, 1998.

[6] Wolday Amha, April 2000

[7] Asrat Betru, April 2000

Figure 1. Ethiopia: Financial Deepening Indicators, 1991-2000 [1/]



Source: Data compiled by the National Bank of Ethiopia, and Ministry of Economic Developments and Cooperation

[1] June 30, except for April 30, 2000

[2] Private sector credit excludes public sector enterprises

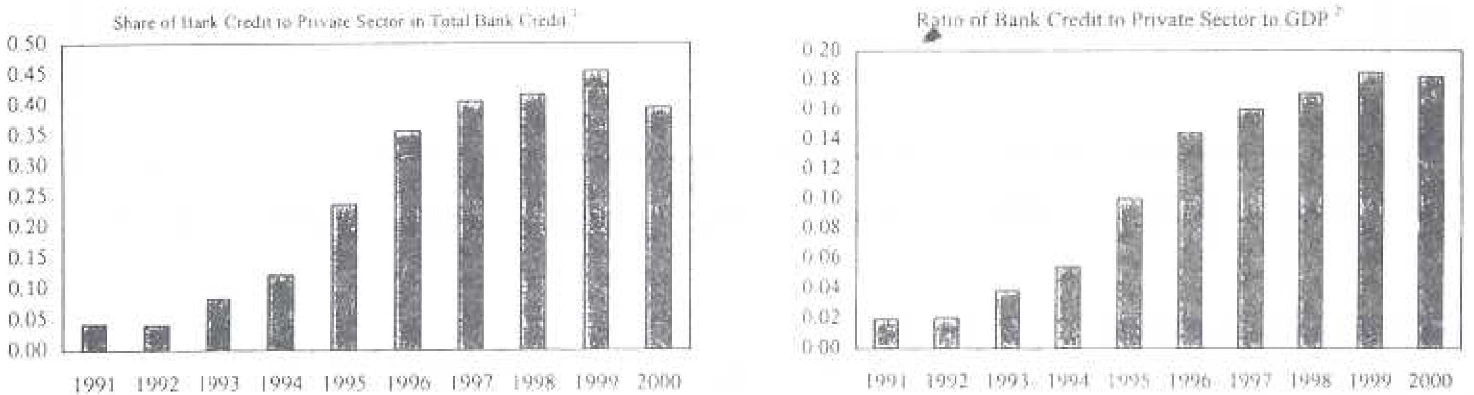
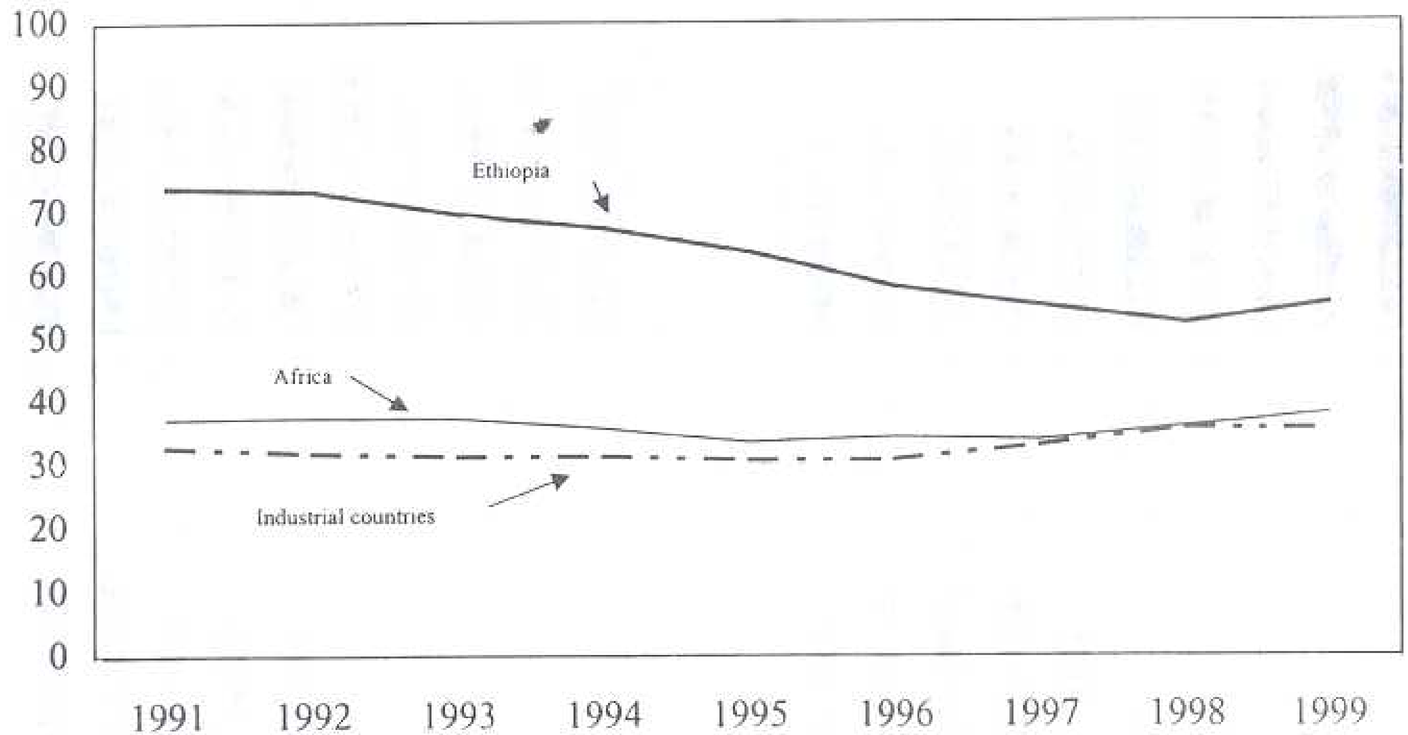


Figure 2a. Ethiopia: Selected African and Industrial Countries' Ratio of M1 to M2 [1]
In percent



Source: *International Financial Statistics*.

[1] Composite aggregates are constructed using simple averages, African countries are Egypt, Kenya, and South Africa; and industrial countries comprise France, Italy, and the United Kingdom

Figure 2b. Ethiopia: Selected African and Industrial Countries' Broad Money in % of GDP [1/]

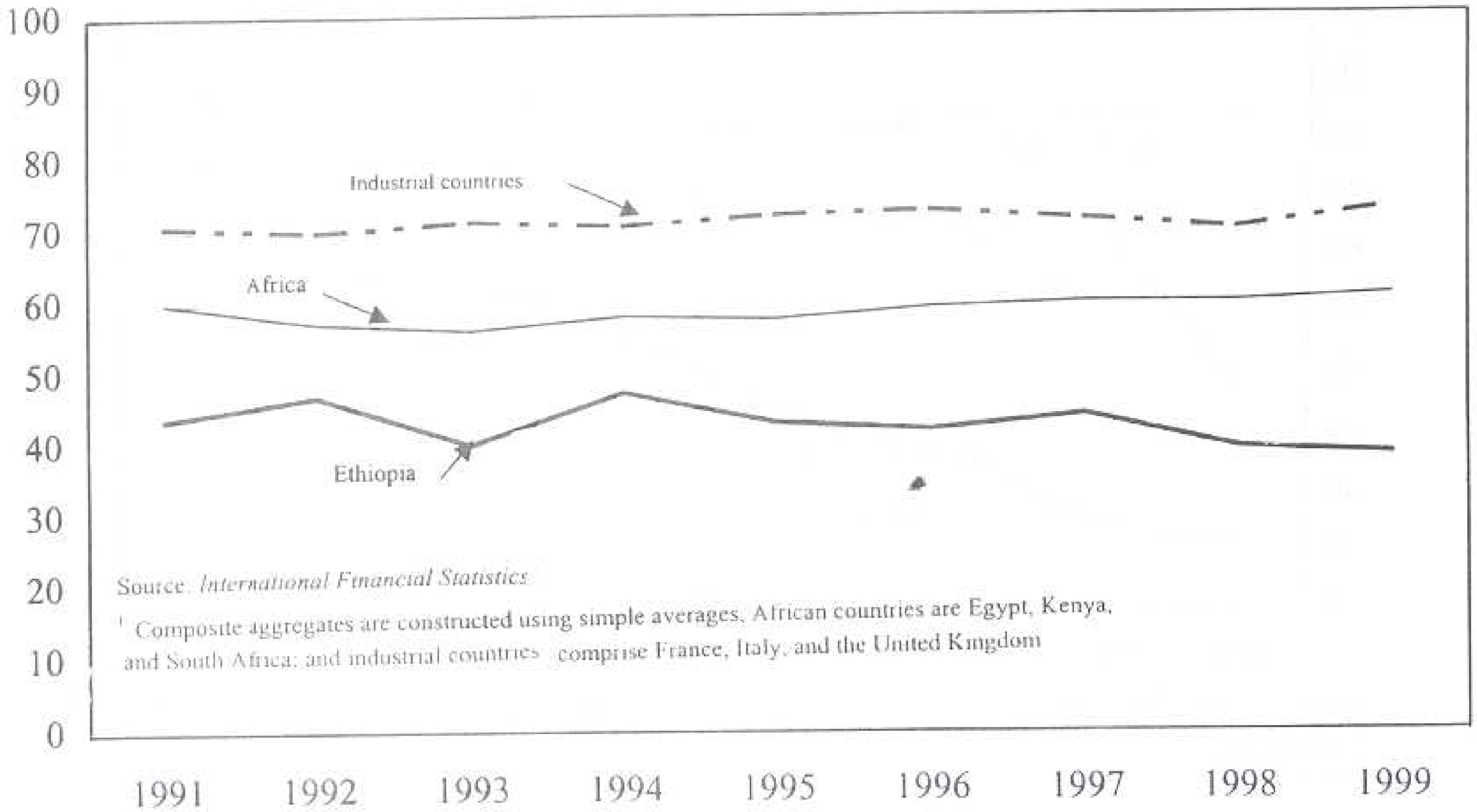
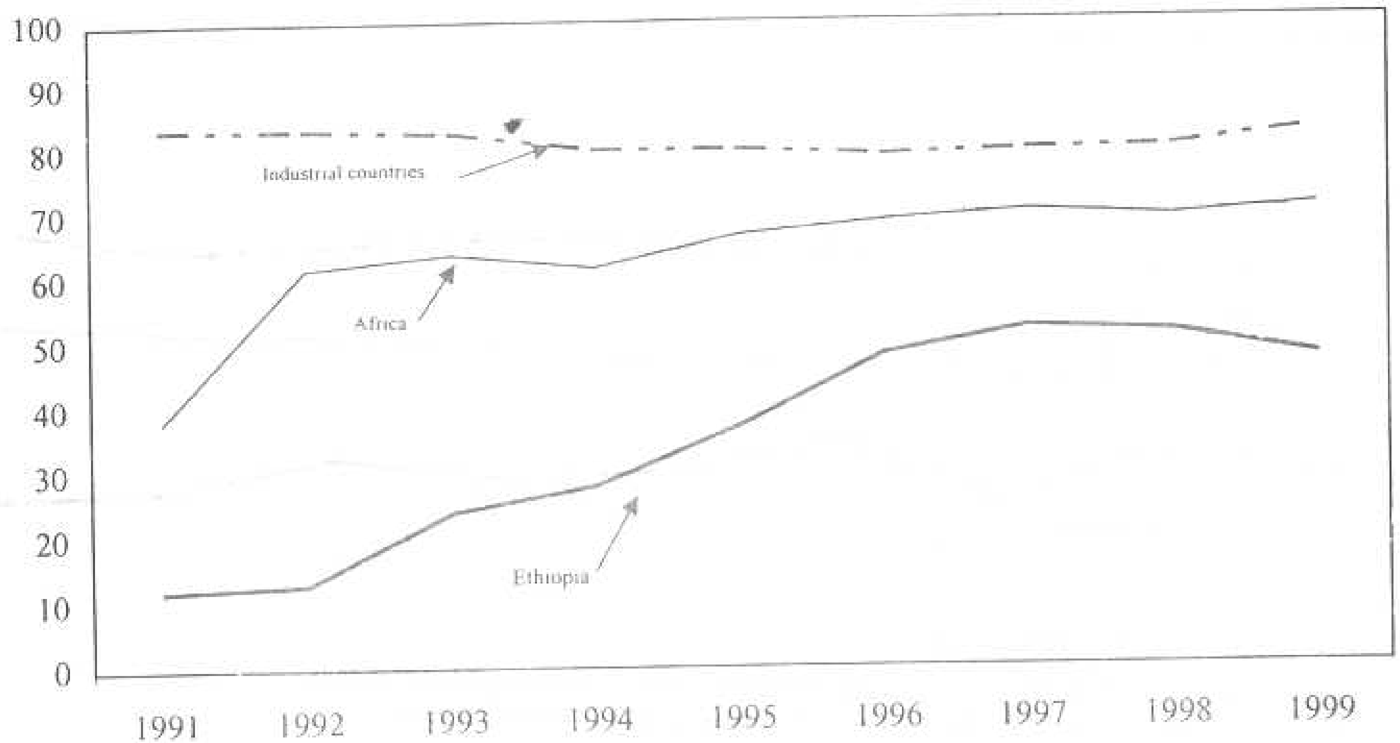


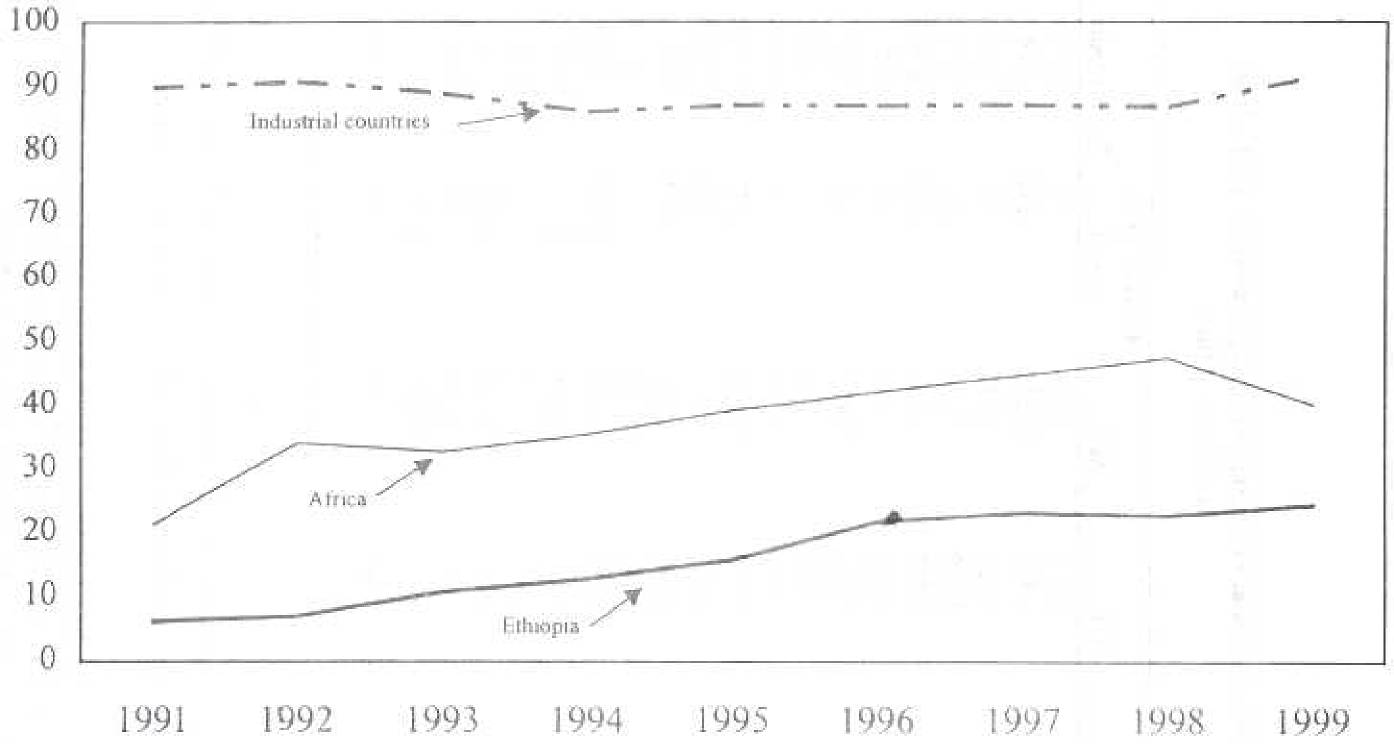
Figure 2c. Ethiopia: Selected African and Industrial Countries' Percentage Shares of Bank Credit to Private Sector in Total Bank Credit [1/]



Source: *International Financial Statistics*

[1/] Composite aggregates are constructed using simple averages, African countries are Egypt, Kenya, and South Africa; and industrial countries comprise France, Italy, and the United Kingdom

Figure 2d. Ethiopia: Selected African and Industrial Countries' Bank Credit to Private Sector as % of GDP [1/]



Source. *International Financial Statistics*

[1/] Composite aggregates are constructed using simple averages; African countries are Egypt, Kenya, and South Africa; and industrial countries comprise France, Italy, and the United Kingdom

Table 1. Ethiopia: Financial Deepening Indicators, 1991 - 2000 [1/]
In millions of Birr

June 30	M1	M2	Private sector credit	Total credit	GDP
1981	1,715	2,378	367	2,766	10,079
1982	1,884	2,635	392	3,065	10,636
1983	2,180	3,041	397	3,648	11,775
1984	2,379	3,384	374	4,092	10,988
1985	2,692	3,849	364	4,478	13,027
1986	3,321	4,421	355	5,081	13,575
1987	3,723	4,951	411	5,655	14,391
1988	3,911	5,239	473	6,406	14,971
1989	4,166	5,688	388	6,865	15,742
1990	4,983	6,688	381	8,042	16,826
1991	6,123	7,935	392	8,999	19,816
1992	6,840	8,992	424	10,168	20,380
1993	7,684	10,450	1,009	12,033	26,035
1994	8,376	11,602	1,557	12,764	28,329
1995	9,922	14,408	3,400	14,352	33,885
1996	9,917	15,655	5,495	15,411	37,938
1997	10,025	16,549	6,656	16,447	41,465
1998	11,038	18,587	7,714	18,523	45,035
1999	11,379	19,399	9,132	20,096	49,239
2000 [2/]	12,191	20,827	10,146	25,748	55,606
Memorandum items:		(Average annual percentage changes)			
1981-90	11.9	11.3	0.8	11.6	5.7
1991-00	7.3	11.0	39.9	10.4	11.8

Source: National Bank of Ethiopia, and Ministry of Economic Developments and Cooperation.

[1/] Data indicated in this table differ from that shown in table 2; the data are for end-June and end-December, respectively. Also, private sector credit in this table excludes public enterprises, and bank credits in this table include claims by the Development Bank of Ethiopia

[2/] Monetary and credit aggregates are for April 30, 2000, and GDP is projected

Table2. Ethiopia: Selected African and Industrial Countries' Financial Deepening Indicators [1]
(In millions of local currency)

	Egypt	Ethiopia	Kenya	South Africa	France	Italy	The U.K.
				Narrow Money			
1991	28,337	6,199	31,667	...	1,624,500	519,834,000	20,085
1992	30,832	7,142	46,577	70,809	1,623,100	526,394,000	20,581
1993	34,571	7,450	59,322	75,550	1,634,800	559,627,000	21,729
1994	38,275	9,027	66,792	94,511	1,688,400	581,395,000	23,322
1995	41,540	9,280	69,333	111,844	1,835,900	584,769,000	24,539
1996	44,521	9,273	78,995	147,664	1,835,300	614,304,000	26,153
1997	48,708	10,087	91,037	173,335	1,956,600	654,658,000	27,802
1998	58,577	9,304	94,092	213,532	1,993,000	727,693,000	29,346
1999	59,066	10,525	109,506	256,075	1,923,500	885,392,500	32,736
				Broad Money			
1991	98,464	8,387	69,471	...	4,189,100	936,321,000	504,717
1992	117,594	9,749	96,579	187,840	4,241,900	986,311,000	517,919
1993	133,174	10,702	123,654	199,692	4,410,900	1,060,372,000	544,097
1994	148,109	13,405	162,547	236,268	4,700,700	1,079,452,000	567,195
1995	162,766	14,605	202,853	274,145	5,209,500	1,105,204,000	623,542
1996	180,403	15,972	254,396	313,290	5,417,000	1,129,950,000	682,999
1997	199,837	18,311	301,925	369,097	5,811,300	1,066,176,000	722,199
1998	221,372	17,792	309,707	419,490	5,622,000	1,073,776,000	782,841
1999	233,910	19,001	328,294	461,820	6,074,260	1,254,451,200	813,350
				Total Bank Credit			
1991	107,483	9,840	83,821	...	7,187,800	1,369,360,000	691,589
1992	111,311	11,204	98,554	219,287	7,484,100	1,554,880,000	705,781
1993	119,278	11,875	96,934	246,036	7,342,300	1,617,110,000	730,604
1994	134,906	12,897	145,142	298,272	7,560,300	1,672,100,000	792,158
1995	157,300	14,361	198,876	333,490	7,902,700	1,708,990,000	880,064
1996	179,230	17,119	236,037	394,082	8,118,200	1,770,520,000	961,856
1997	207,724	18,355	285,817	457,993	8,390,400	1,811,640,000	1,015,920
1998	247,195	19,934	311,661	537,863	8,624,000	1,902,180,000	1,061,170
1999	278,013	25,165	341,495	588,029	8,946,380	2,121,003,600	1,116,260
				Bank Credit to Private Sector			
1991	24,816	1,184	44,752	...	6,664,500	850,926,000	663,088
1992	30,978	1,450	58,587	214,295	6,933,900	943,014,000	684,059
1993	36,885	2,865	61,705	238,522	6,716,400	974,288,000	707,288
1994	48,831	3,618	78,809	282,375	6,592,700	984,219,000	745,718
1995	66,777	5,336	118,189	327,114	6,751,200	1,030,340,000	829,533
1996	83,810	8,243	147,077	382,548	6,671,100	1,060,420,000	912,272
1997	105,545	9,595	183,306	437,386	6,804,200	1,123,530,000	973,365
1998	133,799	10,253	184,267	506,860	6,885,000	1,224,360,000	1,016,750
1999	159,958	12,014	204,037	558,300	6,942,000	1,541,623,900	1,094,060
				Gross Domestic Product			
1991	111,200	19,195	221,250	331,980	6,891,000	1,440,650,000	582,946
1992	139,100	20,792	264,967	372,227	7,120,400	1,517,600,000	606,582
1993	157,300	26,671	333,613	426,133	7,227,100	1,563,270,000	637,817
1994	175,000	28,329	400,722	482,120	7,488,400	1,653,400,000	676,036
1995	205,000	33,885	465,653	548,100	7,757,400	1,787,280,000	712,548
1996	228,300	37,938	527,967	618,417	7,953,900	1,896,020,000	754,601
1997	256,250	41,465	627,436	683,666	8,205,000	1,974,620,000	803,889
1998	280,220	45,035	698,958	740,581	8,535,800	2,057,730,000	847,159
1999	302,300	49,239	737,230	...	8,809,500	2,128,380,900	889,874

Source: *International Financial Statistics*.

[1] M1 refers to money in circulation plus demand deposits for all countries except the U.K. Notes and coins in circulation plus bankers' operational deposits is used as M1 in the U.K., and notes and coins in circulation with the public, plus sterling deposits held with banks and building societies by the private sector is taken as M2.

Table 3. Ethiopia: Interest Rate Structure, 1981 - 2000

(In percents per annum)

	December								May
	1981	1985	1990	1995	1996	1997	1998	1999	2000
Savings Deposit rates	6.0	6.0	6.0	11.0	7.0	7.0	6.0	6.0	6.0
Lending rates									
Minimum	7.5	7.5	6.0	16.0	10.5	10.5	10.5	10.5	10.5
Maximum	10.0	10.0	9.5	16.0	10.5	10.5	12.0	13.0	13.0
Addis Ababa CPI [1/]									
(12-months average percentage change)	6.1	19.1	5.1	7.6	4.5	0.2	0.7	4.3	4.6
Real Interest Rates									
Savings Deposit	-0.1	-13.1	0.9	3.4	2.6	6.8	5.3	1.7	1.4
Lending, maximum	3.9	-9.1	4.4	8.4	6.1	10.3	11.3	8.7	8.4

Source: National Bank of Ethiopia

[1/] The former retail price index of Addis Ababa, which excludes house rent, is used for the period through end-1996.

FINANCIAL SECTOR LIBERALIZATION IN DEVELOPING COUNTRIES

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INTRODUCTION

The financial sector plays a critical role in the process of economic development by efficiently mobilizing and allocating financial resources for their most productive uses. The development of the financial sector, by reducing information asymmetry and transaction cost, encourages financial saving and investment. Since investment is critical in economic growth, the growth impact of financial deepening and development is significant. This hypothesis has received both theoretical and empirical support [King and Levine 1993; Roubini and Sala-i-Martin 1993]. The flow of causality between economic and financial sector development, however, is not unambiguous. Whereas financial sector development is preconditioned by the stage of economic development of the country under consideration, various indicators of financial depth and development have robust explanatory power in most empirical growth analysis.

The issue of financial liberalization has remained controversial both in theory and practice. Moreover, financial sector instability and fragility has come to be more frequent and devastating in nature despite international efforts to manage the problem more effectively [Stiglitz 1993]. The debate has, however, rekindled itself in the aftermath of the Mexican and recently the East Asian financial crisis. The recent experiences have brought home the fact that market failure is endemic in the financial sector and crisis could strike even in economies with strong macroeconomic fundamentals and sound regulatory and supervisory mechanisms. When liberalization measures are dictated by the whim of international pressure with weak risk management capacity and absence of effective international financial architecture would have severe consequences on the performance and welfare of the reforming countries.

The main thesis of this article is that the financial sector in developing countries is confronted with strong forces of market failure that necessitates effective, transparent and credible government intervention. The tone of the argument is that international pressure for premature financial liberalization in developing countries would involve costly financial risk that is not commensurate with the advantage of liberalization for a developing country.

FINANCIAL LIBERALIZATION AND GROWTH: THEORY

The theory of financial sector liberalization in the developing countries came to dominate financial policy discussion since the early 1970s due to two seminal contributions by McKinnon (1973) and Shaw (1973). The core of their hypothesis is that government intervention in the developing countries to control interest rates, put ceilings on lending rates, ration credit to borrowers at below market clearing rate, and widespread use of inflationary taxes has repressed the development of the financial sector. Developing countries often pursued policies that kept interest rate artificially low, even negative in real terms, and in the process discouraged financial saving. This has hampered financial deepening, at times led to financial disintermediation. Moreover, whatever financial savings were made through the financial institutions were allocated to favored sectors, firms and privileged group of borrowers at a rate below the market-clearing rate in an attempt to subsidize their cost of capital. This has generally led to an implicit taxation on savers without necessarily encouraging efficient capital formation and economic growth.

The driving force behind these financial policies in most of the developing countries is fiscal in nature. Governments make wide use of inflationary taxes to finance their fiscal deficits and finance projects and public enterprises that are in its priority areas. This policy stance is not a problem by itself. The problem emerges when public sector expenditure is not sustainable, competition is limited and projects are not operating based on proper economic criteria. When the government drains the meager financial resources available in the economy, it tends to crowd-out the private sector and distorts the smooth functioning of the financial sector to mobilize and allocate financial resources in efficient manner. Projects that are funded with artificially cheap capital would cause more problems and resource misallocation unless they are given clear and hard budget constraints to eventually move to sustainable financial position.

The main argument in the theory of financial liberalization revolves around the relation between financial sector development and economic growth. Does financial market development exert a causal influence on economic growth performance? Do financial liberalization measures lead to financial sector development or is it simply the reflection of the stage of economic development itself? is it a practical policy option to liberalize the financial sector in developing countries?

It should be noted that effective government intervention in the financial sector is necessary and successful in some developing and developed countries by allocating financial resources in some strategic and leading industries with significant positive externalities. When financial control was accompanied by sound macroeconomic fundamentals, coupled with effective and transparent selection criteria of beneficiary sectors and firms, as was the case in East Asian countries, the cost of financial repression was over compensated by positive externalities and crowding-in effects of the subsidized undertakings. Moreover, widespread market failure in the financial sector and the tendency of the market to undersupply financial information and regulation necessitates selective and effective policy intervention.

Financial sector liberalization is intended to reduce financial resource misallocation and bring about financial development and hence accelerate and sustain economic growth. Liberalization is a continuous process that requires constant follow-ups and appropriate measures at the margin with more information and understanding of the operation of the sector. This is a critical capacity element in development policy management.

In developing countries, where the degree of monetization of the economy is generally low and financial intermediation is shallow, liberalization measures alone may not address both financial deepening and monetization of these economies. The main arguments in favor of financial liberalization states that interest rate liberalization, elimination of reliance on inflationary taxes, and reduction in credit rationing provides incentives for economic agents to increase their rate of and form of saving and investment. These measures encourage the mobilization of financial saving and improve the efficiency of investment by allocating financial resources for the most productive sectors and borrowers. The core process is establishing a contest-based credit market of scarce financial capital with transparent rules. The transfer of financial resources from low to high productive sectors of the economy lies at the center of the impact of liberalization measures on economic growth. The relative productivity of the formerly excluded potential borrowers with respect to the favored sectors determines the actual benefits. If liberalization measures and hence the credit market discriminates against low productive borrowers, it would have positive effect on the average efficiency of investment, increase total factor productivity and hence accelerates economic growth.

The liberalization measures, however, tend to increase financial fragility and susceptibility to exogenous shocks over which domestic policies have limited control [Demiriguc-Kunt and Detragiache 1998]. These features necessitate putting in place sound regulatory and supervisory measures and their effective enforcement to reduce, if not to eliminate, crisis in the banking and financial crisis. The main challenge of the reforming countries is developing a dynamic risk management system that identifies opportunities and assesses risks and acting in time to prevent financial sector vulnerabilities to excessive risk.

EXPERIENCES: WHAT HAVE WE LEARNED?

The developing countries pursued a set of policies to mobilize resources both from the domestic and external sources to stimulate and sustain their economic growth. In this respect, we have witnessed a remarkable shift in the financial policy stance of developing counties.

This has encouraged international capital, both short term and long term, to fly across countries and the developing and developed countries benefited in the process. Financial sector liberalization measures, in most cases, were taken within a broad set of reform policies that were dictated within a broad framework of the Washington consensus. Ideology instead of sound theoretical and empirical evidence tends to dictate the path of economic reform policies. The driving force of this approach is limiting the role of the government in economic affairs. The international pressure for financial liberalization, including opening the capital account, has mounted on the developing countries without proper consideration for the domestic capacity to effective financial risk management. This has generally provoked, at least in some East Asian countries, a massive inflow of short-term capital instead of long-term investment capital flows [Stiglitz 1999]. These features increased the critical role of effective supervisory and regulatory framework and the problem of information asymmetry in the financial sector.

The 1990s were remarkable in a sense that the global economy witnessed major shift in policy paradigm. The effects of these changes on the developing countries depended on a number of factors. And yet, from financial sector and policy perspectives, the major features were the increase in capital flows, the increase in the creditworthiness of the emerging market economies, and insatiable and unsustainable rate of external borrowing at times without an accompanying increase in the domestic saving rate. To make matter worse, the composition of capital inflows to most of the developing countries features a high portfolio of short-term capital instead of long-term investment flows. This has increased the vulnerability of these countries to shocks and liquidity problems that carry with them the risk of sudden reversals in capital flows. This massive reversal, as was witnessed in East Asian countries, has a massive power to lead economies into recession in the face of weak international cooperation to manage the crisis.

Irrespective of these remarkable features, however, the international mobility of capital has been quite limited in amount, scope and distribution. The evidence of capital mobility even across developed countries seems not overwhelming and capital tends to remain invested where it is saved [Feldstein and Horioka 1980]. This puzzle holds in developing countries perhaps with the exception of aid-dependent low-income countries. In the best of times, it disproportionately favored a handful of middle-income developing countries and has never been sustainable. Therefore, domestic saving mobilization has remained a critical link in promoting productive investment and hence economic growth. The fast growing economies encouraged domestic saving to finance an increasing share of domestic investment.

The East Asian economies are the typical cases in point where both domestic saving and investment rates were high and increasing. Encouraging domestic saving and hence investment is critical to sustainable economic growth and here comes the critical role of financial sector.

The recent eruption of financial crisis in July 1997 and its contagion effect led to massive disruption in the financial system and the respective nation economies. Economic recession set in. Social and welfare indicators deteriorated within a short period of time. The tigers of Asia were suddenly and unexpectedly fell under the wills of the elephants of international capitalism. The main lesson that emerged from the financial crisis in East Asian countries is that the crisis could strike irrespective of strong macroeconomic fundamentals, an increasingly sophisticated and internationalized financial sector, sound regulatory and supervisory system and an increasing confidence in international finance. And yet, financial liberalization is closely associated with financial fragility and instability [Demirguc-Kunt and Detragiache,1998]. This would discount unqualified claims that financial liberalization leads to financial deepening and development. The ultimate impact of liberalization measures then depends on the social cost of financial fragility and the welfare benefits that accrue from the financial deepening, enhancement of investment productivity and economic growth.

The scope, speed, sequence and success of the reform policies vary across countries and on the prevailing political economy factors of the countries. Generally speaking, however, the success stories are confined in countries where the reform policies were undertaken when economic growth is fast, macroeconomic imbalances are absent or very insignificant, the global economic system is stable and growing, when social consensus is broadly established and where prudential regulation and adequate supervisory system is put in place before adopting full-fledged financial liberalization measures (McKinnon 1991). Financial sector development requires the operation of a credible contract enforcement mechanism, transparent and reliable account standards. This in turn exerts a positive influence on mobilization, processing and dissemination of financial information and efficient utilization of financial resources for economic development endeavors.

FINANCIAL SECTOR REFORM IN ETHIOPIA

There are specific country features that would shape the elements of financial sector reform measures and the probability that such measures would be credibly implemented and consistently pursued. The main challenge for financial sector liberalization in a country like Ethiopia emerges from the very features of the economy. Abject poverty is widespread, income per capita is extremely low, the degree of monetization of the economy is quite shallow, the private sector is at its infant stage of development, economic growth has been stagnant, and breach of fiscal discipline has been the norm rather than an exception, institutional capacity for financial supervision and regulation are weak, and structural rigidities in the economy are prevalent. These features essentially dictate the extent to which policy measures could realize their potential. They require concerted effort instead of declaring policy reform alone.

The financial sector in Ethiopia has been subject to overt government control and intervention in its operation. Interest rates were centrally determined, government owned financial institutions dominated the financial market, financial intermediation was low, the financial depth of the national economy was rather shallow, and the mobilization of financial saving was discouraged by low or even negative rate of interest paid to bank depositors, and the supervisory power of the central bank was eroded by political interventions. The financial sector policy was made to serve the fiscal policy stance of the government.

Since the early 1990s, Ethiopia has undertaken a wide range of policy reform measures within the framework of the structural adjustment program. The policy package includes important provision to financial sector reform policies. The main provisions include:

- The amendment of the monetary and banking proclamation in an effort to strengthen the monetary policy and supervisory role of the Central Bank of Ethiopia;
- Relaxation of the entry of the domestic private sector in the financial services sector. Privately owned commercial banks were allowed to operate alongside government owned commercial banks;
- Devaluation and subsequent determination of the exchange rate in the auction market;
- Interest rates and lending rates were partially adjusted to reflect the cost of capital and to maintain positive real interest rate. Preparatory measures are being undertaken towards market determination of interest rate in the treasury bills and long term bond market;
- In line with the fiscal and monetary policy tightening, credit allocation to the private sector has improved and lending to the central government was reduced;
- The enactment of foreclosure law and attempts to implement when borrowers default on their debt obligations;

The development of the financial sector in Ethiopia depends on the state of the national economy and financial liberalization measures alone would have limited repercussions. Severe limitation in the legal system and contract enforcement mechanisms, the tradition of keeping and reporting financial indicators according of acceptable standards, the tradition of secrecy and the reliance of creditors on non-legal institutions to prevent default in credit repayment are some of the main constraints in the development of the financial sector. These factors operate in an environment where the depth of financial is rather shallow and non-financial saving is still a dominant form of saving.

CONCLUDING REMARKS

Financial sector liberalization is a complex and controversial issue that has attracted currency in public policy discussion. Liberalization measures when taken in a favorable policy environment indeed have considerable advantages to promote and sustain long-term economic growth. Nonetheless, the transition from financial control and restriction to full- fledged financial liberalization requires, among other things, establishing and practicing credible and effective system of property right, contract enforcement, transparent accounting practice, supervisory and regulatory mechanisms and capacity to assess and manage financial risk. Liberalization measures, with out due consideration of these preconditions, would often times increase the financial fragility and systemic financial risk of the reforming countries. Developing an effective, transparent and dynamic risk management strategies are required for successful financial liberalization endeavors. Apparently, these measures are necessary but not sufficient to prevent financial instability and crisis in developing countries. It should be noted that international pressure for premature liberalization of the financial sector could have a devastating impact on national economies as is evidenced by the recent financial crisis in East Asian countries. In this sense, gradual and cautious move towards liberalizing the financial sector in countries like Ethiopia is not a choice but rather a necessity that is dictated by the state of development of the national economy and the pressing alternative policy targets.

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PRUDENTIAL PERFORMANCE OF THE ETHIOPIAN BANKING SECTOR (1991/92-1997/98)*

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INTRODUCTION

After the differentiated outcomes of the financial liberalization endeavors and the slowdown of the debate over the 'financial repression' hypothesis (of Mckinnon and Shaw), issues of prudential regulation and supervision in the financial sector have taken center stage (Vos, 1993; Nissanke, 1991). According to WDR (1989) the latter issues basically comprise the following aspects: off-site inspection and supervision, licensing and capital adequacy (both initial capital and sustainable net worth), asset classification and provisioning, liquidity and portfolio concentration, enforcement power of supervisors, and auditing (World Bank, 1989: 91-94). While prudential regulation is the promulgation of laws in running banks, supervision is about assessing continued compliance with these laws (Bascom, 1994:170; Polizatto, 1993: 173-174, both cited in Alemayehu, 1999:7). Along these lines, Stiglitz (1993) argues for a firm government role in two areas: in the creation and regulation of new and existing financial markets (e.g. by setting accounting standards, creating and thickening markets for signaling) and in keeping and promoting stated social objectives (e.g. consumer protection, ensuring bank solvency, improving macroeconomic stability, ensuring competition, stimulating growth, improving the allocation of resources, etc.).

What do some of these aspects look like in Ethiopia? What are the specific banking sector regulations and what does the associated performance look like? It is in light of this growing importance attached to prudential regulation and supervision in the banking system that this paper tries to discuss the policy framework underlying the system in Ethiopia (only briefly) and to assess the prudential performance of the sector through some crude but indicative ratios.

A BRIEF LOOK AT THE REGULATORY FRAMEWORK

In this regard, the Licensing and Supervision of Banking Business Proclamation No. 84/1994 of the Transitional Government of Ethiopia provided the general framework.

From then on, a series of directives setting out the specific rules and regulations, the quantified requirements and compliance impositions are released and enacted by the NBE. From the outset, the proclamation, in its articles (Articles 3-11), outlines the requirements and procedures in applying for undertaking banking business in Ethiopia. In these are included the requirements for a company to be called a bank, NBE's power as the sole supervisory organ, the exclusion of foreign nationals from involving in undertaking/owning any banking business, requirements/documents to be attached in applying for license, introduction of investigation, procedural and annual license renewal fees, deadlines for NBE to respond in grants or refusals and for banks to commence operations, contravention measures for operating banking business without license and finally the conditions under which the revocation of licenses can occur. Along these lines, Directives No. SBB 1/94, 2/94, and 3/94 of the Licensing and Supervision of Banking Business of the NBE outline the specifications. Directive No. SBB/ 3/94 especially instructs as to the procedures and the standards of capital formation to open a banking business.

Concentrating on the directives associated with prudential supervision, one concerns capital adequacy. To ensure asset quality and solvency, following international guidelines, Directive No. SBB/9/95 provides the weights that should be attached to the assets of a bank and the standards for the computation of capital adequacy to fulfill for the minimum required capital of 8% of risk-weighted assets, as outlined by Proclamation 84/1994 (Articles 13(1)). Similarly, the proclamation, in its Articles 12 and 13(4), augmented by Directive No.SBB/4/95, directs every bank to transfer annually 25% of its net profits after tax to its legal reserve account until such account equals its capital. Once the equivalent is reached and maintained, the legal reserve transfer will only be 10% of annual net profits.

As to liquidity requirements, Article 16 of Proclamation No. 84/1994 imposes a liquidity requirement on banks to maintain liquid assets amounting to not less than a prescribed percentage

* This paper, for the most part, is taken from my senior essay. Due thanks to Dr. Alemayehu Geda who was my essay adviser.

of the total,, as is directed by the NBE. By the latest (See Directive No. SBB/15/95) the NBE expects any licensed bank to maintain liquid assets of not less than 15% of its total current liabilities. This requirement is imposed to avoid critical asset/liability mismatches. For prudential purposes again, Article 16(5) of the Licensing and Supervision of Banking Business proclamation mandates the NBE as the setter of the percentage of a reserve balance that banks are required to maintain out of their total deposit liabilities from time to time. In this regard, Directive No. SBB/14/96 (amending) instructs banks to maintain 5% of their demand, saving and time deposits in balances held at the NBE.

As we come to credit sector regulations, we first find those for provisions. Provisions have to be made for depreciation of assets, operating and accumulated losses, preliminary expenses, the value of any assets lodged or pledged to secure liabilities etc. by every bank in its calculation of the capital and reserve requirements (Articles 15 (1) and (2) of Proclamation 84/1994). Directive No.SBB/7/95 and its amending Directive No.SBB/18/96 of the NBE outline the specifications in this regard. As to provisions for non-performing loans, three phased settings for minimum provisions are instructed (for substandard, doubtful and loss loans).

The other side of the credit sector regulations broadly comprises those morally hazardous issues of single borrower loan limits and insider lending (in turn consisting of what are called accommodation, and loans to related parties). For these, Directives No. SBB/16/96, No. SBB/10/95 and SBB/17/96 have especially restrictive percentages that are meant to avoid any intentional or seemingly unintentional favoritism steps in credit extension of banks. Associated with these, there are also limitations on investment of banks whereby NBE prescribes as to where banks are allowed to invest and operate and not (Directive No. SBB/12/1996).

SOME CRUDE PRUDENTIAL PERFORMANCE MEASURES

To observe the prudential performance of the banking system in the post-1991 era, we can look into certain ratios that are imposed on banks as requirements to be maintained at some level. In this regard, ratios like Capital/Assets (even if this is not the proper way of computing capital adequacy because the assets are not risk weighted, trends in the ratio can hint to net worth positions and subsequent prudence overtime), earnings (returns on assets), profitability (returns on capital) and liquidity and reserve positions are used to assess the overall prudential posture of the banking system.

When we first see aggregate items, total assets of the banking system in the post-reform period grew at a rate of 17.1% on average per annum (over 1991/92-1997/98). 2Noteworth here is that the entrance of private banks in 1996/97 (except AIB, however), did not add much to total assets of the banking system as would have been expected (during this year, i.e. 1996/97, the asset growth rate of the banking system was only 10.6%). This, in turn, has two major implications. First, private banks are still infant in size as compared to the publicly owned ones. Second, AIB is the most dominant of the private banks and its preclusion from the analysis, in terms of size comparisons, really matters (interestingly enough total assets of AIB in December 1996/97 amounted to 524.8 million Birr while total assets of BA and DB added amounted only to 519.4 million Birr in June of the same year) (see related Annexes and Table 2). Continuing with aggregate items, similarly, Capital and Reserves of the banking system grew at an alarmingly high average annual rate of 90.5% during the years 1991/92-1997/98. This can be largely ascribed to the recapitalization of the government banks in September 1994 through government regulations. Among the years however, 1992/93 showed negative Capital and Reserves implying insolvency (see Table 1).

Table1. Aggregate items and prudential ratios of the banking system, (Million Birr)

Of the Banking System (except AIB)[1]	1991/92	92/93	93/94	94/95
a Total Assets	9381.3	10492.7	13025.2	16427.3
b Capital and Reserves	36	(51.5)	163.3	524.2
Net Surplus after tax and Provision	(44.5)	(82.5)	148.4	247.7
d Capital / Assets (b/a)	0.4%	(0.5%)	1.3%	3.2%
e Earnings (c/a)	(0.5%)	(0.8%)	1.1%	1.5%
f Profitability (c/b)	(123.6%)	(121.4%)	90.9%	47.3%

Of the Banking System (except AIB)[2]	95/96	96/97	97/98
a Total Assets	18742.1	20725.4	23991.4
b Capital and Reserves	1022.4	1389	1621.8
Net Surplus after tax and Provision	418.5	57.7	355.5
d Capital / Assets (b/a)	5.5%	6.7%	6.8%
e Earnings (c/a)	2.2%	0.3%	1.6%
f Profitability (c/b)	40.7%	4.2%	21.9%

Source: Computed by Aggregating items in prudential performance Annexes (See Annex 1 and 2)

Net surplus after tax and provisions over the years 1991/92 - 1997/98 grew at an average annual rate of 143.7%. The banking system, however, started with negative net surplus in 1991/92 only for its position to deteriorate further in 1992/93. Starting from 1993/94 up to 1995/96, however, net surpluses caught up on the rise. On the other hand, 1996/97 was a special year when net surpluses faced a dramatic fall amounting to an 86.1% decline from the previous year mainly due to the decline in the annual net profit after tax and provisions of the CBE. The latter was dominantly due to the increase in provisioning by the CBE (a significant expense) presumably to comply with NBE directives regarding the writing-offs and provisions for bad debts and non-performing loans respectively. CBE, in that year, was willing to sacrifice net income to win the confidence of the NBE and the public in general (See Annual Report of CBE 1997:11)[3]

When we get to the specific prudential ratios, capital / assets continually grew in percentage terms over the years after 1993/94 and reached its highest of 6.8% in 1997/98. This shows a growing solvency of the banking system through time (an attribute which a good prudential regulation strives to attain) boosted by the recapitalization of banks in 1994/95.

Earnings (net profits/total assets) also show positive trends. These were negative in the first two years of the post-reform period for reasons of remnants of poor performance of the pre-reform era. However, since 1993/94 the ratio began up the scale reaching its highest of 2.2% in 1995/96 and fulfilling for the "Satisfactory" level if the performance rating adopted by the NBE is applied on the banking system as a whole. The ratio for 1996/97, however, was severely disappointing, again owing to the bitter undertaking by the CBE (see footnote).

In contrast, at a glimpse, the profitability ratios seem saddening. After overcoming negatives in the initial two years of the post reform era, and attaining a high of 90.9% in 1993/94, profitability (net surplus/ capital) consistently went on the decline and actually reached its worst rate of 4.2% in 1996/97. However, except in the case of the year 1996/97, the other years' deteriorating profitability performance can be explained by increases in Capital and Reserves, the denominator (implying declining profitability), rather than by declining net surpluses (because net surpluses were actually rising). The fact of the matter is that net profits were not growing as fast as Capital and Reserves (See Table 1).

Brief Bank-specific prudential performance trends may be more explanatory (see associated annexes). As regards CBE, all aspects of its development are positive. Its net surpluses after tax and provisions increased year after year and reached their highest 356.2 million Birr in 1995/96 (we can reasonably exclude 1996/97 for reasons discussed above). Along with this, profitability and earnings were respectable for most of the years. Capital / Assets ratio also rose through the years showing the building up of solvency.

AIDB/DBE on the other hand seems to be severely struck by the hangover from the pre-reform period. Its net worth was negative for the first three successive years until it was recapitalised in 1994/95. Then, however, its Capital and Reserves have begun to catch up. Similarly, its net surplus was in the negatives for the first three years. Furthermore, in the subsequent four years, even if its surpluses entered positives and reasonably good ones too, the figures highly fluctuate that they render any trial to formulate trends inconclusive. As to the ratios, all–Capital/Assets, profitability and earnings–have caught up after the 1991/92-1993/94 desperate years but the latter two ratios were on observable low figures in recent years (1996/97 and 1997/98, see annex). DBE might have been feeling the pressure competing with the private banks.

Finally HSB/CBB.[4] This is the smallest of the three government banks. As to its prudential trends (See Annex) both its Capital and Reserves and Total Assets are on the upward incline and also Capital / Assets ratio is fairly keeping pace, implicit being solvency. Net surplus was negative in 1993/94 but has maintained positive figures since. Along with this, profitability and earnings ratios are positive in the final four years, but the latter ratio can only earn it a "Marginal" ranking in the performance rating adopted for commercial banks by the supervision department of NBE. Furthermore, the stated figures fluctuate.

Table 2: Aggregate items and prudential ratios for AIB, Million Birr.

AIB	1995	1996	1997	1998
a. Total Assets	233.8	375.5	524.6	562.3
b. Capital and Reserves	27.0	31.5	38.6	49.6
Net Surplus after tax and provision	3.1	6.8	6.3	11.4
d. Capital / Assets (b/a)	11.5%	8.4%	7.4%	8.8%
e. Earnings (c/a)	1.3%	1.8%	1.2%	2.0%
f. Profitability (c/b)	11.5%	21.6%	16.3%	23%

Source: Computed from Annual Reports. All data are as of December.

As is said above and can be seen in the table, Awash International Bank (AIB) is the most dominant private bank. Its prudential performance, as can be drawn form the table, is also good. Aggregate figures like total assets are growing together with Capital and Reserves. Actually, the ratio Capital to Assets is declining but a 9.0% average over its four years of operation is a good one (compare with related annexes for other banks). After all, the banking business is about properly managing and then manipulating liabilities that it can't be expected for capital, in place of liabilities, to grow in the same rate as assets. Net surpluses grew at an average annual rate of 64.3% over the years after commencement of operations, while earnings (net surplus/Assets) in all three successive years earn it a "fair" in the performance rating applied for commercial banks. Finally, profitability also averaged well at 18.1% over the three years (compare with other banks using related annexes).

RESERVE AND LIQUIDITY POSITION OF THE BANKING SYSTEM

As part of the prudential regulation adopted by the NBE (reviewed in the previous section), reserve and liquidity requirements are imposed on banks to guarantee depositors' welfare and bank solvency (in case of reserve requirements), and enhance immediate solvency and efficient bank services (in case of liquidity requirements).

Referring to the previous section again, banks operating in Ethiopia are required to maintain 5% of their deposits in reserve accounts at the NBE. Furthermore, they are required to maintain 15% of their total current liabilities in the form of liquid assets.

To check for compliance track records, we can look into the Reserve and liquidity positions of the Ethiopian banking system (See Table 3). In the three fiscal years from 1995/96 to 1997/98, actually the excess reserves at the NBE amounted to 125.4%, 108.3% and 200% of the annual required reserves. As to liquidity positions, the same story is repeated. The excess liquidity in the banking system was 160.7%, 188.7% and 242.1% of the required liquid assets annually, respectively. This excess liquidity maintained in the banking system can be a major factor to render the inter-bank money market (IBMM) (introduced by the NBE through Directive No. IBM/02/1998 in September 1998) impotent.

CONCLUDING REMARKS

As can be learned from the analyses above, the Ethiopian banking system has been sufficiently prudent in the studied time period (especially in the latter years). Aggregate items have been on the incline, showing a building up of the system in general. The indicative ratios (capital/assets, earnings and profitability) have been encouraging both for the banking system and the individual banks. Such a performance, however, may have been boosted by the initial small size of the system, which allows the banks to tap new and previously unsaturated areas. Furthermore, the NBE, in its supervisory role, could not have been bothered that much due to the uncomplicated nature of the sector. The excess reserve and liquidity position of the banking system, however, indicates as to the low rate of activity in the system in general and the potential that is embodied thereof.

Even if the ratios that are assessed above can be measures that highlight the performance (and hence the status) of the banking system in Ethiopia, other measures that utilize other already accustomed ratios (like non-performing loans/total outstanding loans, especially considering the controversies surrounding the CBE) can be more intuitive and can augment studies of this type.

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NOTE

[1] While annual reports of all the other banks come out as of June every year, that of AIB is published as of December annually. This creates an aggregation problem in data presentation and analysis and this is precisely why the analysis for AIB is presented here separately. The concerned authorities should take note of this and try maintaining some consistency.

[2] All growth rates are simple.

[3] Actually provisions for doubtful loans by the CBE increased by a high 623% between the years 1995/96 and 1996/97 impacting hugely and negatively for Net income after tax and provisions to decrease by almost 1000%. As to the non-performing loans of the CBE, there are seemingly- insider stories of soaring amounts while the CBE itself is claiming a rigorous loan collection campaign with a new type foreclosure law.

[4] Such analysis for the private banks (except AIB) will not be worth considering because, anyway, due to their recent emergence, it won't be conclusive. However, both the aggregated and bank-specific tables are presented in their respective annexes.

Annex 1: Aggregate Figures and Prudential Ratios of Government Banks (1991/92-1997/98)

Million birr

Bank	1991/92	92/93	93/94	94/95	95/96	96/97	97/98
1.CBE							
a-Total Assets	5,986.7	8,936.9	11,187.0	14,240.9	15,808.5	16,504.6	18,595.9
b-Capital and Reserves	104.0	104.0	232.4	365.8	632.4	936	1,091.20
c-Net Surplus after tax and provisions	35.6	51.3	167.3	210.4	356.2	32.4	321.1
-Capital / Assets (b/a)	1.7%	1.2%	2.1%	2.6%	4.0%	5.7%	5.90%
-Earnings (c/a)	0.6%	0.6%	1.5%	1.5%	2.3%	0.2%	1.70%
-Profitability (c/b)	34.2%	49.3%	72.0%	57.5%	56.3%	3.5%	29.40%
2. AIDB/DBE							
a-Total Assets	2,848.7	923.8	1,148.4	1,440.4	1,998.0	2,609.7	3,316.9
b-Capital and Reserves	(86.5)	(175.3)	(112.8)	108.6	334.1	354.3	372.6
c-Net Surplus after tax and provisions	(80.3)	(114.0)	(10.7)	35.3	54.1	19.4	25.6
-Capital / Assets (b/a)	(3.0%)	(19.0%)	(9.8%)	7.5%	16.7%	13.6%	11.2%
-Earnings (c/a)	(2.8%)	(12.3%)	(0.9%)	2.5%	2.7%	0.7%	0.8%
-Profitability (c/b)	(92.8%)	(65.0%)	(9.5%)	32.5%	16.2%	5.5%	6.9%
3. HSB/CBB							
a-Total Assets	545.9	632.0	689.8	746.0	935.6	1,091.7	1,090.7
b-Capital and Reserves	18.5	19.8	43.7	49.8	55.9	61.3	69.8
c-Net Surplus after tax and provisions	0.2	0.2	(8.2)	2.0	6.2	2.2	7.1
-Capital / Assets (b/a)	3.4%	3.1%	6.3%	6.7%	6.0%	5.6%	6.4%
-Earnings (c/a)	0.03%	0.03%	(1.2%)	0.3%	0.7%	0.2%	0.7%
-Profitability (c/b)	0.8%	1.0%	(18.8%)	4.0%	11.1%	3.6%	10.2%

Source: Computed from Annual Reports of respective banks

AIDB/DBE data for 1997/98 are based on a preliminary (unpublished) annual report

- All data are as of June
- CBE - Commercial Bank of Ethiopia
- DBE - Development Bank of Ethiopia
- CBB - Construction and Business Bank
- Figures in brackets show losses or negative performances.

Annex 2: Aggregate Figures and Prudential Ratios of Private Banks (Except AIB)

Bank	96/97	97/98	98/99
1.DB			
a-Total Assets	432.6	599.3	805.6
b-Capital and Reserves	18.4	21.7	58.3
c-Net Surplus after tax and provisions	3.5	3.3	9.3
-Capital / Assets (b/a)	4.3%	3.6%	7.2%
-Earnings (c/a)	0.8%	0.6%	1.2%
-Profitability (c/b)	19.0%	15.2%	16.0%
2. BA			
a-Total Assets	86.8	206.4	387.6
b-Capital and Reserves	19.0	26.9	38.8
c-Net Surplus after tax and provisions	0.161	1.6	6.5
-Capital / Assets (b/a)	21.9%	13.0%	10.0%
-Earnings (c/a)	0.2%	0.8%	1.6%
-Profitability (c/b)	0.85%	5.9%	16.7%
3. WB			
a-Total Assets		182.2	365.7
b-Capital and Reserves		39.6	46.0
c-Net Surplus after tax and provisions		(3.2)	6.1
-Capital / Assets (b/a)		21.7%	12.6%
-Earnings (c/a)		(1.8%)	1.7%
-Profitability (c/b)		(8.1%)	13.3%
4.UB			
a-Total Assets			88.7
b-Capital and Reserves			25.4
c-Net Surplus after tax and provisions			0.5
Capital/ Assets (b/a)			28.8%
Earnings (c/a)			0.6%
Profitability (c/b)			2%
Private banks (except AIB)			
a-Total Assets	519.4	987.9	1647.1
b-Capital and Reserves	37.4	88.2	168.5
c-Net Surplus after tax and provisions	3.7	1.7	22.4
d-Capital / Assets (b/a)	7.2%	8.9%	10.2%
e-Earnings (c/a)	0.7%	0.2%	1.4%
f-Profitability (c/b)	9.9%	1.9%	13.3%

Computed from annual reports of banks

- DB - Dashen Bank
- BA - Bank of Abyssinia
- WB - Wegagen Bank
- UB - United Bank
- The 1996/97 data for DB are based on an 18-month report.

Any entailing aggregation problem (as compared to annual data of other banks) is tolerated. The same applies for BA whose 1996/97 data are based on a 17-month report

- The 1998/99 data for UB are based on an 8 month report
- All data are as of June

TARIFF REFORM, TARIFF RATES AND TARIFF REVENUE IN ETHIOPIA

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1. INTRODUCTION

After the seizure of power by EPRDF in 199 1, both the transitional and the Federal Governments have taken tremendous economic reforms. These include trade and fiscal policy reforms which typically include tariff reforms.

The gradual tariff reforms, aimed at rationalising the tariff code, reduce the dispersion of tariff rates, lower the simple average and weighted average tariffs. Hence, the relation between tariff rates and the reforms is of considerable interest (Pritchett and Sethi 1994).

Regarding the trade reforms: trade has been liberalised to the extent possible. Most negative lists (restriction and prohibition) have been lifted, the trade licensing system has been improved. This in turn has increased the number of importers and the volume of imports as well as the tariff receipts (import revenue).

This article uses data from the Ministry of Trade and Industry, Ministry of Finance, Ethiopian Customs Authority, The National Bank of Ethiopia and The Ministry of Economic Development and Co-operation to examine the tariff structure, the tariff setting procedure, the relation between tariff rates and tariff revenues, and the 'collected rates' of tariffs.

2. THE TARIFF REFORM AND TARIFF REGIME IN ETHIOPIA

Tariff is a duty or tax, which is charged on imports from other countries. That is what we usually call 'customs duty'. The duty may be imposed on 'ad valorem' rate or specific rate. The tariff could be used either to protect home industries from the competition of foreign producers or it may be adopted to reduce the total imports bill a country has to pay (Nagpal, 1995). Bahtia (1994) considers export duties as tariff on exports.

At the outset, the objectives of tariffs in Ethiopia have been to protect domestic industries, to control imbalances in the balance of payments through the control of the balance of trade and to collect revenue from imports and exports tariff, to provide signals to producers and importers and to encourage import substitution, later on, however, liberalisation of foreign trade was most important.

Though there have been different tariff laws before 1943, the first officially known tariff regulation was issued in 1943. This regulation has been revised at different times. The tariff regulation, which was in place just before August 1993, was based on Customs Co-operation Council Nomenclature (CCCN) and had 99 chapters and about 1800 categories of goods. The tariffs levied were both ad valorem and specific rates. Out of these, 1800 categories of goods, about 73%, had ad valorem tariffs ranging between 5-230%; 9% with specific rates and 18% were imported duty free (MOF 1996).

The tariff band imposed on the 1320 categories of goods had reached 23 before major reform was taken by the government.

However, as the result of the trade and fiscal reform, the Council of Ministers issued Regulation. No. 122/1993 in August, 1993. According to this regulation:

- the Ethiopian tariff is based on the 1992 version of the Harmonised Commodity Description and Coding system which had about 5300 categories of goods;

- the ad valorem duty range decreased from 5-230% to 5-80%; the tariff band reduced from 23 to 9;

- 97.3% of the categories of goods have ad valorem duties; the rest 2.6% and

- 0.1 % will have duty free privilege and specific rate respectively.

Regulation No. 122/1993 has been continuously revised until the tariff was reduced to 5-40% range, 6-band tariff, 35% dispersion, 20% average tariff rate and 19.5% weighted average rate and the 1996 version Harmonised System is introduced. These steps have tremendously introduced trade liberalisation and reduced the extent of protectionism. The Effective Rate of Protection formulae were the tools to determine the rate of protection (MOF, 1996) and the enhancement of trade liberalization.

3. DATA ON TARIFFS, COLLECTIONS AND IMPORT VALUES

According to data obtained from the Ministry of Finance, the characteristics of the Tariff Code is summarised in Table 1 below.

Table 1. Characteristics of the Tariff code in Ethiopia

NO	Descriptions	before Aug 1993	August1993	Jan.96 to Dec'96	Dec'96 to Dec '97	Dec' 97 to Dec ' 98	1999/2000
1	Number of tariff items with imports	1800	5332	5332	5332	5297?	5297?
2	Lowest official tariff rate (%)	5	5	5	5	5	5
3	Highest official tariff rate (%)	230	80	60	5	40	40
4	Number of Official tariff rates	24	9	8	7	6	6
5	Simple Official mean tariff rate (%)	?	35	28.8	24.3	20	20
6	Weighted Average Tariff Rate(%)	?	29.6	24.6	23.6	19.5	19.5
7	Tariff Dispersion (%)	225=230-5	75=80-5	55=/60-5/	45=/50-5/	35=/40-5/	35=/40-5/
8	Number of Duty free Items	327	138	169	170	167	167
9	Number of Items charged with specific tariffs	162	3	3	3	3	3

Source: Ministry of Finace 1996-1999/2000

As table 1 shows, in number 1, we see that the number of separate categories of items distinguished in the country's tariff nomenclature were between 1800 and 5000. This shows that the country's tariff codes after 1996 are moderately detailed, compared to the previous years, hence facilitate classification of goods for tariff levying purpose, if customs has professional staff trained in classification.

From the table, the lowest tariff rate is 5% while the highest tariff rate has been reduced from 230 down to 40 in 1998. Consequently this has reduced the number of official tariff rates (tariff band) from 23 to 6; the simple official mean tariff rate from 35% (August, 1993) to 20%(1998); The weighted average tariff rate 'from 29.6% (1993-1996) to 19.5% (1998). The tariff dispersion has tremendously declined to 35% from a high of 225%. The tariff regime has also resulted in the reduction of the number of duty-free items charged with specific tariffs. The rates we are discussing in this table are for import duty. In fact, in addition to import duty, there are additional taxes (for example excise, sales, and sur taxes), and various fees (the preshipment inspection fee, warehouse fee, customs processing fee) which are levied and collected at the customs clearance office. This paper, would focus only on import duties, since the rest are not strictly import duties.

The import-weighted tariff rate gives a hypothetical revenue: the revenue from the tariff code if all import taxes were collected at the official rate (Pritchett and Sethi 1994). In our case the current weighted average tariff rate is 19.5%. If one multiplies this with the assumed import value, the result will be the hypothetical revenue. If the actual revenue collected is under and below the hypothetical revenue, the implication is that there is smuggling, underdeclaration of import values (underinvoicing), and misdeclaration of items with high rates (Pritchett and Sethi 1994).

The actual import duty collection would approximate the hypothetical value if and only if all imports were correctly reported and paid at the official tariff by importers. In the Ethiopian case, therefore, the true picture appears in Table 2 below.

Table 2. Customs Duty Collected from Imports (1990-1999)

		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
1	Customs duty collected (mln birr)	425.88	278.27	218.50	348.86	610.74	771.35	909.34	1059.20	1012.71	1130.47
2	CIF value of imports (mln birr)	1955.01	1824.12	1070.47	3126.65	4725.20	6546.27	7232.93	7379.29	8647.99	10101.47
3	Collected rates 1/2=3	21.8	15.3	20.4%	11.2%	12.9%	11.8%	12.6%	14.4%	11.7%	11.2%

Source: Ethiopian Customs Authority

As shown in table 1, the weighted average tariff rates in 1993-1995, 1996, 1997, 1998 to-date were 29.6%, 24.6% 23.6% and 19.5%, respectively; while the collected rates in the same periods were between

11.2% and 14.4% which indicates that smuggling, underinvoicing and commodity misdescription is rampant and a variation of 7%-15% is a huge loss to the country. So, we can conclude that there is no compliance by importers, customs was not in a position to control these fraudulent practices either due to insufficient training, inadequate logistics and facilities, inappropriate human resource management system including low pay scheme and absence of reward system which do not call upon integrity and honesty amidst the complex international trading system.

Some try to argue that the several rounds of tariff reform with substantial reductions in the official/ statutory tariff rates and the weighted average rates might have contributed to this variance. But, correspondingly, they have to see that the substantial rationalisation and liberalisation of foreign trade has substantially contributed to the growth of import goods (capital goods, consumer durable and non-durable, semi-finished goods and raw materials etc. ...). So, as tariff rates decline the volume of imports increase, supply of goods in the country increase, commodity prices in the country moderately stabilise (despite the effect of devaluation), and inflationary impacts are minimised (in fact this requires rigorous econometric analysis). But high rates do not mean higher revenues. According to a study conducted by Pritchett and Sethi (1994) for Jamaica, Kenya and Pakistan, there are two well-established explanations of why tariff revenues will not increase one-to-one with increases in tariff rates. First, to the extent that import demand for a good has some elasticity with respect to the tariff rate, the value of the import in a category will decrease with an increase in the tariff rate (in fact, other things being equal). Second, the value of imports reported for the collection of duties will decline with an increasing tariff rate, at any level of actual dutiable imports, because of underinvoicing, misdeclaration, and smuggling as the tariff rises. These points really hold true to Ethiopia's tariff and customs receipts as shown in table 3 below.

Table 3: Increase of Tariff Revenues with Liberalisation of Trade in Ethiopia

		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
1	Customs duty collected (mln birr)	425.88	278.27	218.50	348.86	610.74	771.35	909.34	1059.20	1012.71	1130.47
2	Import value (mln birr)	1955.01	1824.12	1070.47	3126.65	4725.20	6546.27	7232.93	7379.29	8647.99	10101.4
3	Exchange rate (annual average marginal rates)	2.07	2.07	2.07	4.27	5.798	6.25	6.32	6.51	6.88	7.524
4	Customs duty collected (US$)	205.74	134.43	105.56	81.7	105.34	123.42	143.88	162.70	147.20	150.25
	Import value (US$)	944.44	881.22	517.13	732.24	814.97	1047.40	1144.44	1133.53	1258.98	1342/57
5	Weighted average tariff rate	?	?	?	26.6%	29.6%	29.6%	24.6%	23.6%	19.5%	19.5%

Source: Ethiopian Customs Authority, Ministry of Finance, NBE

From the above table, ceteris paribus, in the years with fixed/ single exchange rate, one can observe that import value has been declining as a result of which customs duty receipts were also declining. This presuppose that the weighted average tariff rates were on the increase, hence the demand for import goods has declined due to price increases. But with consecutive reduction of tariff rates from 1993 onwards and with a step by step devaluation of the Birr, we can see that the value of imports has increased. For example, if we compare the Birr value of imports in 1999 with 1992, it is about ten times, converted in the USD it is about 2.6 times. In the years between 1990 and 1993, it can be suspected that with increases in tariff rates, the reported value of imports could have declined. But, with further reduction of tariff rates, the reported values might have to some extent increased and improvement of compliance can be suggested. Nevertheless, the magnitude of commercial fraud such as overvaluation, underinvoicing, misdescription of goods and smuggling is very difficult to be determined and their influence cannot be excluded in all tariff regimes.

In the study documented for Jamaica, Kenya and Pakistan, there is a third reason why revenues will no rise (or fall) one-to-one with rates. Even for a given value of imports declared to customs, the collected rate itself will not rise one-for-one with rises in the official rates, because the ratio of imports coming in with exemption will increase as the tariff rate increases. This is because, as the tariff is raised, the value of imports coming in under nonexemptions will decrease, the incentive to lobby for exemptions will increase with levels of tariffs, the temptations for abuse of any system of exemptions will increase with the level of the tariff e.g. exemptions granted to exporters, diplomatic missions, charitable activities, or returning residents (Prichett and Sethi 1994). For example, before 1993, as tariff rates were higher, the number of duty free items (categories of goods) have been greater than 300 (see Table 1). Therefore, in general reducing tariff levels could actually increase revenue if increases in the official tariff rate over and above a certain level actually reduced the collection rate. But, in the Ethiopian case the reason for the wide gap between the collected rate and official weighted average tariff rate has to be investigated despite the positive increase in import value and customs duty collected. This is because, if the official rate were collected on all imports, the collected rate for each tariff item would have been equal or close to the official rate. As can be seen from Table 4 below, the gap between the hypothetical/ official collection and the actual collection is wide.

Table 4: The Gap Between The 1-hypothetical and The Actual Collection Of Customs Duty

		1993	1994	1995	1996	1997	1998	1999
1	Import value (mln birr)	3126.65	4725.20	6546.27	7232.93	7379.29	8647.99	10101.47
2	Official weighted average tariff rate	29.6%	29.6%	29.6%	24.6%	23.6%	19.5%	19.5%
3	Duty revenue should have been collected (mln birr)	925.48	1398.66	1937.70	1779.30	1741.51	1686.35	1969.80
4	Actual duty collection (mln birr)	348.86	610.74	771.35	909.34	1055.20	1012.70	1130.50
5	Revenue loss (mln birr)	576.62	787.92	1166.35	869.96	852.31	[illegible]	839.30

Source: Ethiopian Customs Authority and author's computations

Despite the above revenue loss, the share of total foreign trade revenue share in the GDP and in total tax revenues in the period 1990-1999 ranged between 2.3-6% and 26.8-48.9%, respectively. According to the study conducted by Vito Tanzi (1994), in 1990, the share of Customs revenue in the GDP for middle income countries, low-income countries, and developed countries was on average 3.5%, 5% and 0.6%, respectively and the share of customs revenue in total tax revenue for the above group of countries was 20.1%, 29% and 1.6%. In 1999, for Ethiopia, the share of total customs revenue in the GDP and total tax revenue were 5.3% and 48.9%, respectively. SO, this percentages are above the averages reported by Vito Tanzi, with revenue loss still rampant. In fact those shares will decline with economic growth as the large sum of revenue shall be collected from internal fiscal taxes, charges and fees. But, our government should take the necessary measures cautiously to reduce revenue loss having considered the seriousness of the issue and its impact on the treasury.

4. CONCLUSION

The performance of the foreign trade regime has been improving since 1993. Trade liberalization has changed the tariff structure and the tariff regime, as a result of which liberalization has changed the tariff structure an ' creased. However, the increase in import volume and import duty receipts have in on of tariff rates and the actual customs duty revenue was not one-to-one with the reduction of tariff rates and the actual collected rates do not approximate either the statutory single weighted average tariff rates; the actual collection doesn't tally with the hypothetical duty receipt. This indicates a very big gap. Hence, revenue loss. Had it not been for this, customs duty revenue would have a greater share in total government receipts and the treasury than is currently reported.

Though with growth, the highest share of government revenue is expected from internal fiscal taxes; one cannot leave aside this issue of customs duty revenue loss to continue. As the additional excise and sales taxes are calculated on the underreported values, we imagine that the total foreign trade revenue loss is higher than what is calculated in this paper. This could be the reason that attracted the attention of the Government and why certain activities like quality, quantity, value and classification verification were contracted out to a Preshipment Inspection Company.

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