

REPORT ON THE ETHIOPIAN ECONOMY

2011

***Financial Sector Developments in
Ethiopia: Performance, Challenges
and Policy Issues***

**Ethiopian Economics Association
(EEA)**

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Inquiries should be addressed to:

*Ethiopian Economics Association/Ethiopian Economic Policy Research Institute
P. O. Box 34282
Tel: 011 645 32 00
Fax: 011 645 3020
e-mail: eea@ethionet.et
Website: www.eeacon.org*

Foreword

The Ethiopian Economics Association (EEA) believes that producing an independent professional economic report in a continuous, systematic and constructive way would contribute to the success of the ongoing economic development and transformation process in the country. It is in spirit that the EEA published its eighth economic report on the Ethiopian Economy.

Following the formats of the previous Reports, this year's economic Report has two parts. In the first part, an extensive review of the macroeconomic situation is undertaken together with a brief review of developments in the major economic sectors, namely agriculture, trade and manufacturing and education.

The year 2009/10 marks the end of the five year development plan known as Plan for Accelerated and Sustained Development to End Poverty (PASDEP) and a prelude to a new five year development plan known as Growth and Transformation Plan (GTP). With the aim of drawing some important lessons this year's Report has attempted to review the major macro-economic developments in Ethiopia during the last five years. Comparisons are made to performances during earlier periods such as the five year development plan which preceded PASDEP titled Sustainable Development for Poverty Reduction Policy (SDPRP). The Report also touches upon the extent to which the GTP was informed by possible lessons learned from past performances.

In the second part, this Report has selected a thematic area, i.e. a sector with significant contribution to national development for an in-depth assessment. The selected thematic focus area this time is Financial Sector Developments: Challenges and Policy which has significant implications to the national development efforts in Ethiopia. The focus on the financial sector is justified by the central role a financial system plays in any economy. A sound financial

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system is critical for the sustainable growth of the Ethiopian economy as it helps channel resources to the most productive sectors of the economy thereby enhancing productivity, accelerating growth, and creating a robust and competitive private sector. The development of the financial sector will require expanding and establishing sustainable financial institutions that provide production and consumption credit, saving instruments, inter-temporal insurance mechanisms and efficient and affordable payment systems. Sustained access to needs-based financial services also helps in reducing poverty and improving household well-being.

Accordingly, the Report attempts to highlight in detail the structure and development process of the financial sector including microfinance institutions as well as its major contributions to the Ethiopian economy. The Report also reviews the relationship between money and output as well aspects of monetary policy in Ethiopia. Missing markets in the financial sector are also discussed.

EEA very much hopes that, as previous reports, this specific Report would be useful to all categories of readers, including policy makers who play key roles in guiding the economy, business people, civil society organizations, the academia, other researchers, the media, the international community and the general public.

Finally, EEA would like to express its deepest appreciation to all individuals and organizations whose contribution made this Report possible.



*Alemayehu Seyoum Taffesse (DPhil)
President
Ethiopian Economics Association*

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Part II of the Report, which deals with the Financial Sector Development in Ethiopia: Performance, Challenges and Policy Issues is written by Wolday Amha, Tewodros Mekonnen, Kassahun Abera, Getachew Ahmed and Emerta Asaminew.

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Abbreviations and Acronyms

<i>APL</i>	<i>Adaptable Program Loan</i>
<i>BoFED</i>	<i>Bureau of Finance and Economic Development</i>
<i>CV</i>	<i>Coefficient of Variation</i>
<i>EPDRF</i>	<i>Ethiopian People’s Revolutionary Democratic Front</i>
<i>ESDP</i>	<i>Education Sector Development Program</i>
<i>ETP</i>	<i>Education and Training Policy</i>
<i>GEQIP</i>	<i>General Education Quality Improvement Program</i>
<i>GER</i>	<i>General Enrollment Ratio</i>
<i>GPA</i>	<i>Grade Average Point</i>
<i>GPI</i>	<i>Gender Parity Index</i>
<i>IDA</i>	<i>International Development Association</i>
<i>MoE</i>	<i>Ministry of Education</i>
<i>MoFED</i>	<i>Ministry of Finance and Economic development</i>
<i>NER</i>	<i>Net Enrollment Ratio</i>
<i>NLA</i>	<i>National Learning Assessment</i>
<i>PASDEP</i>	<i>Plan for Accelerated and Sustained Development to End Poverty</i>
<i>PSR</i>	<i>Pupil Section Ratio</i>
<i>PTR</i>	<i>Pupil Teacher Ratio</i>
<i>REBs</i>	<i>Regional Education Bureaus</i>
<i>UNESCO</i>	<i>United Nations Educational, Scientific and Cultural Organization</i>
<i>WOE</i>	<i>Woreda Education Office</i>
<i>WoFED</i>	<i>Woreda Office of Finance and Economic Development</i>

PART I

REVIEW OF ECONOMIC PERFORMANCE

The first part of the report reviews major macro-economic and sectoral performance of the Ethiopian economy for the last five years. The first chapter of the report discusses major macro-economic developments mainly for the period 2005/06-2009/10 in comparison to performances during the preceding periods. In particular, it investigates the possible explanations for the high growth and at the same time high inflation episode that has been observed during the period of the Plan for Accelerated and Sustained Development to End Poverty (PASDEP).

The second chapter reviews performances in the agriculture sector for the last five years and discusses the potential sources of agricultural growth. Chapters three and four focus on the industrial sector. Chapter three reviews the industrial development of Ethiopia and performance of prioritized industries. Chapter four specifically discusses the supply-side constraints in the export of leather and leather products based on a survey result. Chapter five of this part of the report presents an overview of the Ethiopian education system and performance of the sector.

Chapter 1

Macro-economic Performance

1.1. Executive summary

The year 2009/10 marks the end of the five year development plan known as Plan for Accelerated and Sustained Development to End Poverty (PASDEP) and a prelude to a new five year development plan known as Growth and Transformation Plan (GTP). This chapter of the report mainly focuses on major macro-economic developments in Ethiopia during the last five years. Comparisons are made to performances during earlier periods such as the five year development plan which preceded PASDEP under the name Sustainable Development for Poverty Reduction Policy (SDPRP). The report also briefly touches upon the extent to which the GTP was informed by possible lessons learned from past performances.

The Ethiopian economy is reported to have grown by an average rate of 11 percent over the last five years. The period was also characterized by a record high inflation which started to rise as early as 2004/05. The average annual inflation rate for the period measured by the general consumer price index was about 19.2 percent in which the 64.2 percent hike in the general price observed in July 2008 was the highest. The major issue that preoccupied the debate among policy makers, researchers, and other stakeholders was this seemingly paradoxical incidence of high growth and high inflation.

While it is difficult to explain as to why the arguably high growth in the crop-dominated agricultural product failed to dampen the overall price rise, the

developments in the macro-economic fundamentals could explain part of the incidence. This chapter of the report mainly revolves around this issue. The following few paragraphs summarize the patterns of major macro-economic variables and how such patterns possibly fed into inflationary trends.

Sectoral and macro-economic policies along with non-economic factors that have been observed as early as in 2004/05 are believed to have shaped the development of price dynamics that have persisted to linger to date. Primarily, the service sector which normally augments demand dominated the spur in the economy for the last five years. Its share in the GDP growth during the period increased to 55 percent from 41 percent during the preceding five years (SDPRP). The construction sub-sector had a share of 6 percent in the total GDP growth during the period. It is therefore clear that the share of the productive sectors namely agriculture and industry in the GDP growth fell from 59 percent during SDPRP to 39 percent in the period of PASDEP.

In the past five years, other major macro-economic variables performed in the manner that they contributed to the inflationary momentum. Major components of broad money, in particular currency in circulation and demand deposits, expanded faster than before. Unusually high expansion rates of credit to the public enterprises were also observed.

The major macro-economic episodes that might have had an immediate effect on the price level during its height in 2007/08 can better illustrate the mechanics. The highest inflation rate so far was recorded in the year 2007/08. A month to month annual inflation rate reached 64.2 percent for the general price and 94.1 percent for the food price in July 2008. This was in the face of 11.2 percent growth in real GDP. Major macro-economic variables in the year 2007/08 had a peculiar feature. The service sector had the maximum growth

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rate of 15.6 percent compared to what has been recorded so far. The annual rate of increase of the share of the service sector exceptionally doubled. The magnitude of government budget deficit was the highest in volume compared to the magnitudes in the years before and after. Rate of gross fixed investment which is largely outlays on infrastructure was the highest so far. Rate of expansion of currency in circulation was the highest at least among the last ten years and was preceded by one of the highest rate of expansion of demand deposit. The rate of growth of credit advanced to public enterprises was exceptionally high (168 percent).

The pressure exerted by domestic macro-economic variables on prices was reinforced by the significant rise the international price of oil in the same year. The unit price of imports for petroleum products increased by 145 percent pushing its share in the total import bills to 24 percent. The unit price of fertilizer, another important import item, has also increased by 254 percent. Prices of import bills for food items and grain have also soared by more than 55 percent. Those commodities the prices of which have risen significantly accounted for 33 percent of the total import bills.

While some interventions in the form of stringent monetary and fiscal policies seemed to have calmed the inflationary pressure since 2009, the significant devaluation which jerked many economic agents and the increase in the salary of civil servants at the beginning of 2011 seemed to have pulled inflation back to double digit. One major policy reaction from the government towards the soaring inflation is the price cap on basic commodities which has been introduced since early 2011. Unfortunately, the impact of such price distortion is, as one would expect, an immediate shortage of the commodities that leads to rationing, and an eventual increase in prices even higher than before. General and food price inflation stood at 34.7, and 40.7 percent, respectively.

Whatever the magnitude may be, the high growth phenomenon in the past five years was led by the service sector. While it is good news that the demand side of the economy is in a state of assuring, a sustainable growth that moves beyond a five years episode requires the supply side to respond. In this regard, the new Growth and Transformation Plan of the Ethiopian government seemed to have taken a lesson. The GTP foresees the share of the industrial sector in the growth of GDP to rise from 11.7 percent in the past five years to 28 percent in the next five years. That is, value-added in the industrial sector is targeted to grow at a rate of 20 percent in the base case scenario over the plan period, and that the sector would have a share of 16 percent in the GDP by the end of the plan period. While the direction of the plan is commendable, inflation remains to be a major challenge as the next five years would be a period of investment of major projects with big financial outlays. A parallel effort of increasing agricultural output through operation at commercial scale might help dampen the threat of inflation. Institutional and financial constraints have also yet to be tackled to get the plan moving and make it a success.

1.2. Economic growth

The last five years were phenomenal for Ethiopia in terms of economic growth. According to national income account figures of the Ministry of Finance and Economic Development, real GDP grew at an average rate of 11 percent for the period 2005/06-2009/10. This is a significant leap over the 6.2 percent average growth of the five years prior to 2005/06. With an average population growth rate of 2.8 percent in the country, the high growth in GDP translates into a comfortably high per capita income growth which had a potential of reducing poverty with significant margins. However, this heavily depends on

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the quality of growth and most importantly on the nature of specific sectors which led the growth.

The service sector dominated the period in terms of growth. Value-added in the sector during the period grew at an average rate of more than 14 percent. A growth rate of about 8 percent in the value-added of the agricultural sector for such relatively longer period was unprecedented. Given the structural constraints of the agricultural sector and tight possibilities of expansion of arable land in major crop-growing areas, the 8 percent growth is ostensibly on the high side. With such high growth in the value-added in the agricultural sector, the period marks the highest rate of improvement of average rural welfare so far, in the country, measured on a basis of five years average. Value added in the industrial sector grew at 10 percent accelerating only by 2 percentage points over the preceding five years.

Table 1.1: Growth rates

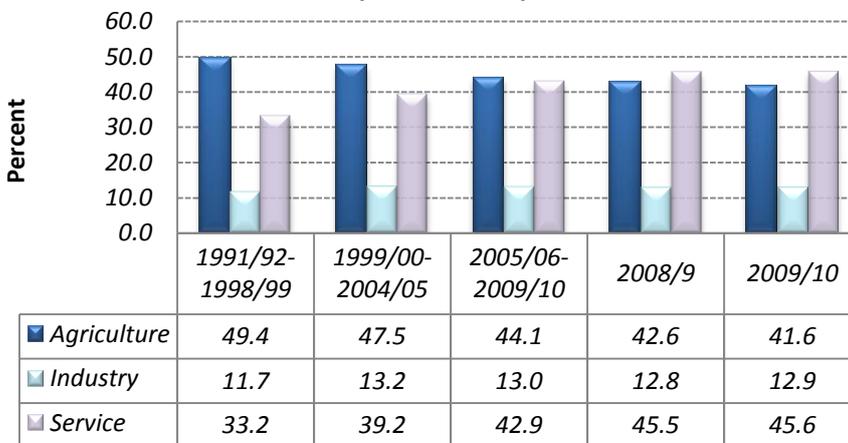
Period	Agriculture	Industry	Service	GDP	Per capita GDP
1960/61-2009/10	1.87	3.83	4.91	2.96	0.04
1960/61-1973/74	2.10	7.04	7.47	3.60	1.33
1974/75-1990/91	0.06	3.60	3.41	1.75	-0.07
1991/92-2009/2010	4.14	7.16	8.42	6.09	3.28
1991/92-1999/00	2.11	6.38	7.99	4.56	1.78
2000/01-2004/05	5.55	8.20	6.70	6.22	3.42
2005/06-2009/10	8.37	10.01	14.33	11.01	8.21
2008/09	6.36	9.67	13.97	10.05	7.25
2009/10	7.63	10.58	13.04	10.41	7.61

Sources: EEA/EEPRI computations using data from MoFED.

The period has also marked a shift of dominance in the overall economy from agriculture to the service sector. The seemingly high growth rate of 10 percent

in the value-added in the industrial sector was not robust enough to enable the sector gain a share in the GDP. This is because the industrial sector has a small base and the smallest share in the GDP. The sector gains only a mere 1 percentage points increase in the share in GDP over two decades from about 12 percent in the 1990s to 13 percent in 2010. In contrast, the share of the service sector has increased from 33 percent to 46 percent within the same period. A significant gain in the share in the GDP for the industrial sector with such small base requires an aggressive growth in the sector. This phenomenon in the dynamics of the structure of the Ethiopian economy has an important implication on the direction and sustainability of the growth of the Ethiopian economy.

Figure 1.1: Structure of the Ethiopian economy: share of sectors in the GDP



Source: MoFED

In terms of leading the growth, the share of the service sector was quite significant. Out of the 11 percent growth, 6.15 percent (about 55.2 percent of the growth in GDP) was the share of the service sector. Wholesale and retail

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trade, hotels and restaurants, and real estate and renting have together accounted for 36 percent of the 11 percent growth in GDP. This might be one of the reasons for the fact that the phenomenally high rate of growth was accompanied by record-high inflation. It has also implication on the sustainability of growth. Such a boost in demand can only be welcomed if it is accompanied by supply responses from the agricultural and industrial sectors.

Table 1.2: Growth decomposition by sector

	2000/01-2004/05 (SDPRP)		2005/06-2009/10 (PASDEP)	
	Weighted growth	Share in total growth	Weighted growth	Share in total growth
Agriculture	2.64	41.5	3.7	33.2
<i>Crop</i>	2.23	33.3	2.83	25.1
Industry	1.08	17.1	1.3	11.7
<i>Manufacturing</i>	0.26	3.9	0.48	4.2
<i>Construction</i>	0.69	10.3	0.63	5.6
Services	2.63	41.4	6.15	55.2
<i>Wholesale and Retail Trade</i>	0.71	10.6	1.85	16.4
<i>Hotels and Restaurants</i>	0.17	2.5	0.73	6.5
<i>Transport and Communication</i>	0.65	9.7	0.55	4.9
<i>Financial Intermediation</i>	0.14	2	0.49	4.4
<i>Real Estate and Renting</i>	0.83	12.4	1.44	12.7
<i>Public Administration and Defense</i>	-0.11	-1.64	0.43	3.9
<i>Education</i>	0.29	4.3	0.45	4
<i>Health</i>	0.07	1.1	0.14	1.3
GDP	6.35	100	11.14	100

Sources: EEA/EEPRI computations using data from MoFED.

The agricultural sector which had a significant contribution to growth with a magnitude equivalent to that of the service sector during the period of SDPRP fell short of keeping up to the service sector in term of its share in growth. Its

contribution to growth has declined from about 42 percent during SDRP to 33 percent during the last five years. This was not, however, because value added in the agricultural sector decelerated during the period of PASDEP over the SDPRP. In fact value added in the sector has accelerated from 5.6 percent during SDPRP to 8.4 percent during PASDEP. The reason for the decline in its share in the overall GDP growth was due to the extraordinary high rise of the value-added in the service sector. The growth in the service sector has more than doubled from 6.7 percent to 14.3 percent during the last five years compared to the preceding five years.

1.3. Saving and investment

Gross fixed investment over the last five years has kept the same momentum as the preceding five years. Rate of capital formation has been about 23.6 percent of GDP in both periods. On the other hand, saving rates shrank from 7.6 percent during the period 2000/01-2004/05 to 6.1 during the last five years further widening the resource gap. A typical phenomenon during the last decade is that resource gap widened by a margin of 6 percent of GDP witnessing a heavy dependence on foreign source of financing of investments. Rate of domestic saving failed to resurrect from its depression after the early 1970s. According to the national income account of Ethiopia, the highest saving rate so far was the 13 percent rate recorded in 1972/73 and 1973/74.

Table 1.3: Expenditure on GDP (proportion to GDP)

Period	Absorption	Est	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
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	Total (=1+2+3)	Private Consumption (1)	Government Expenditure (2)	Gross Fixed Investment (3)				
	101.5	78.8	9.9	12.8	11.3	1.5	10.6	12.1
1973/74-90/91	105.5	77.4	15.9	12.2	6.7	5.5	10.3	15.8
1991/92-99/00	109.3	81.0	12.9	15.4	5.7	9.7	12.2	21.9
2000/01-04/05	115.5	78.8	13.7	23.0	7.8	15.2	13.3	28.1
2005/06-09/10	117.6	84.1	9.8	23.7	6.1	17.6	12.4	32.2
2005/06	120.6	83.2	12.2	25.2	4.6	20.6	13.8	36.5
2006/07	117.1	80.8	10.5	25.8	8.7	17.1	12.7	32.0
2007/08	117.1	85.0	9.8	22.4	5.2	17.1	11.4	30.8
2008/09	116.3	85.4	8.2	22.7	6.4	16.3	10.5	28.7
2009/10	116.8	86.1	8.3	22.3	5.5	16.8	13.6	33.0

Source: MoFED

*The updated Ethiopian national income account shows a discrepancy of 1 to 4 percent of GDP between the resource gap and current account balance for the period 1999/00-2009/10.

The Growth and Transformation Plan embarks on major investments both in infrastructure and public enterprises which require huge financial resource to the tune of 569.2 billion Birr off the government budget for the next five years. One of the major challenges the GTP is likely to face is resource mobilization. The GTP envisages raising the rate of gross domestic saving to 15-17 percent during the plan period. The revision of the interest rate from 4 percent to 5 percent and the floating of the new government bond with minimum price of 500 Birr are part of the policy interventions in the effort of domestic resource mobilization.

For the last five years, real interest rate was deeply negative. The recent revision of the minimum deposit rate by 1 percent does not commensurate with the double digit inflation either. A continuous revision of the rate that

ensures positive real interest might be required to induce potential savers shift from holding less productive real assets to financial portfolios.

A major problem in saving mobilization in the rural Ethiopia is the fact that the agrarian economy has not been monetized. Without access to banks and options for financial savings, rural households hold part of their securities in the form of livestock and consume the rest over unnecessary holidays and occasions. The introduction of the bond which targets the rural farmers would help bridge the gap of financial intermediation with appropriate implementation strategies.

1.4. Price developments

The last five years have witnessed a record high inflation. The average annual rate of inflation for the period 2005/06-2009/10 was 19.2 percent. Food prices in general soared by an average annual rate of 22.1 percent while prices for non-food items increased at an average rate of 15.6 percent for the period. This phenomenon was particularly an issue in the case of Ethiopia because it occurred in the face of double digit growth (11 percent) in real GDP and specifically 8 percent growth in the agricultural component of the GDP.

General and food price levels more than doubled (increased by 140 percent) between December 2005 and December 2010. This contrasts with the only 55 percent rise in food prices and 40 percent rise in non-food prices between December 2000 and December 2005.

The upsurge in prices in the fiscal year 2008 was typically noticeable. In terms of month –to- month annual inflation, the rates for July 2008 were the highest.

Food and general price soared by 92 percent and 64 percent, respectively. The price for non-food items during the period rose by 27 percent.

Deflationary trends were observed after 2009 partly due to the move by the National Bank of Ethiopia (NBE) to resort to tight monetary policy. This, however, was not sustainable probably due to other policy interventions by both the NBE and the government since late 2010. Month-to-month annualized general, food, and non-food inflation for May 2011 stood at 34.7 percent, 40.7 percent, and 26.2 percent, respectively.

There has been much debate on the causes of inflation. Some argued that the inflation was much to do with international episodes and as such it was imported. Still others associated the high inflation rate with domestic policies and supply side responses. Though it is required to empirically verify the various determinants of the price rise and determine their relative contributions to the hike, it is worthwhile to document the timeline of a number of phenomena that have occurred in the process with a high potential to contribute to the inflation. In general, it is difficult to rule out the role of macro-economic developments in triggering the high inflation.

Ethiopia had in the past been one of the countries where inflation was modest except during drought and war periods. This was partly due to the stringent monetary and fiscal policy that the country had adopted. With a larger share of food items in the total household expenditure (about 60 percent), international price shocks had little impact on price levels in the country. During the military regime (1974-1991), the impact of monetary overhang on the overall price level had been limited due to direct price control.

Since the launch of the agriculture development-led industrialization (ADLI) strategy of the Ethiopian government in 1995, price deflation had been a problem to farmers in particular during periods of bumper harvest. The average month-to-month annualized cereal inflation between January 1998 and December 2002 was only 1 percent. Consumer prices for cereals fell by 15.6 percent for the period May 2000 to May 2002. Until 2005, high food price episodes were observed only during severe drought such as the one in 2003 and Ethio-Eritrean war. In recent period, however, the country has experienced the record high rate of inflation. For the period January 2005 to December 2009, food and cereal prices soared by 23 and 31 percent, respectively. If we consider the period 2007-2008 which was characterized by international shocks (oil price and the financial crisis), prices for cereals increased by as high as 172 percent. The average month-to-month annual inflation for food and cereals during the period was 41 and 58 percent, respectively.

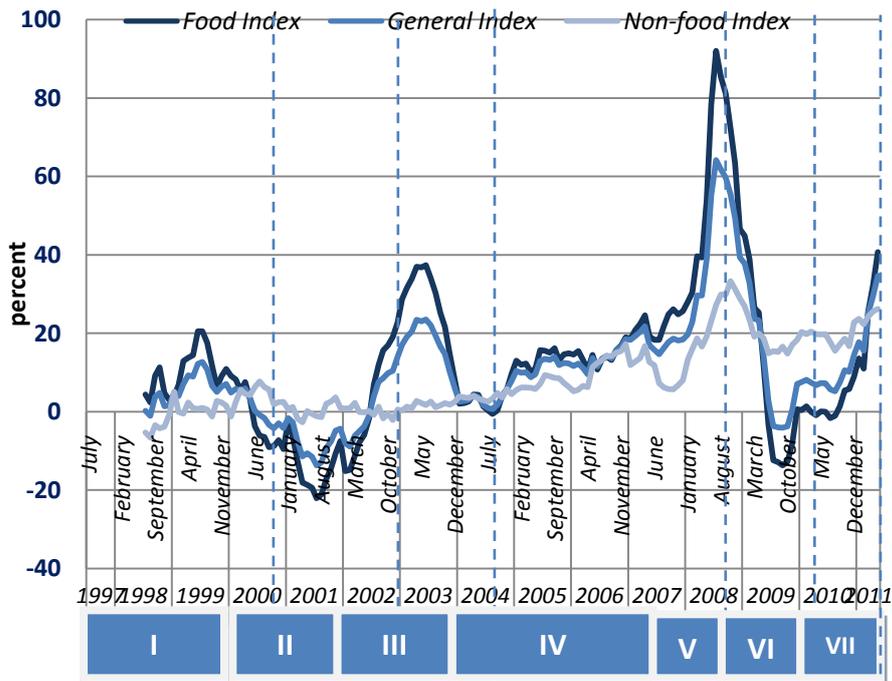
The major question is what caused the high price episodes which we have been witnessing since 2007/08? It is apparent that during the last decade inflation in Ethiopia has exhibited different patterns. At the same time different events that possibly have shaped the price dynamics have been observed. Some of the factors such as climate conditions, market, and government policies are the fundamentals that are believed to have long shaped the price dynamics in Ethiopia. Other factors include uncertainties related to war and natural calamities, and global shocks.

Figure 1.2 shows major price episodes and some incidences that have possibly shaped the price dynamics in Ethiopia in the recent past.

Periods of high prices in Ethiopia were observed between 1999 and 2000, 2001 and 2004, 2007 and 2009. Deflationary situations were observed during the

periods 2000-2001, and in 2004/2005. The 1999-2000 price episodes were associated with the Ethio-Eritrean war and drought. The 2003 inflation is believed to have been exclusively caused by the severe drought which forced about 14 million people to look for food aid. The 2000/01 deflationary situations could be attributed to the bumper harvest and the low demand from urban centers due to slow business after the Ethio-Eritrean war.

Figure 1.2: Trends in the month-to-month annualized inflation rates (July 1997-May 2011)



Source: EEA/EEPRI computations using data from CSA

The root causes of the record- high inflation that was observed in 2007 and 2008 have started to set in as early as 2005. Partly learning from the adverse impact of

the fall in agricultural prices in 1997 and 2000/01 on farmers' incentive to produce more crops, farmers were advised not to sell their products to traders until the price rises. Credit availability to purchase important inputs such as fertilizer, and government's involvement in purchasing some agricultural surplus at pre-set higher prices helped in curbing a seasonal fall in agricultural prices. Moreover, the government preferred cash to food aid under the safety-net program which eventually contributed to the relative monetization of the rural sector in some parts of the country.

In 2005/06, election was held and the aftermath of the election caused uncertainty to set in. The uncertainty itself had the potential to trigger inflation. More importantly, however, major donors reduced direct budget support to the government following the handling of the post-election events, and as such the government had got reason to increase money supply and run deficit to finance projects. In 2007, the cumulative effect starts to kick in.

In 2007-2008, energy price escalated; the global financial crisis erupted; drought hit the Southern part of the country. On the macro-economic side, there were major developments whose impact on prices cannot be underestimated. Money supply expanded at faster rates in 2008. In particular, currency in circulation grew by 28.8 percent while the average rate of currency expansion for the period 2000/01-2004/05 was 14 percent. Credit advanced to the public enterprises increased by 168 percent in 2008.

It can thus be noticed that the possible candidates for driving inflation at least in the Ethiopian case for the period 1998-2009 are unfavourable climatic conditions, uncertainty, government policy, and global shocks such as oil price and financial crises. In general, the fact that the 6.7 percent out of the 11 percent average growth recorded during the period was contributed by the

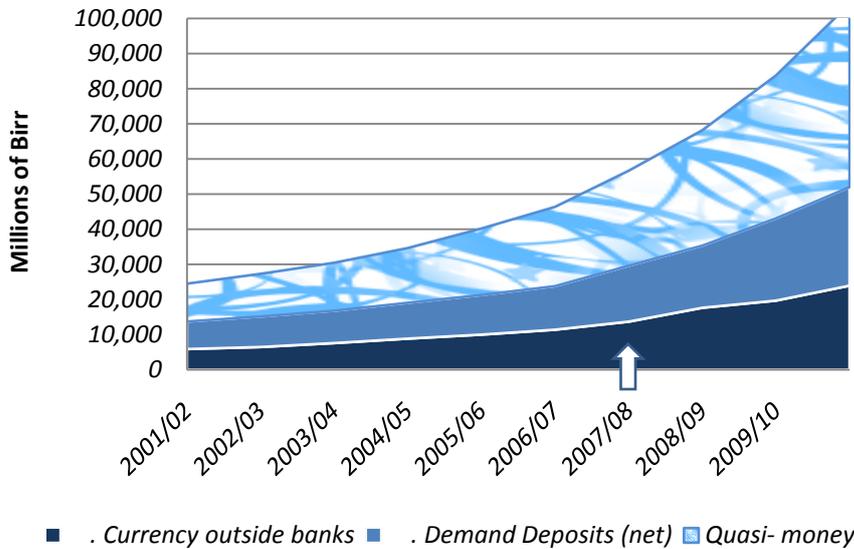
service and the construction sectors is consistent with high growth and high inflation episode.

The rising trend in prices began to reverse in 2009/10 following the move by the NBE to exercise tight monetary policy through instruments particularly direct credit ceiling and reserve requirement. However, the actions adopted by the NBE and the government thereafter had the potential leverage to cause further inflationary trends. The NBE devalued the Birr against US dollar by about 17 percent; the government has increased the salary of civil servants by more than one-third; the government also imposed price cap on basic commodities which was believed to have been distortionary in many ways. These actions coupled with the rise in prices of petroleum products pulled prices up again. A month-to-month general inflation in May 2011 was 34.7 percent.

1.5. Monetary aggregates

The last five years period was typified by a significant upsurge in money supply. Broad money had accelerated from an average rate of growth of 13 percent for the period 2000/01-2004/05 to a rate of expansion of 21 percent during the past five years. Money supply measured by broad money has reached 104.1 billion Birr by the end of the fiscal year 2009/10. Quasi money which includes saving and time deposits accounted for 50 percent of the broad money in the fiscal year. The balance was accounted by demand deposits and currency outside banks which had a share of 27, and 23 percent, respectively, in the broad money.

Figure 1.3: Trends in the components of broad money



Source: NBE

All three major components of the broad money namely currency in circulation, demand deposit, and quasi money have expanded at faster rates during the period under review than during the preceding five years (see Table 1.6). Quasi money had a stable share of 51 percent in the overall growth of broad money in both periods of SPRDP and PASDEP while currency in circulation and demand deposit changed positions in terms of their share in the growth of broad money. In particular, currency in circulation began to swell in 2006/07 and grew at 20 percent over the period in contrast to a 14 percent average growth during the preceding five years. It had even further accelerated to a 29 percent growth rate in 2007/08. This might be one of the factors which contributed in triggering the record high inflation from the monetary side during the period.

Table 1.4: Growth Rates in Broad Money and Its Components

	2000/01- 2004/05	2005/06- 2009/10	2005/06	2006/07	2007/08	2008/09	2009/10
<i>Net foreign assets</i>	32.1	19.1	-12.7	10.2	-12.5	70.4	40.4
<i>Domestic credit</i>	10.5	21.3	22.3	25.5	29.3	12.0	17.6
<i>Claims on government</i>	9.4	10.1	16.6	20.1	9.0	0.7	4.2
<i>Claims on non-government*</i>	13.3	30.9	28.9	31.1	48.8	19.9	25.6
<i>Other items (net)</i>	16.9	16.1	7.6	23.3	26.5	9.5	13.4
Broad Money	13.2	21.0	15.3	22.2	20.4	22.8	24.3
<i>Narrow money</i>	11.6	19.6	11.8	24.4	19.4	21.9	20.6
<i>Currency in circulation</i>	14.2	19.2	13.9	20.0	28.8	11.6	21.6
<i>Demand deposits</i>	9.5	20.3	10.0	28.4	11.2	32.2	19.8
<i>Quasi money</i>	15.2	22.5	19.3	19.8	21.4	23.8	28.2

*it includes public enterprises.

Source: EEA/EEPRI computations using data from NBE.

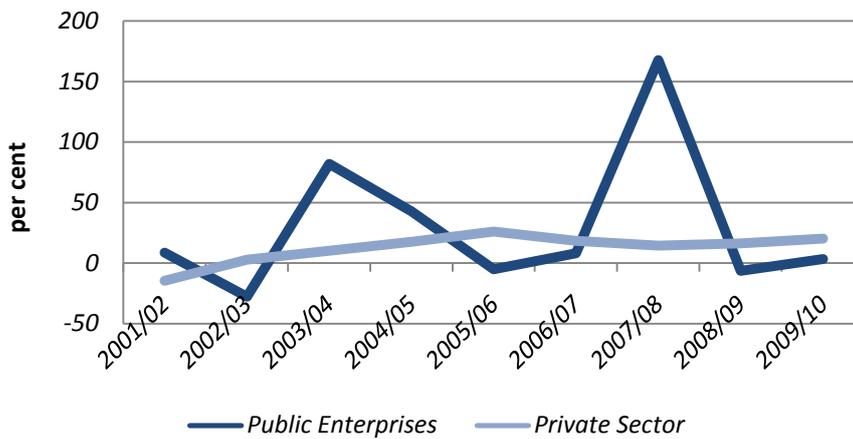
The growth rate in demand deposits almost doubled from 10 percent during the 2000/01-2004/05 to 20 percent during lasts five years. The growths in currency in circulation and demand deposit have been volatile since 2005/06 unlike the preceding years. Such significant volatility in both components of the broad money is believed to have contributed to the inflationary pressure the economy has been experiencing.

During the period under review, net foreign asset encountered depletion in 2005/06 and 2007/08. The decline in the net foreign asset by 12.7 percent in the fiscal year 2005/06 coincided with the aftermath of the 2005 election when donors restricted direct budget support to the government in response to the government's handling of the election result. A more serious shortage of foreign reserve was observed in 2007/08 in a situation where foreign reserves

could not even fully recover in 2006/07. Net foreign asset positions were improved the following years partly due to support from International Monetary Fund (IMF), and recovery from export earnings following the stabilization of the coffee trade in the country. The credit cap which has been in place since 2008/09 might have also contributed to the revival of net foreign asset by limiting imports.

One of the most important components of monetary aggregates which determine volume of money from the asset side is credit. Since 2000, credit advances to the private sector has been growing at a stable rate though there is a sign of deceleration in 2005/06. On the other hand, credit advances to public enterprises has been subjected to fluctuations with dominant upsurges in some years such as 2003/04, 2004/05, and 2007/08 (see Figure 1.4). In particular, volume of credit to the public sector rose by about 168 percent in 2007/08.

Figure 1.4: Growth rates in credits advanced to private and public sector



Source: NBE

In terms of credit expansion, there was an increase in the share of the public sector in the past five years. The share of credit advanced to the public sector in the total credit was 15.4 percent; a 5 percent increase over the preceding five years. The share of the private sector showed a decline from 82.5 percent during SPRDP to 76.7 percent during PASDEP. The share of cooperatives in the total credit rose by the balance rate.

In terms of sectoral distribution of credit, the service sector still dominated by attracting 70 percent of the total credit. Agriculture and industrial sectors had a share of only 30 percent. This has important implications in terms of redirecting meager resources into productive activities. The impact of credit expansion on inflation crucially depends on which of the demand and supply sides of the economy each Birr is spent on.

One major policy intervention by the National Bank of Ethiopia as part of the effort to control inflation was the introduction of credit cap on the private banks. This led to an increase in excess reserve and liquidity position. The legitimacy of the action at least from the point of view of controlling inflation should be judged on the share of the private banks in the total disbursement of credits and the particular sectors the banks are lending to.

The other major recent development is the revision of the minimum interest rate on savings deposits. It has been raised from 4 percent to 5 percent per annum. While the move is in the right direction, this might be too low to attract potential savers in the face of double digit inflation as it still pays to hold portfolios in real assets such as residential building.

A related intervention by the National Bank of Ethiopia is the revision of the reserve requirement. The bank has first increased the rate from 5 percent to 10 percent and recently to 15 percent during the same period.

The government has also floated bond with minimum price of 500 Birr primarily targeting the rural farmers. Although the yield with an interest rate of 5.5 percent is still low, it can play an important role by providing the rural communities an alternative means of financial saving which banks failed to do so. If implemented based on the economic rationale of the rural farmers, it would help monetize the rural economy and mobilize domestic resource which might otherwise have been consumed in a traditional and extravagant way.

1.6. The external sector

Over the last five years, values of both imports and exports grew faster than during the preceding five years. Value of exports accelerated from 14.3 percent during the period of 2000/01-2004/05 to 20 percent for the period 2005/06-2008/09 narrowing down its difference in pace with that of imports. Value of imports grew by 26.7 percent during the period in contrast to its 23.2 percent growth over the period of SPRDP. Taking depreciation of the Birr against the US dollar during the period into account, the rate of growth of the value of both exports and imports is lowered by about 5 percentage points.

The share of coffee in the overall value of export has declined by 4 percentage points during the last five years compared to the preceding five years. This was not, however, because of the significant rise in other items. It was rather coffee export faced difficult times during 2008/09 where value of coffee exports fell by 19 percent.

Table 1.5: Share of major exports

	2000/01- 2004/05	2005/06- 2008/09	2005/06	2006/07	2007/08	2008/09
<i>Coffee</i>	37.3	33.2	35.4	35.8	35.8	26.0
<i>Oilseeds</i>	10.5	19.1	21.1	15.8	14.9	24.6
<i>Hides & skins</i>	10.9	6.8	7.5	7.6	6.8	5.2
<i>Pulses</i>	4.2	6.4	3.7	5.9	9.8	6.3
<i>Flower</i>	0.0	5.5	0.0	5.4	7.6	9.0
<i>Chat</i>	12.5	8.4	8.9	7.8	7.4	9.6
<i>Gold</i>	7.5	6.7	6.5	8.2	5.4	6.8
<i>Others</i>	17.0	13.8	16.9	13.5	12.3	12.6

Source: EEA/EEPRI computations using data from NBE.

One noticeable phenomenon in the exportable items is the rise of share of cut flower in the total exports. While flower exports were virtually non-existent five years ago, the share of this item in the total value of exports reached 9 percent in 2008/09.

The growth of exports of oilseeds was also significant pushing its share in the total export from 11 percent during the period 2000/01-2008/09 to 19 percent during the last five years. While the growth rates of exports of pulses were significant in both periods, its share has remained low.

A significant decline was observed in the share of hides and skin in the overall export during the last five years. That is because exports of hides and skins declined by about 15 percent in 2008/9. In general, the fall of exports of major commodities such as coffee, hides and skins was compensated by the rise in gold and chat exports. As a result, overall export increased by 11 percent in the year 2008/09.

Table 1.6: Growth rates in major export items

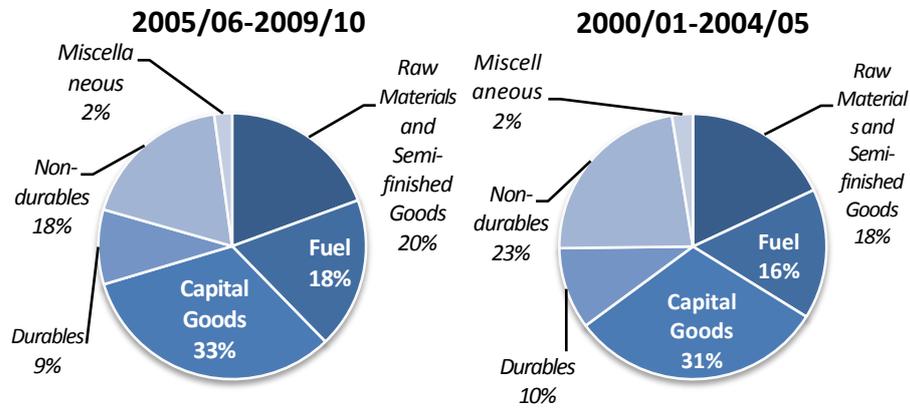
	2000/01- 2004/05	2005/06- 2008/09	2005/06	2006/07	2007/08	2008/09
Coffee	10.2	9.5	6.1	21.3	30.0	-19.2
Oil seeds	36.6	41.4	69.7	-10.2	22.7	83.5
Hides & Skins	26.0	8.6	11.3	21.2	16.2	-14.5
Pulses	61.9	45.8	4.9	92.9	114.3	-28.8
Flower					84.8	31.8
Chat	10.0	15.4	-10.8	5.6	22.5	44.4
Gold	15.4	21.6	9.3	51.9	-14.6	40.0
Total	14.3	20.0	18.5	20.0	30.0	11.3

Source: EEA/EEPRI computations using data from NBE

A noticeable change in the structure of imports during the past five years compared to the preceding five years is that there was a decline in consumer non-durables from 23 percent to 18 percent. The share of imports of semi-finished goods, capital goods, and fuel has increased by 2 percentage points each. The increase in the share of imports of semi-finished goods, and fuels in the total imports is partly due to rises in import prices of fuel, and fertilizer. Increase in the imports of industrial goods resulted in the overall increase of the share of imports of capital goods.

A major policy intervention by the NBE was the devaluation of the Birr by about 17 percent against US dollar in summer 2010. The Bank has argued the action would improve the balance of payment of the country. Nevertheless, given the basic nature of imports (see Figure 1.5) and supply-constrained exports of the country, the devaluation is unlikely to bear the result it is intended for. Rather, it aggravates inflationary pressure by making imports more expensive.

Figure 1.5: Structure of imports



Chapter 2

Performance of the Agricultural Sector

2.1. Introduction: Purpose and motivation

This chapter provides an update on the performance and some analysis of the Ethiopian agricultural sector. The report and analysis is based on the official data available. Reference is also made to a wide range of other literature. Unlike the previous years' economic reports, this one provides an update and analysis over the past five years, and more. The rationale for presenting the past five years stems from the need to provide comparison with bench marks and the broader five years plans i.e. the PASDEP that was put to operation five years back as of 2005/6 and the next five year plan (or the Growth and Transformation Plan (GTP)).

This approach of summarizing the sectoral performance of the past five years benefits the readers and stakeholders to gain the knowledge of critical elements and factors that influence sectoral performance in a way that lesson can be drawn for policy and strategy planning and implementation of the sectoral development activities.

2.2. Overview of sectoral policy and strategy framework

Since the mid 1990s the guiding economic development strategy has been the Agricultural Development Led Industry (ADLI) strategy. The essence of ADLI is that by supporting the smallholder agriculture development, capital and wealth will be created for investment and development of industry and other

sectors of the economy. The support for the smallholder agriculture has been devised in terms of massive extension work, technology packages mainly in crop production, livestock production, and land and water resources management. Besides ADLI, the Rural Development Strategy developed and adopted in 2004, has guided investment and development efforts in the agriculture and rural economy. There have been discussions and arguments about the efficacy of ADLI.

One of the criticisms has been the limited attention given to the demand side of development. In some years (e.g. 2002/3), there has been bumper harvest in some grain crops like maize. But the low price led to the frustration of smallholder producers in the high maize producing areas of the country. This phenomenon has given rise to the emergence of the idea of commercialization of the smallholder agriculture, market and export orientated agricultural development. This latest development in the agriculture and rural development strategy discourse was officially adopted around 2005.

The series of poverty reduction strategies (PRSP) initiated in 2002 and then after have also contained agricultural development strategies as major instruments. The plan for accelerated and sustainable development to end poverty (PASDEP) (2005/6 to 2009/10) has included strategies and plans for agriculture and rural development. The second five year development plan (SFYP) or the Growth and Transformation Plan (GTP) also focuses on agricultural development as one of the main pillars. The Ministry of Agriculture has developed a 10 years road map for sectoral investment and development.

A very recent and detailed analysis of ADLI was done by Kenichi in 2009. A summary of the major issues covered is provided in Annex 1.

2.3. Analysis of the performance of Ethiopian agriculture: Past five years

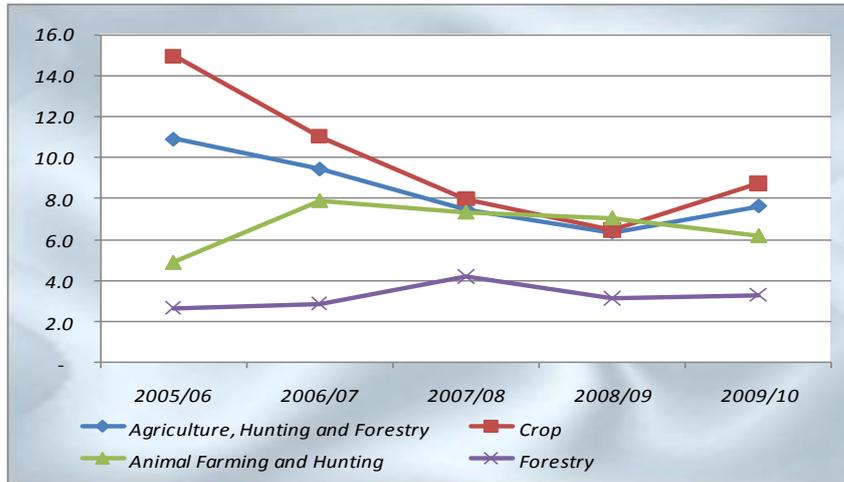
This section addresses the performance of the agricultural sector taking some key indicators. The main indicators of performance of the sector include: agricultural GDP and its growth rate, total volume of food production and the per capita amount (especially grain food), land and labour productivity. Other indicators including budgetary resources allocation, investments in key factors of production and support systems (irrigation, extension, research, seed, fertilizer, chemicals for crop protection, marketing, etc) are also important to see the extent of success in the sector.

2.3.1. Agricultural GDP and growth rate

The official time series data obtained from the Ministry of Finance and Economic Development (MoFED) for the period 2005/6 to 2009/10 show that the Ethiopian agricultural sector GDP grew at an average rate of 8.4 percent per annum. During the period growth rate declined from the highest 10.9 percent in 2005/6 to 6.4 percent in 2008/9 before it slightly increased to 7.6% in 2009/10. The decline in growth rate during the years 2005/6 to 2008/9 is more related to the decline in the growth of value of crop production sub-sector while the change in the growth of the value from livestock production and hunting has been very small but slightly declined over the past years up to 2009/10 from its level four years back (2006/7). But the livestock sub-sector GDP growth rate nearly doubled between the two years 2005/6 and 2006/7. The growth rate of value of crop production declined from 15% in 2005/6 to

6% in 2008/9. The livestock value growth rate stayed at around 8 to 6% between 2006/7 to 2009/10.

Figure 2.1: The growth rate of agricultural GDP at constant prices (%)



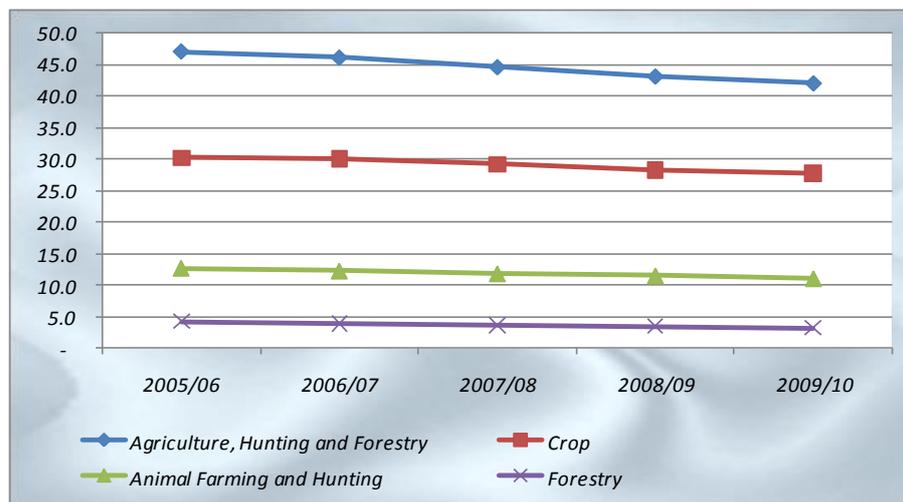
Source: computed based on the MoFED data.

The national GDP reached 142.8 billion Birr less FISIM (at constant market prices) in 2009/10. In the same year agricultural GDP is reported to be 59.3 billion birr (at constant market prices). It shows the rate of agricultural GDP was 42% of the total GDP. Over the last five years the share of agricultural GDP has been slightly declining from its level of 47.1% in the year 2005/6 to 42% in the year 2009/10. Looking into the share of sub-sectors of agriculture in the AgGDP during the last five years, crop production contributed 64% to 66% while livestock and hunting contributed 27% to 26% and the remaining, 9% to 8% is from Fisheries sub-sector. As shown in Figure 2.1, the share of agriculture and its components has been declining at somewhat a constant rate. The share of AgGDP declined by 2% between 2005/6 and 2006/7 and at a

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constant rate of 3% in the next three years from 2007/8 to 2009/10. The share of livestock and hunting declined by 1% to 4% while that of fisheries by 6% to 8%.

Figure 2.2: The trend in the share of agriculture in the national GDP at constant prices (%)



Source: Computed based on the MoFED data.

Although the decline in the sectoral share in the national GDP is expected, however, the uniformity in the rate of decline for the different sub-sectors of agriculture is not readily explainable. Given the fact that some sub-sectors like livestock especially the value of export of meat and live animals has been significantly rising in recent years, this uniform rate of decline may not be expected.

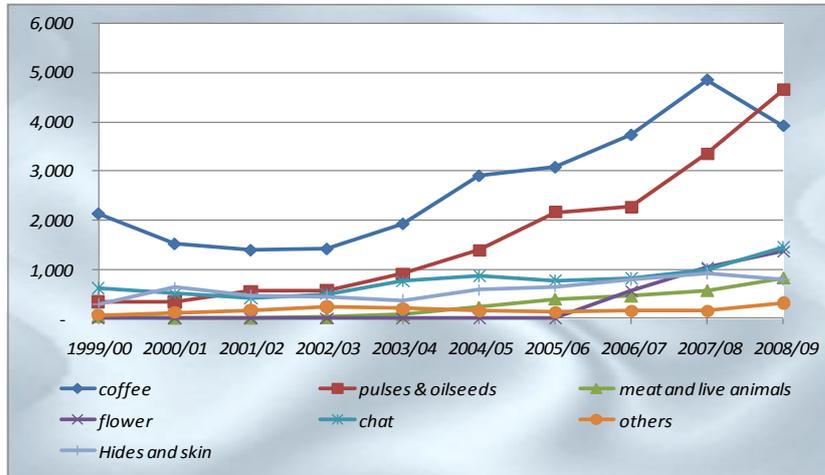
2.3.2. Agricultural export and earnings

Agriculture contributes the largest share to Ethiopia's total export earnings. This share has been ranging between 83% in 2005/6 to 88% in the year 2008/9. Total export earning was 15.08 billion birr in 2008/9 out of which agriculture and related products (including hides and skin) account for 13.3 billion birr. As shown in Figure 2.2, two major groups of commodities contribute the most to agricultural export earnings of Ethiopia- coffee and pulses and oil seeds. Chat follows at the third level, in the last five years earnings from flower significantly increased and became the third largest foreign exchange earner almost equal to earnings from chat.

The export earnings from coffee has been increasing at a higher rate after a recovery from the coffee market crises of the late 1990s and early years after 2000. Earnings from coffee more than doubled between 2003/4 and 2007/8 and reached double of the level of 2003/4 in the year 2008/9 reaching 4 billion birr. Similarly, earnings from pulses and oilseeds increased to close to five fold between 2003/4 and 2008/9. Although hides and skins are among the traditional export commodities, trade volume and value have not been increased over time. On the other hand, the country is said to have known brands of skins and hides of high quality. The problem of effective collection, competitive pricing and export activities must have been a major obstacle that hindered increased benefit from hides and skins. The data show that there has been little effort to diversify the basis for agricultural export earnings, although very few non-traditional export commodities like flower have been newly introduced.

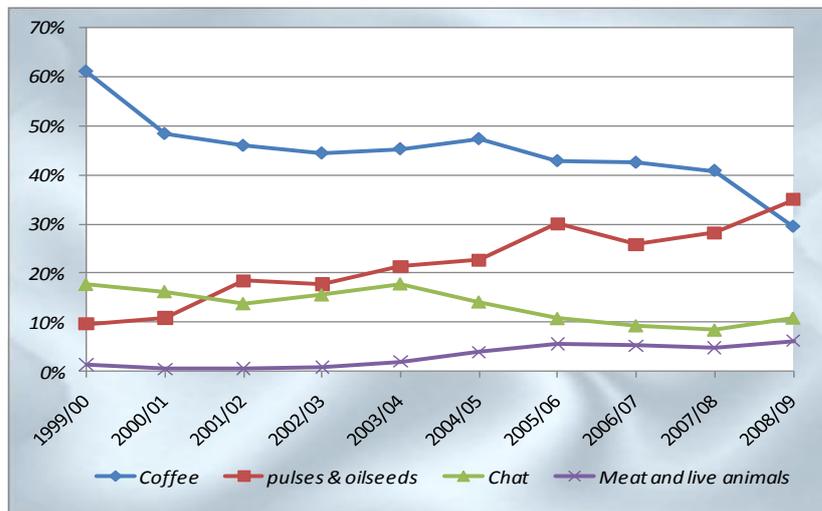
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Figure 2.3: Value of export of agriculture and related products (million birr)



Others include fruit and vegetables, sugar, bee's wax, oil cakes.

Figure 2.4: Share of some major products in total agricultural export value



Source: Computed based on data of Customs Authority.

Looking at the structure of the agricultural export commodities, one realizes that it is composed of few major commodity groups- coffee, pulses and oilseeds, chat and meat and live animals. These major export commodity groups constitute different shares of the total agricultural export volume and value. About ten years back coffee contributed the largest share, 60%, of the total value of agricultural export. In 2008/9, the share of coffee decreased to half of the level of ten years back i.e. 30%. In the last one year, the price of coffee has been dramatically rising reaching over 80 birr a kg in domestic markets. International price has also been significantly rising in the past months. On the other hand, the contribution of pulses and oilseeds significantly increased from 10% to about three and half fold. The share of chat in total agricultural export value gradually declined from about 18% in 2003/4 to 10% in 2008/9. The share of meat and live animals has changed only very slightly from 4% in 2004/5 to 6% in 2008/9.

Although agriculture still remained a major source of foreign exchange earnings for Ethiopia, not much has been done in terms of value-addition to the agricultural export commodities i.e. the bulk of agricultural products is still exported in the form of raw materials. Very few private companies started to export roasted coffee while the government put some restraints on export of unprocessed skin and hides with the intension of getting more value from export. It needs more strategic investment and competitive marketing and export system to exploit the potential of the country's agriculture to increase benefits from export trade.

2.3.3. Food production and food security

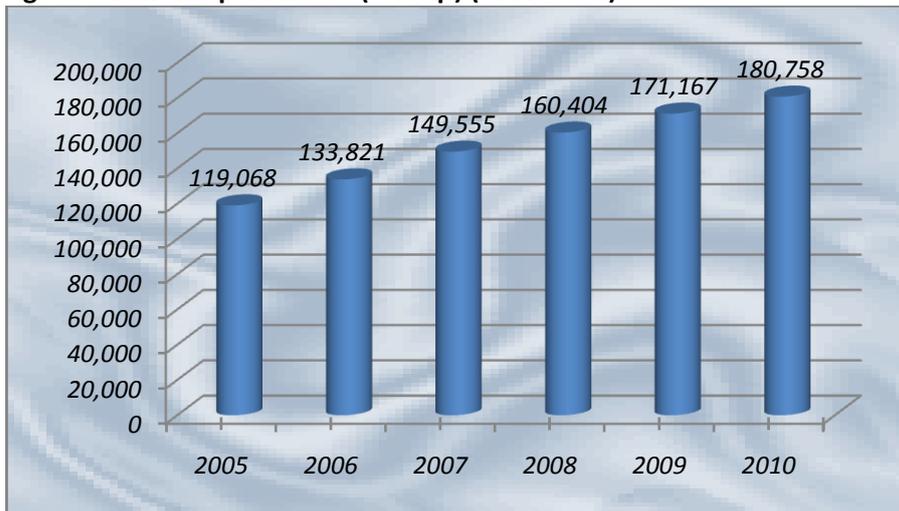
2.3.3.1. Agricultural production

Food grains

The total food grain production in Ethiopia reached 18.1 million tons in the year 2009/10 (see Figure 2.4). Grain production increased by 50% between 2005/6 and 2009/10 implying an annual average increase of 8% per annum. As shown in the figure, grain production has been consistently increasing over the past years.

At an estimated Ethiopian population of around 82.82 million in 2009, as provided in the World Bank country data profile report, this level of production implies a per capita grain production of 2.17 qt, well close to the minimum grain requirement per person a year.

Figure 2.5: Grain production ('000 qt) (2005-2010)



Source: Based on CSA data.

Total crops production reached 22.7 million tons in 2009/10 (see Table 2.1). Cereals, pulses, root crops, and enset account for 68%, 8%, 8%, 4%, respectively. Sugarcane on private smallholder farms and oilseeds account for 3% each. Fruits and vegetables account for a small share of only 4% of crop production while coffee and chat only for 1% each.

Cereals take the largest share of the total area of cultivated land under crops followed by pulses and oilseeds. The three major grain crops constitute 72%, 12% and 6% of the crops land. A significant increase in the area and production of root crops from 2008/9 to 2009/10 has been due to potatoes and sweet potatoes. Especially the area under sweet potatoes increased by 70% while production also increased by 62%. Area and production of Irish potatoes increased by 49% and 45%, respectively. In the year 2009/10 area under Irish potatoes was 69,000 ha while production was 5.7 million quintals. Expansion of the sweet potato production seems to be driven by a food security motive while that of the Irish potatoes might be partly due to its demand as a cash crop.

In terms of land productivity, the highest production per hectare is obtained in sugarcane production (35tons/ha) followed by root crops (8.5 tons/ha), fruits (8 tons/ha) vegetables (4tons/ha). Average cereals, pulses and oilseeds productivity is still lowest at 1.7 tons/ha, 1.3 tons/ha and 0.8 tons/ha, respectively.

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Table 2.1: Area of cultivated land, production and productivity in crop production

Crops	Cultivated land (000 ha)		Change (%) 2008 - 2010	Share in 2009/10 (%)	Production (qt)		Change (%) 2008 -2010	Share in 2009/10 (%)	Productivity in 2009/10 (qt/ha)
	2009/10	2008/9			2009/10	2008/9			
Cereals	9,233,025	8,770,118	5	72	155,342,000	144,964,059	7	68	17
Pulses	1,489,308	1,585,236	-6	12	18,980,473	19,646,301	-3	8	13
Oil seeds	780,916	855,147	-9	6	6,436,144	6,557,044	-2	3	8
Vegetables	138,393	162,125	-15	1	5,573,568	5,988,571	-7	2	40
Root crops	212,208	145,742	46	2	18,063,778	12,136,043	49	8	85
Fruits	50,271	45,876	10	0	3,993,522	3,442,877	16	2	79
Chat	138,811	138,145	0	1	1,162,797	1,149,211	1	1	8
Coffee	395,003	391,296	1	3	2,654,693	2,602,392	2	1	7
Hopes	23,998	24,409	-2	0	309,384	302,813	2	0.14	13
Sugar cane	18,908	15,602	21	0	6,724,394	5,594,041	20	3	356
Enset	395,632	278,668	42	3	8,015,531	5,565,899	44	4	20
Total	12,876,473	12,412,364	4	100	227,256,284	207,949,251	9	100	18

Source: Computed based on the CSA data.

Table 2.2: Change in the production of major traditional cash crops in Ethiopia

Year	Coffee		Vegetables		Sugarcane		Sesame		Chat	
	Area (ha)	Production (qt)	Area(ha)	Production (qt)	Area (ha)	Production (qt)	Area (ha)	Production (ha)	Area(ha)	Production (qt)
2005/6	261,175	1,716,311	117,650	4,501,995	18,857	16,050,251	205,152	1,488,610	136,189	196,603
2009/10	395,003	2,654,693	138,393	5,573,568	18,908	6,724,394	315,843	2,605,343	138,811	1,162,797
% change	51%	55%	18%	24%	0.3%	-58%	54%	75%	2%	-3%

Source: computed based on the CSA data.

Cash crops

The major cash crops produced and sold in Ethiopia are coffee, chat, and sugar cane. Some vegetables like tomato and onion are also largely produced by smallholder farmers for market. Oilseeds are mainly produced as cash crops. Oilseeds like sesame are becoming important cash crops for export markets.

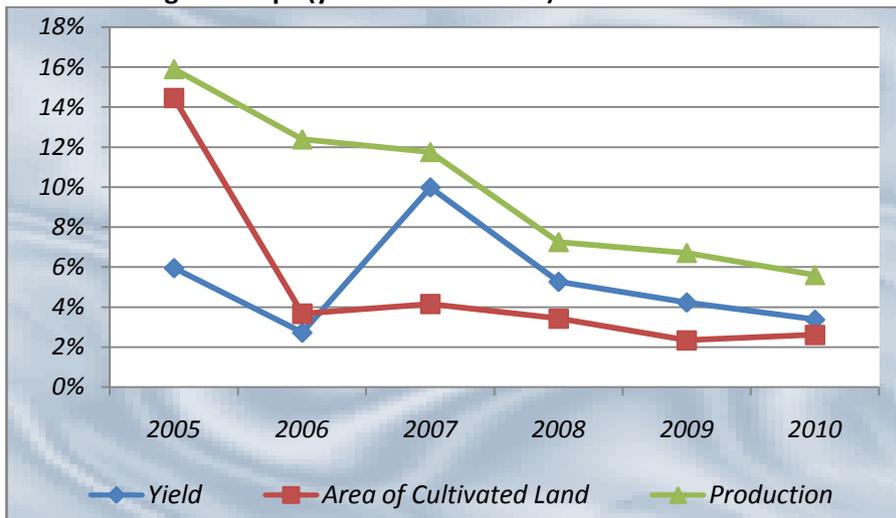
In 2009/10 the quantity of coffee, chat and sugarcane produced reached 265,469 tons, 1,162,797 and 672,439 tons, respectively. Production of vegetables was 13,839 tons while that of sesame was 31584 tons. In 2009/10 area under coffee, chat, and sugarcane (by smallholder farmers) reached 395,000 ha, 138,800 ha, and 18,900 ha, respectively. Cultivated area under vegetables was 138,393 ha while that of sesame was 315,840 ha.

Compared to the level of the cropping year five years back, 2005/6, the area under coffee increased by 51% while its production increased by 55% (see Table 2.2). There has been some focus on planting coffee seedlings in the major coffee growing regions: Oromiya and SNNPR. The gradual recovery of coffee price from the major crises around late 1990s and early 2000 must have given an incentive to expand coffee production. During the same period, area under chat has not been changed while production has been slightly reduced. Area under vegetables increased by 18% while production increased by 24%. The area of land cultivated with sesame increased by 54% while production increased by 75%. This shows the increased attractiveness of sesame production and export in recent years.

Drawing on the Central Statistical Agency data, area under grain crops reached 11.5 million hectares. Data reported over the period 2005 to 2010 show that the rate of increase in grain production and area expansion under

grain crops has been significantly declining (see Figure 2.5). Change in production (increment) declined from 16% between the years 2004/5 to about 6% between the years 2008/9 and 2009/10. Change in area also declined from 14% to 2% during the same period. Change in grain productivity (yield per hectare of cereals, pulses and oil crops) has been varying /fluctuating from year to year.

Figure 2.6: The rate of change (growth) in area, yield and production of grain crops (years 2005 to 2010)



Source: EEA/EPRRI database 2009 based on the CSA data. Data of 2010 from CSA.

Livestock products

Livestock plays an important role in Ethiopian agriculture. It is estimated that livestock contributes about 27% of the agricultural GDP. The 10 years policy and investment roadmap (2010/11 to 2019/20) (MOARD, 2010) shows that Ethiopia’s agriculture is dominated by cereals (32% of AGDP) and livestock

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(33%) while export crops (17%) and other agriculture (18%) account for the remainder. The document also mentions that the livestock sector is believed to have been undercounted in GDP figures (only 29%). On the other hand, a recent report for BMGF on Ethiopia (2010) states that livestock contributes between 20-40% of agricultural GDP and 10-20% of total GDP in Ethiopia (World Bank 2002). The same report also mentions that experts generally argue that, particularly in pastoral regions, livestock's economic contribution is undercounted by traditional GDP calculations, which do not fully reflect the economic value of milk, meat and hides which are consumed in a subsistence manner, rather than marketed¹.

Livestock also accounted for approximately US\$150 in formal export earnings in 2008, or 10% of total formal exports². Roughly half of this value comes from live animal and meat exports, with the remainder coming from hides and skins. It is also known that a significant level of informal cross-border trade in live animals is taking place, and the difficulty of accounting for the value of this type of trade is part of the reason for undervalued importance of the livestock sub-sector for the Ethiopian Economy³.

The data obtained from the official annual report on PASDEP in 2009 shows that in the years 2007/8 and 2008/9 a total of 4.16 million tons and 3.62 million tons of livestock and related food products (including meat, egg, milk, honey and fish) were produced (see Annex 3). The data show that production

¹ A study by Berhanu and Fayera (2008) assessed the direct values and measurable indirect values of pastoralism and estimated a total value of 15 billion Ethiopian birr per annum. This amounts to about 1.6 Billion USD. This is also noted to be a conservative estimate of the direct values of Pastoralism in Ethiopia given the inconsistencies and inadequacies in some of the data base.

² Ibid

³ Estimates of informal trade volume vary widely between 250,000 and 500,000 head of cattle per year, compared to formal exports of 84,000 head in the year 2008. The value of informal livestock exports is estimated at US\$150-300 million per year, implying that livestock contributes up to 25% of Ethiopian exports if the value of informal exports is included (Report for MBGF, 2010).

in 2008/9 declined by 13% compared to the level in 2007/8. These products include 40,000 tones of honey produced in 2008/9. 94% of the honey is produced by traditional hives while the modern and transitional hives account for only 5% and 1%, respectively. The data show that there is still a long way to go in terms of introducing a modern way of honey production by the use of modern and transitional hives which are said to have doubled and tripled the production of honey under the smallholders' productions system.

The data also show a per capita livestock food production- 7.7 kg of meat and 37 kg of milk – in the year 2008/10. This includes a 4.7 kg per capita of cattle meat and 35 kg per capita of milk from local cows. No data is reported on improved dairy animals and products. This data of live stock food products is among the lowest in any standard. It implies a low performance of the livestock sub-sector in Ethiopian agriculture.

2.3.3.2. Food security achievement

The Policy and Investment Framework for the coming 10 years (MOARD, 2010) reports that in Ethiopia the food poverty head count decreased from 44% in 1999/00 to 38% in 2005/06 and is expected to be 28% in 2009/10. The per capita grain production increased from below 1.5 quintals in 2003/04 to 2.13 quintals in 2007/08. Data also show that Ethiopia is almost meeting the 2,100 Kcal per capita per day requirement, the equivalent of which in terms of production is 2.16 quintals⁴. However, the Government of Ethiopia (GoE) recognizes that much has yet to be done in the agricultural sector to tackle the problem of widespread poverty and realize its vision for the country to achieve

⁴ As shown in section 2.3.3.1 above, in 2009/10 per capita grain food production reached 2.17 qt.

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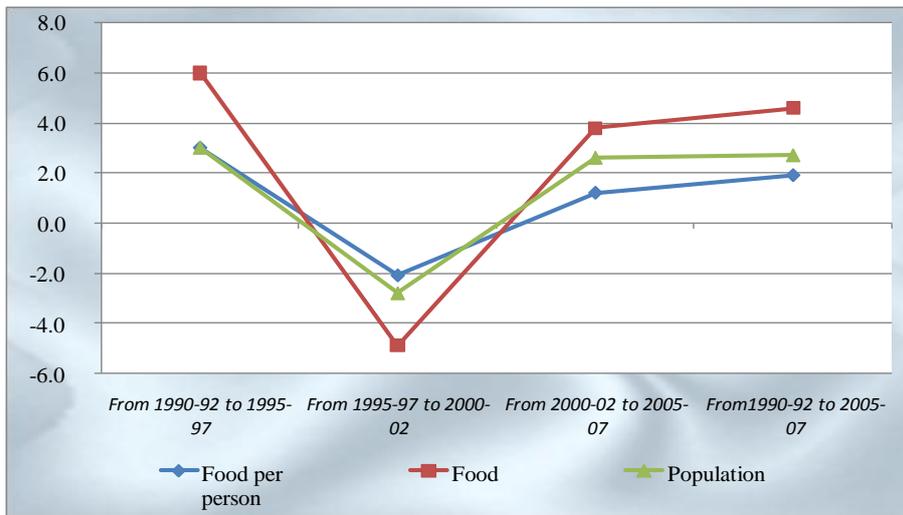
a middle income status by the year 2020. Middle income is defined as per capita income of \$1,000.

Although the national food production, especially grain, has been increasing, reaching 18 million tons, a significant amount of post harvest losses also reduce food availability. At the national level, food security has not yet been achieved as there are parts of the country where people are vulnerable to shocks that lead to food insecurity while there are others who have problems of chronic food shortages.

Due to several factors that undermine the national food security including unfavorable weather, and the presence of vulnerable and chronically food insecure population, major public food security programs have been operating in Ethiopia. The government has launched the New Coalition for Food Security 2003/4 that proposed a Food Security Program (FSP) aiming at shifting households out of the emergency relief system while also enabling them to “graduate” to sustainable food security. The productive safety net program (PSNP), also known to be one of the largest social protection programs in Sub-Saharan Africa, has been covering 7.57 million people that reside in 290 rural woredas in Ethiopia. Historically vulnerable woredas were selected to benefit from the program. Households in the selected woredas known to be chronically food insecure are selected as program beneficiaries. Beneficiary households get transfers in the form of cash and kind. The PSNP budget includes resources for household transfers, inputs for public works, and other program management costs. The first phase of PSNP covered the period 2005 to 2009 and the second phase has been initiated to operate during another five years, 2010 - 2014.

Total food production, per capita food availability in relation to population growth has shown a positive trend during the last one and a half decade. Average annual rate of change of total food production and per capita food availability was positive (6% and 3%) between the years 1990-92 to 1995-97 (see Figure 2.7). The rate declined (even below zero) during the five years period 1995-97 to 2000-2002. The annual growth has recovered at a rate of 4% and 1% per annum between 2000-02 and 2005-07.

Figure 2.7: Average annual rate of change in food production and per capita food availability in Ethiopia (%) (1990 – 2007)



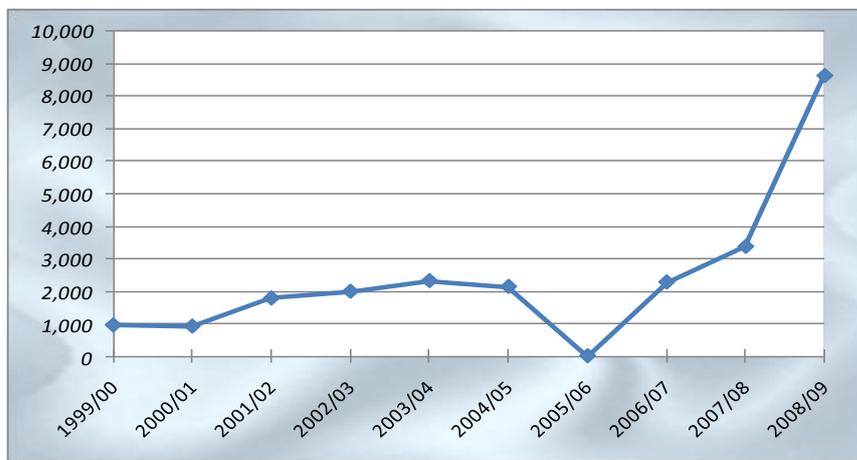
Source: Computed based on the FAO Statistics

The rate of growth of food per person reflects the difference between the rate of growth of food production and population growth. The data show that population growth rate stood around 2.6% between 1990 and 2007.

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Food security is achieved not only through national food production but also by supplementing food supply through food imports. Food import is, however, significantly affected by the world food prices, especially for major food commodities. Between the years 2005/6 to 2008/9 Ethiopia's food import bills increased fourfold (see Figure 2.8). While the value of food import for the six years from 1999/2000 to 2004/5 remained almost constant around 2 billion birr per annum, the value of food import increased from 2 billion birr to 9 billion birr in 2008/9. Cereal takes 74% of total food import while other food items take a share of 26% in the year 1990/2000. In 2006/7, 2007/8 and 2008/9, the share of cereals in food import was 62%, 57% and 77%, respectively.

Figure 2.8: The trend of Ethiopia's food import over the last decade (million birr)



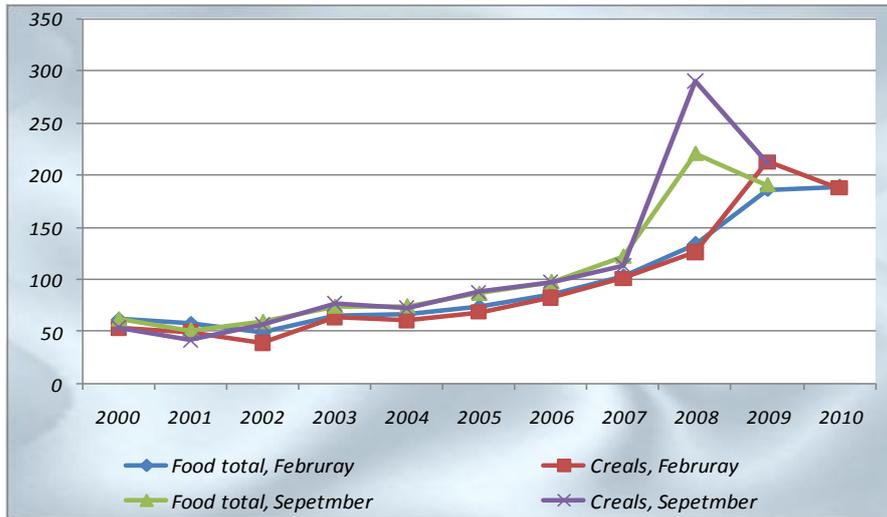
Source: NBE and EEPRI compilations using data from Customs Authority

In the face of the volatile food price of the world food trade regime, raising own domestic food production capacity is imperative. The UNFAO's recent assessment also reached a similar conclusion and proposal saying that looking

at the increasing problems of food price volatility in the long run, countries can lower their vulnerability by raising agricultural productivity for a diverse set of crops that proves both competitive and sustainable, as well as by promoting dietary diversification (FAO, 2010).

Food price is also an important aspect of food security as food constitutes a significant share of household budget in Ethiopia. Considering a price index for cereal crops and total food items, the CSA data show that during the last four years both cereal and total food prices have been higher and significantly increased from the year 2006 onward (see Figure 2.9). Food price was tripled and that of cereals more than doubled in just one year between 2007 and 2008. Price levels slightly declined but were still high in 2010 compared to five years back in December 2006.

Figure 2.9: Total food price and cereal price index in specific months (February and September) over a decade (December 2006=100)



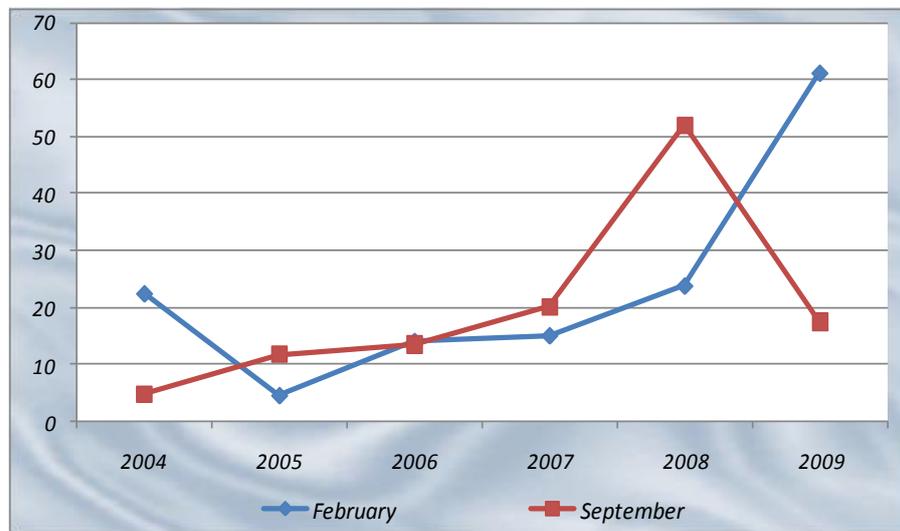
Source: Based on the CSA data.

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Food inflation has been important in Ethiopia over the last many years. Inflation was a single digit around 2004 and gradually rose to double digit in 2005 reaching 50% in September 2008 and 60% in February 2009 before it dropped to 20% in September 2009 (see Figure 2.10).

Raising agricultural productivity and adequate food supply must be one of the primary goals towards reducing food inflation and attaining national and household food availability. It is to be recalled that the Ethiopian government has taken a measure of cereal food price stabilization by importing food grains in the years 2008 and 2009. The measure has played a role in gradually bringing down the price of major cereals.

Figure 2.10: Trends in food inflation in Ethiopia (2004-2009)



Source: Based on the CSA data.

2.4. Agricultural input use and support systems

2.4.1. Land

Land is a major resource base for the Ethiopian agriculture. Estimates show that more than 50% of the country's landmass is arable land⁵. However, a limited portion of the arable land potential is put under agricultural use. The crop agriculture zones are concentrated in the highland and mid altitude areas while pastoralism and agro-pastoralism occupies the vast areas of lowland semi arid/arid lands.

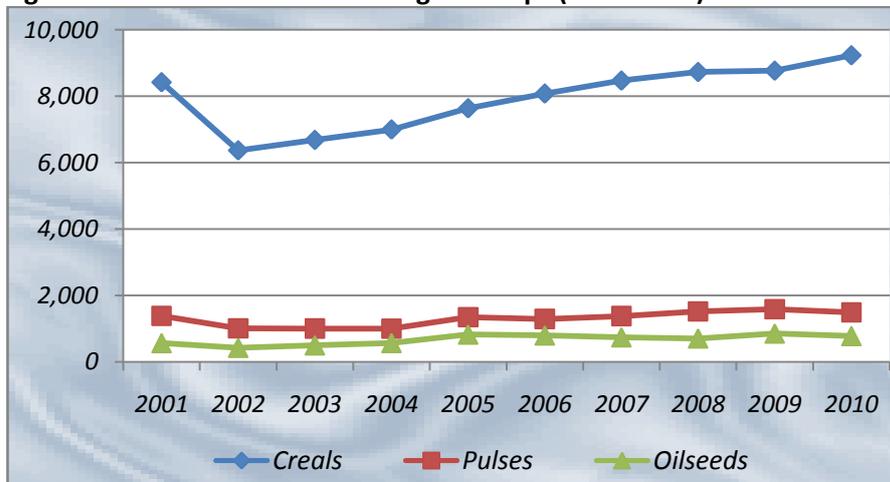
The total area of cultivated land (private peasant holdings) increased from 9.44 million hectares in 2000/01 to 12.88 million hectares in 2009/10 (see Figure 2.11). This shows an increase in area cultivated by 36% over a decade at an average growth rate of 4% per annum.

The data also show that compared to the data in 2000/01 (sample survey), the share of cultivated land under cereals slightly decreased from 81% to 72% in 2009/10 while that of pulse decreased from 13% to 11.6%. As shown in figure 2.10, the area of cultivated land under pulses and oilseeds more or less remained constant at around 1.5 million hectares for pulses, especially during the last five to six years, and close to 1 million hectares for oilseeds during the last six years. The data reveal that major focus is still on cereal crop production, although pulses and oilseeds are increasingly becoming among the export commodities for the country.

⁵ Different institutions report different figures on the amount of arable land that the country has. The estimate ranges from 32 million to 53 million hectares. Data from the World Bank Country Profile shows that in the year 2000 agricultural land was 30.7% of the total land area while this slightly increased to 33.7% in the year 2005.

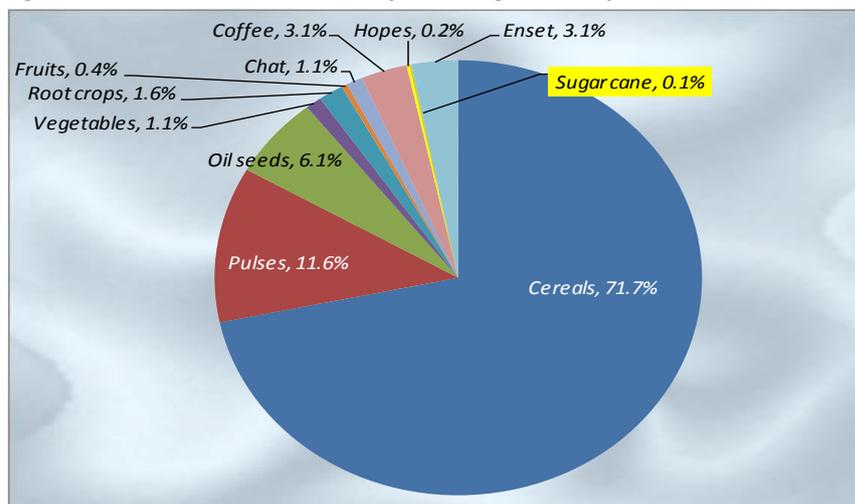
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Figure 2.11: Land cultivated with grain crops (2001-2010)



Source: Based on the CSA data.

Figure 2.12: Land use in the crop farming in Ethiopia (2009/10)



Source: Based on the CSA data.

The lack of structural change in the smallholder production system can be depicted looking at, among other aspects, the distribution of allocation of cultivated land to the various commodity groups (see Figure 2.12). In the cropping year 2009/10, more than 70% of the cultivated land was under cereals, leaving the remaining less than 30% of the land to many other crops. Coffee took only 3.1% of the total cultivated land although the commodity has a big potential to fetch foreign exchange earnings from export trade. Pulses account for 11% followed by 6% for oilseeds. These two groups of commodities are not only important as food crops but also as cash crops including export. Although known to be a source of food security for rural population in many parts of the country – southern highlands, south western and western central highlands- enset holds only a 3% portion of the total cultivated land. The production of chat is witnessed to have been expanding too many pocket areas of the country. However, it occupies only 1.1% of the total cultivated land. The various vegetables and root crops are not only important for household nutrition, source of some cash, but also are higher in terms of land productivity compared to cereals and other crops. In the face of ever increasing land scarcity, focus on land saving (higher land productivity) crop technologies and systems is imperative. To date vegetables and root crops occupy a minute portion of the cultivated land under smallholders' production i.e. 1.1% and 1.6%, respectively. Similarly, sugarcane occupies an insignificant space of the cultivated land although it has been emerging as one of the sources of cash for smallholder farmers, and is known to have the highest land productivity compared to other crops.

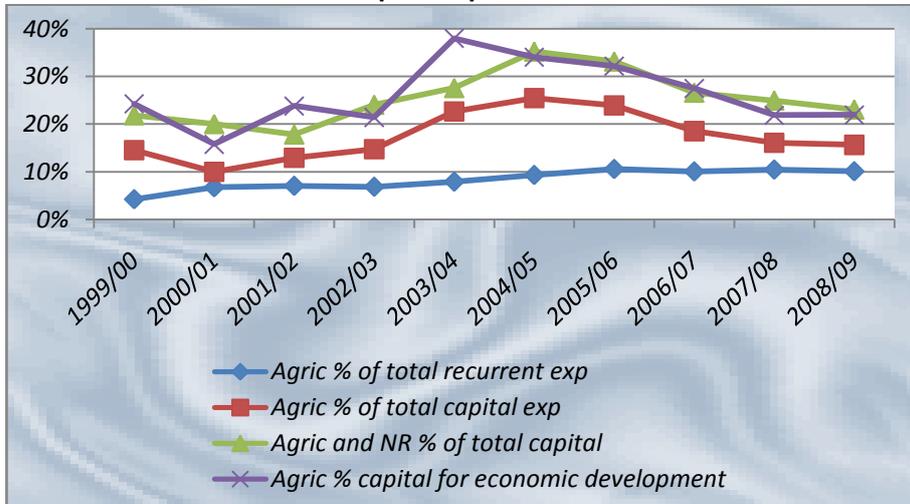
Beyond the agro-ecological suitability, few major factors may explain why land allocation is largely dominated by the cereal production system in the country. The historical focus of the agricultural service support system (extension, research and input and output markets) focused on cereals as

major sources of food security through production of cereal crops; there had been limited attention to other crops in terms of technological bases (research and extension and production investives -inputs, markets, prices, etc).

2.4.2. Capital resources

Capital is a key factor of production. The agricultural sector being one of the pro-poor sectors it has been receiving attention by the government in terms of allocation of public expenditure. Data obtained from MoFED show two patterns of public expenditure for agriculture during the last decade. During the first half of the decade (2000/1-2004/5) resources allocated for agriculture and natural resources (from total national capital expenditure and also in terms of share from allocation for economic development sectors) have been significantly rising. Agriculture and natural resources received 20% of the total capital expenditure in 2000/1 and that share increased to 35% in the year 2004/5. The share of agriculture alone increased from 10% in 2000/1 to 25% in the year 2004/5. Agriculture also received between 15% and 37% of the capital resources allocated for the economic development sectors. During the second half of the decade starting 2005/6, the share of agriculture and natural resources has been declining in terms of a share from total public capital expenditure and capital allocated for economic development sectors. Capital resources allocated for agriculture and natural resources declined by 10% by 2008/9 compared to the level in 2004/5. Unlike the capital expenditure, recurrent expenditure for agriculture has been steadily rising from around 6% in 2000/1 to 10% of the national recurrent expenditure in 2008/9.

Figure 2.13: The share of agriculture and natural resources in national recurrent and capital expenditure



Source: Based on the MoFED data.

The Comprehensive African Agriculture Development Program (CAADP) adopted by African countries (Maputo decision) targets at achieving 10% of the national budget to be allocated for the agricultural sector. Ethiopia has already surpassed this target reaching 13% in the year 2009 and committed to increase and sustain this level of the national expenditure for the agricultural sector (Ethiopia CAADP Compact, September 2009).

The issue of recurrent and capital budget expenditure for agriculture is not only a mere number or percentage share; rather more important is how much of the resources reach the end beneficiaries (farmers) in terms of tangible capacity for technical supports and access to the necessary inputs. It is clearly seen that resources and capacity to implement sectoral development plans at grassroots - districts and kebeles (i.e. farmers training centers and

development agents at community levels) are usually scarce and lacking. Hence, effort should be made to bring resources down to the grass roots agencies that support the development of agriculture.

2.4.3. The supply and use of improved inputs

The role of inputs and institutional support services for the growth of the agricultural sector is a well established fact. A well functioning system that provides a modern agricultural input and service is of critical importance to attain higher agricultural growth. Use of technological inputs- fertilizer, seed, chemicals, veterinary, improved breed, irrigation practices - is critical for higher agricultural productivity.

In Ethiopia, the major provider of access to modern inputs and technical support for the agricultural sector, especially for the smallholder agriculture, is a public system. Historically, agricultural inputs markets, agricultural extension, research and technology developments have been the mandate of the government, with very limited private sector engagement. Limited experience of the non-state actors in this respect, especially in extension and research services, and issues of affordability of service provisions from the point of view of the smallholder farmers are some of the major reasons why input services largely remained in the hands of public. While attempts were made to engage some private sector traders in fertilizer procurement and distribution during the late 1990s and the early years after 2000, that did not operate very well to date as the private sector groups have lately withdrawn from the fertilizer market. The same is true with the production and distribution of improved crop seeds. There is limited engagement of the private sector in the production and distribution of improved seeds.

The problem with improved seeds is one of shortage, mainly for varieties demanded by farmers as farmers revise their expectations of rainfall, prices, and so on, and the estimated demand mismatches with the actually demanded amount during the planting season. There is a limitation of capacity to supply the demanded amount of improved seeds. Given the focus of both the research and agricultural extension programs on major cereal crops, there seems to be much less attention to the improvement and distribution of the non-cereals or non-grain seeds. Improved seed pricing has also been an unsettled issue. The government is of the opinion that private sector seed producers demand higher prices not affordable by farmers. Consultation with a senior expert in the national research system reveals that to date not more than 20% of the annual demand of improved seed is met.

There is a considerable variability in the level of supply among the different crops, The data recorded over three years period through the FAO and World Food Program annual assessments (2004/5 to 2006/7) show that use of improved seeds is largely limited to two crops, namely wheat and maize. The two major cereals, wheat and maize, account for 24% - 30% and 43% to 67% of the quantity of improved seeds.

Dawit and David (2006) made the analysis of investment and returns to seed production. It was shown that among the cost components of Ethiopian Seed Enterprise (ESE) in maize seed production, overhead costs account for about 65 percent of the total cost and the price margin between ESE and farmers' is about 35 percent for open pollinated varieties (OPVs) and hybrid maize (with regional variations due to transportation costs). This suggests a considerable inefficiency in the production and distribution of seed. The rate of return to seed production taking into consideration the cost and price relationship that prevailed during the 2005 production season for hybrid maize produced by ESE

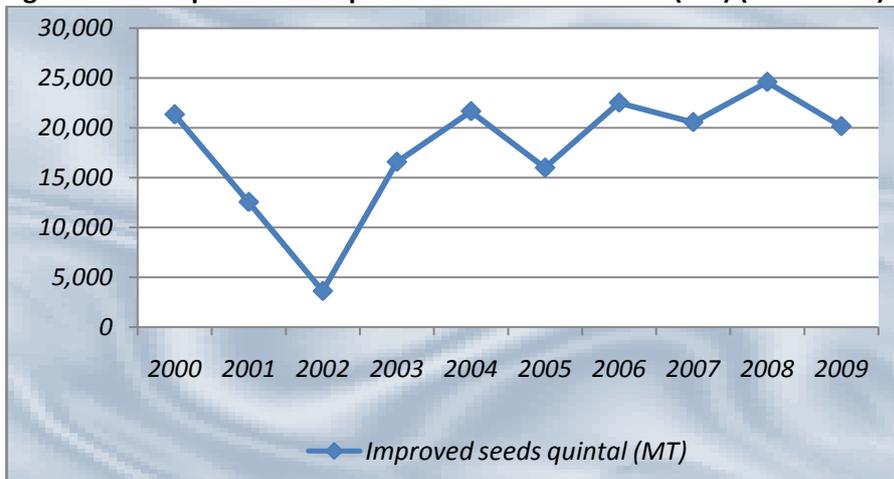
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was shown to be about 147%. This shows the presence of good opportunity and profitability in seed production.

The amount of improved seed supplied is gradually increasing with notable variability from year to year. In the cropping year 2009, only 20 thousand tons of improved seed are produced and supplied (see Figure 2.14). This is about the same volume produced 10 years back in 2000. It somehow shows a little progress made in the volume of improved seed produced in the country.

On the other hand, the 2008/9 PASDEP Annual Report provided by MoFED shows that in the cropping year 2007/8, 44 thousand tons of improved seed are supplied and all of these were utilized while in the next cropping season 30.6 thousand tons were supplied out of which only 20 thousand tones were consumed.

Figure 2.14: Improved seed production and utilization (MT) (2000-2008)



Source: Based on CSA.

Chemical fertilizer has been and still is a strategic input for Ethiopian agriculture. As shown in Figure 2.15, the import and use of chemical fertilizer has been increasing over time. The total amount of chemical fertilizer imported and used reached over 400 thousand tons in the year 2009/10 (300 thousand tons of DAP and over 100 thousand tons of Urea). While the national demand for fertilizer has been increasing, the cost of fertilizer import has also been rising. There was a dramatic rise of the total cost of fertilizer import in 2007/8 and 2008/9, most likely following the increase in the international energy prices. The total import cost of fertilizer tripled to close to 3 billion birr from its level of 1 billion birr in 2006/7.

Figure 2.15: Consumption of chemical fertilizer in Ethiopia (MT) (2000-2009)

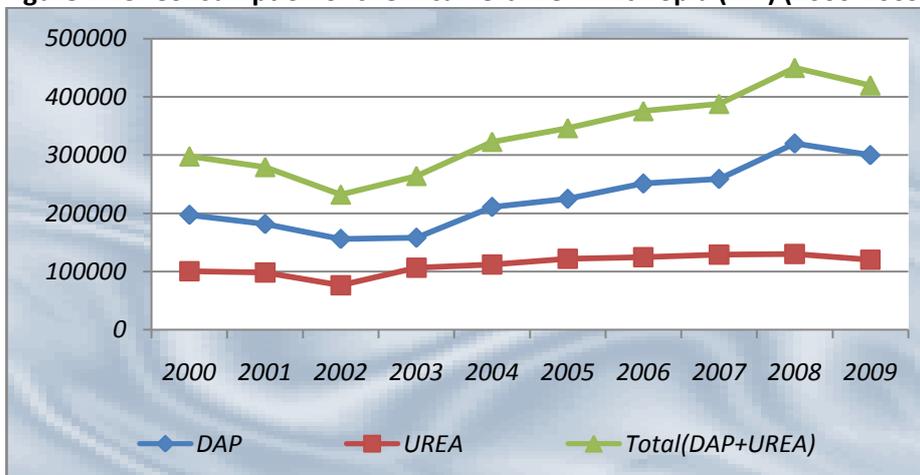
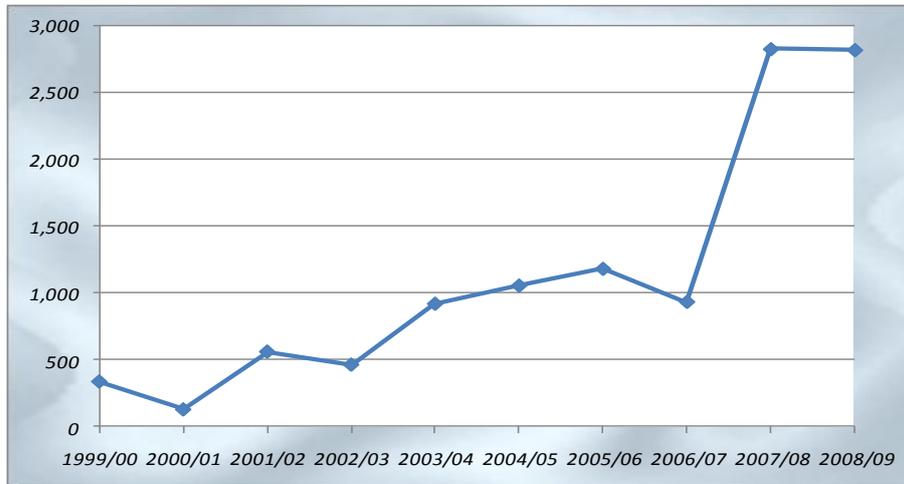


Figure 2.16: Value of fertilizer import (millions of Birr)



Source: Based on CSA

In the medium and long-term, in the face of the trend of increasing energy cost and fertilizer prices, integrated soil fertility management needs to be given attention: soil and water conservation, organic fertilization, agronomic practices including crop rotations- to attain sustainable soil fertility and agricultural productivity.

It is now several years since indigenous soil management practices like fallowing are abandoned owing to land scarcity, especially in the highland areas, and following the intervention by extension services (fallowing considered as a hindrance to increasing production).

The present status of the improved inputs and technology supply system can be depicted in a data provided in Table 2.3. As shown in the table, out of the total cultivated land in the cropping season 2009/10, only 24% has used

chemical fertilizers. Similarly, chemical fertilizers were applied to about 30% of the land cultivated with cereals. For vegetables this was 26%. The proportion of cultivated land under teff, maize and wheat that received fertilizer in the cropping year 2009/10 was 65%, 44%, and 44%, respectively. With regard to the use of improved seeds, only 3% of the total cultivated land and 3% of cereal cultivated land was planted with improved seeds. On the other hand, 12% of area under maize was planted with improved varieties. Overall, 12% of the total cultivated land was treated with crop protection chemicals (pesticides). Irrigated area was extremely low, 1% of total cultivated land and 3.7% of land under vegetables. The agricultural extension packages served 12% of the total cultivated land, 15% of cereal land, 19% of teff, 16% of maize and 18% of wheat land.

Table 2.3: The application of improved inputs and practices in crop production (2009/10)

Crop type	Crop area (ha)	Urea area	Urea +DAP	DAP	Improved Seed	Pesticide	Irrigation	Extension Package
Total cultivated	12,954,749	2%	12	1	3%	12%	1%	12
Maize area	1,772,253	2%	31	9	12	5%	2%	16
Teff area	2,588,661	4%	47	1	2%	17%	1%	19
Wheat area	1,683,565	3%	25	1	2%	24%	1%	18
Pulses area	1,489,308				1%	10%	1%	6%
Oilseeds area	32,074				1%	9%	0.10	5%
Total cereal	9,233,025	2%	15	1	3%	13%	1%	15
Vegetable area	138,393	6%	12	8	2%	4%	3.70	13

Source: Based on CSA data

The data show that a lot has to be done to increase the application of improved inputs and practices in crop production in order to sustainably increase agricultural production in Ethiopia.

2.4.4. Research and extension education

Research has been generating tens and hundreds of technologies in crop and livestock production, and natural resources management. However, the disseminations of technologies is less than the expectation. Dissemination and use of improved crop seeds is a good example. To date the area of cultivated land under improved seeds is at best less than 10% of the total crop plans.

The government has made a huge investment in establishing agricultural TEVT colleges and has trained tens of thousands of middle level agricultural professionals to help in developing the skill and practices of farmers and uptake of better and proven productive technologies. A huge force of development agents, hence, is now deployed to serve at the community levels (farmers Training centers). One of the hindrances to the effective delivery of grass roots agents (districts and farmers training centers) is the low capacity in terms of budget, transport and mobility, facilities including demonstration centers.

2.4.5. Land and water management

Land and water management has a history of several decades (three to four) in Ethiopia. There have been several programs of land rehabilitation, through soil and water conservation activities. The productive safety net program (PSNP) that has been running over the years 2005-2009 and entered a second phase (2010 -2014) has big public works component that involves soil and

water conservation practices. Other notable programs like the MERET project supported by development partners like the World Food Program over years have been doing commendable jobs. Recently, the Ethiopian government in collaboration with donors has designed a national strategy and investment framework for sustainable land management (ESIF-SLM).⁶ This is a 15 years program (2009 -2023). The program looks forward for integrated land management and seeks a huge investment requirement. It has major components that include integrated watershed management, land certification and administration. The program of the MOARD under the framework of SLM has identified 3100 micro-watershed for intervention in 177 food secure high potential woredas. The targeted micro-watersheds cover an estimated area of 1.5 million hectares. The estimated program cost is 440 million USD (Josef, 2008). On the other hand, the Ethiopian Strategic Investment Framework (ESIF) for sustainable land management estimates that incremental funding required over 15 years period (2009 -2023) is 5.392 billion dollars (MOARD, 2010).

While efforts being made by the public and development partners in developing natural resources management and development strategies, their implementation frameworks, and resource mobilization are quite commendable, problems of effective implementation and sustainable land management and use by farming communities still remain challenging.

Irrigation

Official estimates that are quite often quoted show that Ethiopia has a potentially irrigable land amounting to 3.7 million hectares. Different sources

⁶ MERET: *Managing Environmental Resources to Enable Transitions to More Sustainable Livelihoods.*

provide different figures on the current level of achievement in irrigation in Ethiopia. According to a website based information from the Ministry of water Resources (MOWR) the total area irrigated till 1991 was 176015 ha; this figure has increased to 197,250 ha in 1998. According to data recently compiled by MOWR 2004/5 from different master plan studies and regions the area under irrigation in the country has increased to about 250,613 ha. This is due to rapid increment of the area under traditional irrigation⁷. On the other hand, a recent assessment of irrigation development in the four major regions (Tigray, Amhara, Oromiya and SNNPR) shows that currently area under irrigation is 852000 hectares⁸, and the regions are planning an aggressive expansion of irrigation. In the annual report on PASDEP (2008/9) it was stated that during the Fiscal Year 2008/9, Small-scale irrigation was considered as the means for achieving food security at household level. To this effect, it was planned to develop 438000 hectares under small scale irrigation and 630970 hectares (144.06 %) was developed.

2.4.6. Agricultural marketing

Recognition has been given to the role of efficient and effective marketing in agricultural growth. To that effect a significant level of public investment has been made to expand infrastructure and communication over the past years. Effective utilization of the infrastructural and communication facilities is imperative. Despite a huge effort in developing road infrastructure, a rural transport service is still a big challenge in many areas. Ways and means must be created to increase the attractiveness of transport service in order to ease

⁷ <http://www.mowr.gov.et/index.php?pagenum=4.2&pagehgt=1000px>

⁸ Assessment made for the Policy and Investment Framework for the Ethiopian Agriculture Sector (MOARD, 2010).

rural mobility through better access to transport and reduction in cost of transport.

In terms of supporting institutions one of the major focuses has been the establishment of federal and regional cooperative agencies (commissions) to strengthen the development of farmers' primary cooperatives and cooperative unions. Farmers' cooperative unions are either multipurpose (handling marketing of various commodities, providing access to inputs and credit, etc) or specialized in creation of commodities (milk, coffee, grains, etc). Some strong unions have earlier started to import fertilizers few years back (three or two years ago).

According to a document by the Ministry of Agriculture (MORAD, 2010), currently, there are 27,000 primary cooperatives and 175 unions, of which more than 80% are agricultural and multipurpose cooperatives. With around 5.5 million members, they are serving 31% of the country's population. The plan is to establish a minimum of one primary cooperative in every rural kebele. There has been some experience of fertilizer imports by unions; however, due to capacity limitations and economies of scale, that role has now been transferred to the Agricultural Input Supply Corporation (AISC).

One of the recent developments in agricultural marketing services in Ethiopia is the creation and operation of the Ethiopian Commodity Exchange (ECX). ECX aims at transforming the commodity trading business in Ethiopia by providing accurate, reliable and timely data on a continuous basis to all market actors. For now ECX is handling limited agricultural commodities like coffee, export pulses, and some oil crops like sesame.

2.5. Current performance and implications for future: Key challenges and suggestions

As reported in the Growth Transformation Plan (GTP) (MoFED, 2010), during the past five year plan (PASDEP) that covered the period 1997 -2002 Ethiopian calendar (2005/6 – 2009/10), total production of major crops reached a level of 18.08 million tons from the 11.9 million tons at the start of the plan year (1997 Ethiopian calendar (2005/6). The data show that production grew at a rate of 10.4% per annum during the completed plan period. The draft GTP document envisages an increase in the production of major crops to 39.5 million tons from the level of 18.08 million tons at 2002 E.C (2010). The plan shows a 24% annual growth rate of production over the five years plan period i.e. more than double the growth rate achieved in the previous plan. The underlying assumptions take growth scenarios of the agricultural and related sectors – starting from 6% growth in the last year of the previous plan (2002 E.C or 2010), and considers 8% (a basic scenario) to 14.9% (highest scenario).

What does GTP need to achieve its goals? It requires a huge level of investment and implementation capacity of service providing institutions in the sector to as well as that of farmers to sustainably increase the productive capacity of the sector.

Productivity and sources: Increasing productivity is urgent

Effective dissemination and use of better productive agricultural inputs, technologies and practices is one of the key issues of Ethiopian agriculture towards enhanced productivity. Scaling up of proven technologies and better practices is a government agricultural strategy agenda. Achieving the desired

target needs capacity building at grass roots level; i.e. strengthening districts and farmers training centers.

What should be the future source of agricultural growth?

The growth of Ethiopian agricultural sector over the past years is traced to several factors. These are favourable weather conditions compared to the earlier years, expansion of cultivated land, the support provided to farmers by a mass of development agents (DAs) deployed and active on the ground (in terms of advices in agronomic and other farm management practices), and increased use of technological inputs. The analysis of sources of the recent growth in the Policy and Investment Framework report (MOARD, 2010), however, shows that the effect of use of improved inputs and technologies on growth has not been significant. Rather the growth was attributed more to expansion of cultivated land and awareness rising through advices of the extension workers to farmers. The summary of the analysis from the report is provided in Annex 2.

The implications drawn from the analysis of source of growth are:

- i. The current sources of growth especially expansion of cultivated land will not be suitable any more. This is so in the face of the increasing population pressure on land and natural resources, and scarcity of cultivable land.*
- ii. Future growth of Ethiopian agriculture must rely on the expanded dissemination of and use of improved technologies and higher crop and livestock yields. This needs*
 - a. Increased investment in agricultural research and technology generation for crop and livestock farming;*
 - b. Increased investment in irrigation and effective and efficient utilization of it;*

- c. *Improved soil fertility management to enhance crop response to application of chemical and organic fertilizers. A recent study commissioned by Bill and Melinda Gates Foundation has also arrived at a similar conclusion about the urgency to enhance integrated soil management to increase the productivity of Ethiopian agriculture⁹.*
- d. *High quality agricultural extension services coordinated with the efforts of research.*

Managing vulnerability to weather shocks

Climate resilience and adaptation issues are crucial for Ethiopian agriculture as the sector very much depends on what happens to water and other natural resources. The latter are significantly affected by weather calamities, directly and indirectly causing shocks in the performance of the sector. Investments in water resources management, water harvesting and storage and irrigation are essential not only to raise agricultural productivity, but also for better management of weather-related risks through enhanced resilience of the smallholder producers, pastoralists and agro-pastoralists.

In this respect, the current positive development in setting climate change related policies, strategic frameworks, roles of actors and efforts made at

⁹ See: <http://www.ifpri.org/book-748/node/7226>. A study commissioned by Bill and Melinda Gates Foundation (Gete Zeleke, et al., 2010) studied the FERTILIZER AND SOIL FERTILITY POTENTIAL IN ETHIOPIA draws attention to soil fertility management among the key issues for the future. The report states that it reaffirms the need for significant improvements to soil fertility and fertilizer applications that take into account Ethiopia's varied agro-ecologies, soil, and climate. These steps are critical to achieve the aspirations of higher crop yields contained in the sectoral strategies of the Government of Ethiopia (GOE) and its development partners. Since the early 1990s, Ethiopia has achieved marked improvements in the distribution of agricultural inputs through programs such as the Participatory and Training Extension System (PADETES) and the work of Sasakawa Global 2000. However, the majority of production growth has come largely from increased land under cultivation rather than yield growth. Given forecast population growth of over 2 percent p.a. to 2030, and the increasing scarcity of cultivable lands in high-potential areas, Ethiopia must consider approaches to improve future outputs through considerable enhancement in crop yields. These activities should complement a forward-looking strategy to increase the country's cultivable land'.

soliciting financing need to be coordinated and consolidated towards better implementation at the economy -wide, sectoral and grass roots level.

Integrated and value-chain approach

For sustainable and higher results from investments in research and technology, agricultural extension and irrigation development, better functioning agricultural markets, and agro-processing are equally important. In other words, development in the agricultural sector needs to embrace an integrated and value chain approach. The development of marketing and agro-processing sector through an integrated value-chain (coordinated efforts from production all the way through to end use) plays a major role by creating incentives for more and better quality production and ensuring a backward and forward linkage between agricultural and non-agricultural sectors.

Landlessness, rural employment and poverty reduction

It is more and more clear and evident that agriculture is not the only source of livelihood in rural Ethiopia where currently more than 80 million people live and lead their life. Currently, in the major highland and medium land agricultural zones of the country, the increasing population has led to increasing land scarcity. A significant share of the bodied farming population has become landless, especially in the major agricultural regions. It is high time to seriously think of the effects of increasing landlessness and look for ways and means of providing non-farm employment in rural areas. Drawing a lesson from the experience of some of the on-going public-supported programs like the Productive Safety net Program (PSNP) is essential in this respect.

2.6. Summary and conclusions

PERFORMANCE OF THE AGRICULTURAL SECTOR

This chapter provides an update on the performance and some analysis of the Ethiopian agricultural sector over the past five years. The chapter aims at providing readers and stakeholders the knowledge of critical elements and factors that influence sectoral performance and lessons that can be drawn for strategic planning and implementation of the sectoral development activities. The chapter begins by providing a brief account of the sectoral policy and strategies, followed by analysis of the sectoral performances based on key indicators, assessment of the input use and support services in the sector, key challenges in the sector and suggestions for future improvement.

In the past few years the growth rate of the agricultural sector declined from the highest 10.9 percent in 2005/6 to 6.4 percent in 2008/9 before it slightly increased to 7.6% in 2009/10. This decline in growth rate is more related to the decline in the growth of value of crop production. Over the last five years the share of agriculture in the national GDP has been slightly declining from its level of 47.1% in the year 2005/6 to 42% in the year 2009/10. Looking into the share of sub-sectors in the AgGDP during the last five years, crop production contributed 64% to 66% while livestock and hunting contributed 27% to 26% and the remaining, 9% to 8% is from Fisheries. Despite the fact that livestock, especially the value of export of meat and live animals has been significantly rising in recent years, the data shows that the rate of decline for the different sub-sectors of agriculture has been uniform. Agriculture contributes the largest share to Ethiopia's total export earnings - 83% in 2005/6 through 88% in the year 2008/9. The value reached 13.3 billion birr in 2008/9. The two major groups of commodities that contribute the largest share are coffee and pulses and oil seeds. In the last five years earnings from flower significantly increased and became the third largest foreign exchange earner. Although hides and skin are among the traditional export commodities, the trade volume and value has not been increased over time. The data shows that there

has been little effort/success to diversify the basis of agricultural export earnings. Few non-traditional export commodities like flower have, however, been newly introduced. Although agriculture still remained a major source of foreign exchange earnings for Ethiopia, not much has been done in terms of value-addition to the agricultural export commodities i.e. the bulk of agricultural products is still exported in the form of raw materials. It needs more strategic investment and competitive market system to exploit the potential of the country's agriculture to increase benefits from export trade.

The total food grain production in Ethiopia reached 18.1 million tons in the year 2009/10, and increased by 50% between 2005/6 and 2009/10 at an annual average increase of 8% per annum. This implies a per capita grain production of 2.17 qt, well close to the minimum grain requirement per person a year of 2 qt. Total crops production reached 22.7 million tons in 2009/10. Cereals, pulses, root crops, and enset account for 68%, 8%, 8%, 4%, respectively. The major cash crops produced and sold in Ethiopia are coffee, chat, and sugar cane. Some vegetables like tomato and onion are also produced by smallholder farmers largely for market. Oilseeds like sesame are becoming important cash crops for export markets.

The official data shows that area under grain crops reached 11.5 million hectares. Over the period 2005 to 2010 the rate of increase in grain production and area under grain crops has been significantly declining. The three major grain crops (cereals, pulses and oilseeds) constitute 72%, 12% and 6% of the share cultivated land. A significant increase in the area and production of root crops from 2008/9 to 2009/10 has been observed. Area under sweet potatoes increased by 70% while production increased by 62%. Area and production of Irish potatoes increased by 49% and 45%, respectively.

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Change in production (increment) declined from 16% between the years 2004/5 to about 6% between the 2008/9 and 2009/10. Change in area also declined from 14% to 2% during the same period. Change in grain productivity (yield per hectare of cereals, pulses and oil crops) has been varying /fluctuating from year to year.

A total of 4.16 million tons and 3.62 million tons of livestock and related food products were produced in the years 2007/8 and 2008/9. The per capita livestock food production was 7.7 kg of meat and 37 kg of milk – in the year 2008/9. This data of livestock food products is among the lowest in any standard, implying a low performance of the livestock sub-sector in Ethiopian agriculture. It is also argued that the livestock sector is undercounted in GDP figures. Some recent reports mention that the livestock's economic contribution, particularly in pastoral regions, is undercounted by traditional GDP calculations, which do not fully reflect the economic value of milk, meat and hides which are consumed in a subsistence manner, rather than marketed.

Although the national food production, especially grain, has been increasing reaching 18 million tons, a significant amount of post harvest losses also reduces food availability. At the national level, food security has not yet been achieved as there are parts of the country where people suffer vulnerability to shocks that lead to food insecurity while there are others who have problems of chronic food shortages. Food price is an important aspect of food security as food constitutes a significant share of household budget in Ethiopia. During the last four years prices of cereals and of total food items have been significantly increasing from the year 2006 onward. Price levels slightly declined from the level of 2008 but still are high in 2010 compared to five years back in December 2006. Food inflation has been important in Ethiopia over the last many years. Inflation was a single digit around 2004 and

gradually rose to double digit in 2005 reaching 50% in September 2008 and 60 in February 2009 before it dropped to 20% in September 2009. Raising agricultural productivity and food supply must be one of the primary goals towards reducing food inflation and attaining national and household food security.

The lack of structural change in the smallholder production system can be depicted looking at, among other aspects, the distribution of allocation of cultivated land to the various commodity groups. In the cropping year 2009/10, more than 70% of the cultivated land was under cereals, leaving the remaining less than 30% of the land to many other crops. Few major factors may explain why land allocation is largely dominated by the cereal production system in the country. These are the historical focus of the agricultural service and support system (extension, research and input and output markets) on cereals as major sources of food security; and the limited attention to other crops and livestock as well, in terms of technological bases (research and extension) and production investives (inputs, markets, prices, etc).

Agriculture and natural resources received 20% of the total national capital expenditure in 2000/1 and that share increased to 35% in the year 2004/5, but declined by 10% by 2008/9 compared to the level in 2004/5. Unlike the capital expenditure, recurrent expenditure for the sector has been steadily rising from around 6% in 2000/1 to 10% of the national recurrent expenditure in 2008/9. On the other hand, Ethiopia is said to have already surpassed the Comprehensive African Agricultural Development Program (CAADP) target of achieving 10% of the national budget by allocating 13% in the year 2009. The issue of recurrent and capital budget expenditure for agriculture is not only a mere number or percentage share; rather more important is how much of the

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resources reach the end beneficiaries (farmers) in terms of tangible capacity for technical supports and access to the necessary inputs.

The use of technological inputs- fertilizer, seed, chemicals, veterinary, improved breed, and irrigation practices - is critical for higher agricultural productivity. In Ethiopia, the major provider of access to modern inputs and technical support for the agricultural sector, especially for the smallholder agriculture, is a public system. Limited experience of the non-state actors in this respect, especially in extension and research services, and issues of affordability of service provisions from the point of view of the smallholder farmers are some of the major reasons why input services largely remained in the hands of the state. While attempts were made to engage some private sector traders in fertilizer procurement and distribution during the late 1990s and the early years after 2000 that did not operate very well to date as the private sector groups have lately withdrawn from the fertilizer market. There is limited engagement of the private sector in the production and distribution of improved seeds. The problem with improved seeds is one of shortage, mainly for varieties demanded by farmers. To date not more than 20% of the annual demand of improved seeds is met. The pricing of improved seeds has also been an unsettled issue. The government is of the opinion that the private sector seed producers demand higher prices not affordable by farmers. With regard to fertilizers and soil fertility, integrated soil fertility management needs to be given attention: soil and water conservation, organic fertilization, agronomic practices including crop rotations- to attain sustainable soil fertility and agricultural productivity.

Land and water management has a history of several decades (three to four) in Ethiopia. The efforts that have been made by the public and development partners in developing the natural resources management and development

strategies, their implementation frameworks and programs, and resource mobilization are quite commendable. The problem of effective implementation and sustainable land management and use by farming communities still remain a challenge.

Performance of the agricultural sector during the PASDEP period shows that total production of major crops reached a level of 18.08 million tons from the 11.9 million tons at the start of the plan year (2005/6). Production grew at a rate of 10.4% per annum. The Second Five Year Plan (draft GTP document) envisages an increase in the production of major crops to 39.5 million tons by the end of the plan year from the level of 18.08 million tons in (2009/2010). The plan shows a 24% annual growth rate of production over the five years plan period i.e. more than double the growth rate achieved in the previous plan. What does it need to achieve this SFYDP/GTP goals? This requires a huge level of investment and implementation capacity of service providing institutions in the sector as well as that of farmers to sustainably increase the productive capacity of the sector. The following are key issues towards achieving the goals of higher production.

Increasing productivity is urgent: *What should be the future source of agricultural growth? Effective dissemination and use of better productive agricultural inputs, technologies and practices is one of the key issues of Ethiopian agriculture towards enhanced productivity. The growth of Ethiopian agricultural sector over the past years is traced to several factors - mainly expansion of land cultivated, while favorable weather conditions, the support provided to farmers by a mass of development agents (DAs), and increased use of technological inputs are other factors. The implications drawn from the analysis of source of growth are:*

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- i. *The current sources of growth especially expansion of cultivated land will not be sustainable any more. This is so in the face of the increasing population pressure on land and natural resources, and scarcity of cultivable land.*
- ii. *Future growth of Ethiopian agriculture must rely on the expanded dissemination and use of improved technologies and higher crop and livestock yields. This needs: increased investment in agricultural research and technology generation for crop and livestock farming; increased investment in irrigation and its effective and efficient utilization; improved soil fertility management to enhance crop response to application of chemical and organic fertilizers.*

Managing vulnerability to weather shocks: *climate resilience and adaption issues are crucial for Ethiopian agriculture as the sector depends on what happens to water and other natural resources. Investment in natural resources management, water harvesting and storage and irrigation are essential not only to raise agricultural productivity, but also for better management of weather related risks through enhanced resilience of the smallholder producers, pastoralists and agro-pastoralists.*

Integrated and value-chain approach: *for sustainable and higher results from investments in research, agricultural extension and irrigation development, better functioning agricultural markets, and agro-processing are equally important. In other words, development in the agricultural sector needs to embrace an integrated and value chain approach.*

Landlessness, rural employment and poverty reduction: *it is more and more evident that agriculture is not the only source of livelihood in rural Ethiopia where currently more than 80 million people live and lead their life. With the*

increasing population pressure and land scarcity challenges in the major highland and medium land agricultural zones of the country, a significant share of the able-bodied farming population is becoming landless. It is imperative to think of ways and means of providing non-farm employment in rural areas.

Chapter 3

The Industrial Development Strategy of Ethiopia: The Performance of Prioritized Industries

3.1. Introduction

It is now eight years since the industrial development strategy of Ethiopia has been in place. Given that the economy is predominantly agricultural, the focus of the strategy is to encourage industries having direct linkages to the former, thereby providing support to agricultural growth through the demand effect.

Accordingly, some specific industrial groups, regarded as strategic, were selected for promotion, including Textiles, Wearing apparel, Leather tanning and Footwear. However, other broadly defined industrial groups were also identified, such as agro-processing for their linkage to agriculture, construction for their importance to general economic development and employment, and SME's for their employment potential. However, agro-processing and construction, each involves a number of specific industries; SMEs constitute all industries in all economic sectors. Such categorization, however, has little practical importance as the industries (firms) are too many to attach performance based incentives.

As a result, a blanket incentive package (non-discriminatory sectorally or activity wise), equally applicable to all enterprises and sectors satisfying the requirements has been put in place. Such general incentives include investment incentives such as tax exemptions, duty free imports of investment

goods, etc. Exporting firms are granted additional incentives, including duty draw back system, limited credit until export proceeds are received, etc.

Now that the first five year plan (PASDEP) is complete, and also, since the strategy has been flagged for over 8 years, it would be logical to assess, at least broadly, the performance of selected strategic industries, those clearly identified specific industries: Leather tanning, Footwear, Textiles and Wearing apparel, to have an idea of whether the industrial development strategy is taking root, in practice.

The assessment is based on both temporal and cross sectional basis. The former compares performances of prioritized industries before and after 2002, the year the strategy was launched; and the latter involves assessment of prioritized industries' performances against others, as of 2002. This approach does not represent a comprehensive and systematic analysis of whether the industrial development strategy is working, but only provides a partial reflection of the effectiveness of the strategy through a comparative assessment of the performances of those industries identified as strategic.

3.2. Investment in manufacturing industries

Be it prioritized or not, expansion of production capacity is largely realized through additional investment on new establishments or existing ones. Wherever underutilized capacity prevails, exploiting such capacity could as well enhance the overall production capacity. But, this is a short-term measure. Production capacity could only be substantially enhanced either through increased productivity or physical expansion of enterprises, or both. Whichever approach is pursued additional investment is a key factor.

3.2.1. Investment in existing manufacturing industries¹⁰

One way of assessing how the industrial development strategy has been effective since its launch, is to see the level of investment on prioritized industries under operation. If the strategy is effective enough, then it is logical to expect more investment to have been made in prioritized industries than in others. Table 3.1 shows the level of investment by broad industrial group during the six years period before and after 2002. Between 2002/03-2007/08, total investment increased by 112 percent, from its level in the previous period (1996/07-2001/02). It increased to a level of Birr 6151 or US \$ 699 million considering the average exchange rate in the period. This implies average investment of \$116.5 million per year.

Consider investment in specific industries, identified as strategic for industrial and general development. During the same period of time, investment in Textiles increased by only 50 percent, less than half of the average; and in the Leather tanning, by 124 percent, marginally more than the average. Similarly, investment growth in the Footwear industry, during the same period of time, was only 43 percent. Investment in Wearing apparel industry has shown a substantial rise, though from a low level. The level is still quite insignificant. In fact, not only in the Wearing apparel industry, but even in the Textiles and Leather tanning, the absolute values of investments are quite small – respectively \$ 35 and \$ 31 million in the latter two.

¹⁰ Investments made on existing enterprises, i.e., already operational, does not capture investments on newly established enterprises. Often, less than half of the enterprises surveyed reported to have incurred additional investments.

Table 3.1: Investment in existing manufacturing industries (USD millions)

Industrial sector	1997- 2002	2003- 2008	Change %
<i>Food Products and beverages</i>	139.7	311.4	123
<i>Malt liquors and malt</i>	30	136.7	356
<i>Textiles</i>	23.4	35.1	50
<i>Wearing apparel</i>	2.8	7.7	174
<i>Tanning and dressing of leather</i>	13.8	31.0	124
<i>Footwear</i>	16.3	23.2	43
<i>Wood and wood products</i>	1.3	1.5	16
<i>Paper and paper products, and printing and publishing</i>	16.9	38.8	130
<i>Chemical and chemical products</i>	25.2	27.0	7.1
<i>Rubber and plastic products</i>	24.0	47.5	99
<i>Non-metallic mineral products</i>	30.4	60.3	98
<i>Manufacture of cement, lime and plaster</i>	19.5	41.1	111
<i>Basic iron and steel</i>	8.5	43.6	411
<i>Fabricated metal products</i>	6.8	19.6	187
<i>Machinery and equipment</i>	0.4	1.2	221
<i>Motor vehicles</i>	12.4	22.0	77
<i>Furniture</i>	6.7	17.4	160
Total	329.0	699.1	112

Source: Based on information from CSA, 'Report on Large and Medium Scale Manufacturing and Electricity survey, various issues.

Another industrial group that holds the attention of the government is construction. As noted above, priority is attached to construction not for its direct linkage with agriculture or its export capacity, but for its importance for general socio-economic development and employment. Construction, however, involves a number of different industrial groups, which makes it practically difficult to intervene. Considering two of the most important

industries in the group, substantial investments have taken place in metal and cement industries. As shown in the same Table, during the same period of time – 2002/03-2007/08, investment, largely private, in Basic Iron and Steel industry, increased on average by nearly fourfold (411 percent) from the level prevailing during the first period (1996/97-2001/02). Similarly, investment in cement industry amounted to \$41 million, a rise of 111 percent from the investment level in the previous period. Driven by the currently fast expanding construction works, primarily of governments' construction projects – roads and buildings, substantial investment is in the making in Cement and Structural Metal industries.

But, as noted above, except in the Leather tanning and Basic Iron and Steel industries, investment growth in other prioritized industries is less than the average. The level of investment in the Wearing apparel is still quite small, though growth is above average. In fact, large investments are made in non-prioritized ones, of which malt liquors and malt, rank the topmost. Over \$136 million had been invested in this industry over the same period following the strategy launch. This represents a growth of 356 percent.

3.3. Investment in newly established industries

The other aspect of manufacturing investment is in new enterprises. Unlike investment on existing ones, establishing new enterprises carries incentives, if the level of investment amounts to Birr 250,000, minimum. Hence, investment on new enterprises is incentive driven.

Between 1996/97 and 2006/07, a total capital of about \$3.18 billion was invested in all economic sectors, of which \$989 million (31%) was in manufacturing. Over half of the total investment 52% was made in

construction, real estate and service sectors, while agriculture and mining got the balance.

Table 3.2 shows investment growth and its distribution across manufacturing industries, during the same period of time. Though it is quite challenging to identify actual investment capital on yearly basis, as an investment project takes, on average, about 3 years to complete, and also there is no system and obligation for submitting the amount of capital invested yearly, actual investment has, in fact, been consistently declining since 2000/01 (EEA, Chapter 2, 2004). As shown in the same table, investment during 2002/03–2006/07 declined by 35 percent from that of the previous period. Investment declined in nearly half of the industrial groups listed in the table. Except in the Footwear industry, however, investment in other prioritized industries actually increased. Investment in the Wearing apparel industry in particular has shown an appreciable rise, 190 percent, though from a low level. In the Textiles and Leather tanning industries, investments increased modestly by 77 and 33 percent respectively.

Despite a positive growth, however, investment shares of these prioritized industries in total manufacturing investment are quite limited. The four prioritized industries together account for about 20 percent of the total investment during 2002/03–2007/08. Investment in the Wearing apparel industry has a share of 7.6 percent, more than that in Textiles. The investment level in the former was quite low in the earlier period but increased sharply since 2003. Three relatively large garment factories alone accounted for over a half of the total investment in this industry. The share of investment in the Textiles is quite moderate – only 6.9 percent. A textile and acrylic yarn enterprises, together, accounted for over half of the total investment in this

industry. In the Leather tanning and Footwear, investment shares are insignificant – 3.3 percent each.

Substantial investments were actually made in other industrial groups, including Food products & Beverages, Chemical, Rubber & Plastic, and Fabricated metal. These four industrial groups, together, account for 70 percent of the total manufacturing investment. Manufacturing of food products and beverages alone accounts for one-fourth of the total investment. It is largely private investment, though government has also invested on the expansion of the State-owned (Harrar) brewery during the same period. Over one-third of the investment in this industrial group was made in soft-drinks, mineral water and brewery manufacturing; another 16 percent in grain mills; and a further 16 percent in three factories: sugar, tea and meat processing. Hence, two-thirds of the investment in this group is accounted by these few industries.

The next largest investment, nearly 20 percent of the total, was made in Chemical and C. Products industry. The bulk (66%) of the investment capital in this industrial group accrues to a single private pharmaceutical factory.

Investment in Rubber and Plastic manufacturing is the third largest investment, accounting for about 13.2 percent of the total. Again, this too is largely private investment, with tire factories accounting for over one-fourth of the investment in this industrial group.

Fabricated Metal products industry also attracted a relatively significant share (11.2 percent) of the total investment capital. As noted earlier, driven by a large demand for construction materials, largely for state initiated construction projects, substantial investment was made in this industrial

group. Steel melting and rolling, attracted nearly 50 percent of the investment in this industrial group. Another one-fifth of the investment was allocated to industries producing galvanized corrugated iron sheets.

Table 3.2: Investment in newly established industries 1996/97 – 2006/07

Industrial group	Total investment \$ Mills			Investment pre-post 2002 - \$ Mills	
	1996/07-2006/07	Share %	1996/07-2001/02	2002/03-2006/07	Change (%)
<i>Food products and beverages</i>	261.1	26.4	192.5	68.7	-64.3
<i>Tobacco products</i>	6.5	0.7	6.5	0	-100.0
<i>Textiles</i>	68.2	6.9	24.6	43.6	76.7
<i>Wearing apparel</i>	75.4	7.6	19.3	56.0	190.2
<i>Leather tanning and dressing</i>	32.8	3.3	14.1	18.7	33.1
<i>Footwear</i>	32.2	3.3	27.0	5.2	-80.6
<i>Wood and W. products</i>	2.1	0.2	1.4	0.7	-51.5
<i>Paper and P. products</i>	13.6	1.4	9.5	4.1	-57.2
<i>Printing and publishing</i>	11.6	1.2	9.1	2.4	-73.3
<i>Chemical and C. products</i>	189.8	19.2	167.6	22.1	-86.8
<i>Rubber and plastic products</i>	130.8	13.2	59.5	71.3	19.8
<i>Non-metallic mineral products</i>	15.7	1.6	3.5	12.2	248.5
<i>Fabricated metal products and basic metal, except M & Eq.</i>	111.1	11.2	50.0	61.1	22.2
<i>Machinery and equipment</i>	16.0	1.6	8.8	7.2	-18.3
<i>Motor vehicles</i>	9.2	0.9	1.9	7.3	276.9
<i>Furniture</i>	13.3	1.3	4.5	8.7	91.8
Total	989.4	100	600.0	389.4	-35.1

Source: Based on information from Ethiopian investment Authority

Note that, given the size of the country – population and potential resource, the investment level in manufacturing (\$989 Million over more than a decade or on average \$90 million a year) was quite small. In prioritized industries, the investment level in both cases – on existing and newly established enterprises, was even much lower.

Prioritized industries are not receiving any special treatment. For investors on existing firms, i.e., for up-grading and expansion, no incentive is in place. As in all other industries, new investments in prioritized industries also receive similar incentives. But, there is no additional incentive attached to prioritized industries. So, priorities have no correlation with incentives.

But prioritization does not mean much as long as it does not carry incentives to attract enough investment in the industries at issue. In the absence of incentives, investments follow market signals only. In fact, it might be much preferable to attach effective incentives to such prioritized industries rather than for the government to involve itself in heavy investment in some of the prioritized industries, either because of the ownership status or otherwise.¹¹ Such public investment would not induce further private investment in these industries.

3.4. Production capacity

3.4.1. Capacity utilization

Irrespective of the establishment of new enterprises overtime, thereby increasing the potential of the overall industrial production capacity, nearly all

¹¹ It is said that as of 2009 government has been investing considerable amount, over Birr 600 million, on the expansion of Kombolcha and Bahr Dar textile factories. Since 2007 expansion of the Mugar Cement Factory is undertaken at a cost of over half a million Birr. In the footwear industry, government is renovating Anbessa Shoe Factory at a cost of about 16.5 million Birr.

manufacturing industries currently operate at less than full capacity. For instance, for the specific years noted in Table 3.3, production, for all industries, has never exceeded two-thirds of full capacity.

Table 3.3: Capacity utilization (percent)

Industry	2007/08	2004/05	2001/02	1997/98
Textiles	59	47	39	35
Wearing apparel	48	57	36	29
Leather tanning and dressing	87	76	66	81
Footwear	70	50	62	59
All industries	54	66	48	58

Source: CSA, report on Large and Medium Scale Manufacturing and Electricity Industries, several issues.

The Textiles industry, despite a gradual and continuous improvement, has never exceeded 60 percent of its full capacity to date. So is the Wearing apparel industry, which is also characterized by frequent variations. Also, in most of the years, these industries have been operating below the average for all industries. On the other hand, the Leather tanning industry, despite a steep decline immediately after 1997/98, not only has been constantly improving its utilization capacity since 2001/02, but is also approaching full capacity – 87 percent. The Footwear industry is also characterized with notable variations over the years. Despite this setback, however, it is enhancing its utilization capacity significantly, currently (2007/08) operating above two-thirds of its full capacity. In Ethiopia, as in all other poor economies, industries such as Wearing apparel and Footwear are relatively small firms with low capital and, most of them, employing a handful of workers; hence, largely less competitive and prone to significantly reducing their capacity or totally closing down under external pressure.

So, irrespective of the high priority accorded to these industries, most of them are still (nearly 8 years after the strategy was in place) operating much below the maximum capacity they could have attained. A number of both supply side and demand-related reasons are provided for capacity underutilization and variations. A decline in agricultural output (hence, raw material shortage) and foreign exchange constraint (hence, shortage of intermediate inputs), in general, lack of adequate inputs is often regarded as a prime factor for the variation in capacity utilization. Lack of market (which in effect implies lack of competitiveness) and capital are, however, regarded as the underlying factors for long-term capacity underutilization.

If prioritization implies some advantage to certain industries than others, then there must be a means to motivate these industries, at least, to make improvements that may not require heavy capital investment, such as effective and efficient management, efficient utilization of inputs – labor, raw materials and intermediate inputs, etc, which could enhance existing capacity utilization.

3.4.2. Production performance

Irrespective of the timeframe, if priority implies claim to a certain advantage over others, then prioritized industries should be able to record better output performance than non-prioritized ones. Table 3.4 compares production levels and growth by industrial groups for the six years periods: pre–post 2002.

First, consider growth in the four prioritized industrial groups: Textiles, Wearing apparel, Leather tanning and Footwear. In all these, production values and average annual growth rates are higher during the second period (2002/03-2007/08), i.e., after the launch of the strategy (Table 3.4). For

instance, growth in the Textiles industry was, on average, 1.8 percent per year during the second period, while it was negative during the first. In the Leather tanning, it was 7.4 percent during the second period, but only 2.6 percent during the first. Also, performances of the Footwear and Wearing apparel industries, after the launch of the strategy, were better than the earlier period.

But this was not an exception only to prioritized industries. In fact, except one specific industry, Sugar and sugar confectionary, all other industries too have recorded higher growth rates during the period after 2002 than that of the earlier period. In fact, growth rate in the Textiles industry, though positive, is the lowest. Also, except in the Wearing apparel industry, growth in the Leather tanning and Footwear industries is less than the average for all industries (17.5 percent). Since growth performances in these prioritized industries are comparatively low, their production shares in total manufacturing output declined during the period after the strategy launch - 2002. For instance, production shares in the Textiles, Leather Tanning and Footwear industries declined respectively from 9.4, 6.8 and 2.6 percent to 6.0, 5.1 and 1.9 percent (Table 3.4). The Textiles industry, which used to have the second largest share in production during the first period, fell sharply to fifth place during the second.

High growth performing industries with significant production shares are in fact those non-prioritized, but market driven ones, including Sugar, Basic Iron and Steel, Malt Liquor, and Cement. These industries recorded average annual growth rates as high as 14.7, 21.0, 21.1 and 31.8 percent respectively.

The significance of this is that despite the priority, production performances of these industries are not better than others. In fact, some industries, excluded

from the priority list, but driven by market forces only, seem to show better growth performances.

Table 3.4: Average annual production (Birr Mill) and growth

Industrial Groups	Output value		Share %		Growth %	
	1995/06-2000/01	2002/03-2007/08	1995/06-2000/01	2002/03-2007/08	1995/06-2000/01	2002/03-2007/08
<i>Food Products and Beverages</i>	2767.6	5353.8	39.4	36.2	6.6	17.6
<i>Sugar and S. Confectionary</i>	816.5	1538.1	11.6	10.4	23.0	14.8
<i>Malt Liquors and Malt</i>	542.7	1179.7	7.8	7.9	1.5	21.1
<i>Tobacco Products</i>	248.9	.99.4	3.6	2.7	-0.6	14.0
<i>Textiles</i>	649.3	885.9	9.4	6.0	-1.0	1.8
<i>Wearing Apparel, except fur</i>	60.2	160.7	0.9	1.1	-6.4	52.5
<i>Leather Tanning</i>	472.2	758.4	6.8	5.1	2.6	7.4
<i>Footwear</i>	183.2	287.0	2.6	1.9	5.4	13.3
<i>Wood and W. Products and Cork, except furniture</i>	45.7	76.5	0.7	0.5	-11.0	19.1
<i>Paper and P. Products and Printing</i>	309.6	804.0	4.4	5.4	7.4	18.5
<i>Chemical and C. Products</i>	416.7	984.8	6.0	6.6	6.1	21.4
<i>Rubber and Plastic Products</i>	326.5	877.7	4.6	5.9	14.1	20.4
<i>Non-Metallic Mineral Products</i>	552.9	1770.8	7.9	11.9	6.7	27.9
<i>Cement, Lime and Plaster</i>	375.1	1441.8	5.4	9.7	7.8	31.8
<i>Basic Iron and Steel</i>	286.9	1026.4	4.2	7.0	9.5	21.0
<i>Fabricated Metal Products, except M. & Eq.</i>	108.3	575.2	1.6	3.9	6.7	38.7
<i>Machinery and Equipment</i>	7.6	36.2	0.1	0.3	-5.1	163.1
<i>Motor Vehicles</i>	460.2	526.4	6.3	3.6	40.2	39.6
<i>Furniture</i>	106.6	281.4	1.5	1.9	9.8	22.3
<i>Total</i>	7002.2	14805	100	100	4.37	17.5

Source: Based on information from CSA, 'Report on Large and Medium Scale Manufacturing and Electricity survey, various issues.

3.5. Rates of employment in labor-intensive industries

One of the three major criteria for priority setting in manufacturing is labor intensiveness. The focus on specific industries such as Textiles, Leather tanning, Wearing apparel, and Footwear is partly for their labor intensiveness. So, the issue to investigate is whether the rate of employment in prioritized industries has been increasing as industries are expanding or whether they are moving to less labor intensive technique of production to meet competitiveness requirements, particularly, in those export-oriented ones.

Table 3.5 depicts growth of employment and capital for the two periods: pre-post 2002.¹² With the exception of Textiles, employment in all industrial groups has increased over the decade ending in 2008. It increased annually, and on average, by 1.5 and 5.1 percent respectively during 1996/97-2001/02 and 2002/03-2007/08 (Table 3.5). In the first period, employment level declined in few industries, but not in the second, except, marginally, in Textiles.

¹² *It should be underlined that survey results on financial aspects of manufacturing firms are very unreliable, basically for two reasons. One is that enterprises are said to be very careful not to release any information implicating them to tax obligations. There is always a tendency to understate financial income to shield themselves from any unforeseen tax and/or other related obligations. Also, there is no a standard and obligatory accounting system for enterprises to follow. Each enterprise uses its own depreciation method. As a result factories are over-depreciated and operate long after they are said to have fully depreciated. Hence, caution is necessary in interpreting movements of capital.*

Table 3.5: Average annual growth rates of employment and fixed capital*

	Employment (%)		Capital (%)	
	1996/97- 2001/02	2002/03- 2007/08	1996/97- 2001/02	2002/03- 2007/08
<i>Food products & beverages</i>	3.8	6.3	24.6	7.6
<i>Tobacco products</i>	-3.5	9.8	105.8	16.7
<i>Textiles</i>	-3.8	-0.4	9.1	-7.6
<i>Wearing apparel except fur</i>	-1.3	19.4	15.3	78.9
<i>Tanning and dressing of leather</i>	0.1	0.6	33.7	-0.1
<i>Footwear</i>	-4.5	8.0	13.8	-1.6
<i>Wood & W. products, exc. Furniture</i>	-8.4	17.5	10.9	3.7
<i>Paper & P. products and printing</i>	2.0	6.3	9.5	11.2
<i>Chemical & C. products</i>	11.1	8.3	18.4	-2.0
<i>Rubber and plastic products</i>	12.3	12.9	-0.2	12.6
<i>Non-metallic mineral products</i>	5.5	14.0	3.4	29.1
<i>Basic iron and steel</i>	5.0	0.1	59.5	21.1
<i>Fabricated metal products, exc. M. & Eq.</i>	5.8	16.0	5.3	10.5
<i>Machinery and equipment</i>	-9.6	9.6	28.3	55.1
<i>Motor vehicles</i>	11.2	17.1	19.6	22.9
<i>Furniture</i>	16.1	10.0	13.7	14.1
<i>Total</i>	1.5	5.1	12.8	5.2

- Capital growth is based on dollar values

Source: Based on information from CSA, 'Report on Large and Medium Scale Manufacturing and Electricity survey, various issues.

However, this was not so in the case of employment per enterprise/establishment. Table 3.6 shows employment per establishment for each industrial group for the two periods before and after the strategy launch. Except for few industrial groups, employment per establishment declined in most industries during the second period (Table 3.6). For all industries, employment per establishment fell by 25.8 percent during the second, from

what it was during the first period. Considering the movement of employment in the two periods, for all industries, though employment per establishment declined, on average, by 4.2 and 7 percent during the first and second periods respectively, it declined by a higher margin in the former.

Considering prioritized industries, regarded as labor intensive, employment per enterprise in the Textiles and Leather tanning fell by 23.3 and 17.7 percent, respectively. The decline in the Textiles is quite conspicuous – nearly a quarter of the total workforce. In the Footwear industry too, employment per establishment declined, though the rate is marginal (4.7 percent). It, however, remained, nevertheless, unchanged in the Wearing apparel industry.

It should also be noted that during the same period, as in the Textiles, employment per establishment fell in other relatively large labor employing industries, such as Tobacco, Sugar, and Malt Liquors, though the decline in the Textiles is much greater.

But what accounts for the fall in employment per establishment while employment in absolute terms shows a notable rise? Surely, given that employment has been increasing (including the level of production) during the same period, decline in employment per enterprise could not be due to economic depression. A couple of factors might, however, contribute to this effect. One is that entrepreneurs might have reduced their employment rate in privatized enterprises to become more competitive as high employment has been the central target of these enterprises while they were under state control. This might have reduced the level of employment per establishment in some industries, though marginally. Second, newly established enterprises inevitably kick-off with low production capacity until they manage to introduce their product and access a fair share of the markets. Given, a dwarf

manufacturing sector, this tends to reduce the overall level of employment per establishment. Hence, though one cannot tell the extent of the impact of these factors without a thorough investigation of individual firms, their adverse impact on employment per establishment is obvious.

Another important factor, and central to the discussion on prioritizing industries for their labor intensiveness, is whether reduction in employment per establishment is due to the tendency of entrepreneurs to shift from labor-to capital-intensive production technique, now that competitiveness is becoming a critical factor for business survival. To investigate this, comparison is made between the development of labor and capital per establishment over the same period of time—1996/97-2007/08. Table 3.6 depicts this comparison. Like employment, capital per establishment, for all industries, has declined during the second half of the period. However, the rate of decline is much lower than that of employment: 15 percent for capital as opposed to 25.8 percent for labor. Moreover, while employment per establishment decreased in most industries, capital per establishment decreased in only few industries.

Considering prioritized industries, except in the Textiles, where capital per establishment decreased by nearly the same rate as employment (24.5%) during the second period, in the other three industrial groups, namely Wearing apparel, Leather tanning and Footwear, capital per establishment increased notably. It increased by 56.5, 3.3 and 3.4 percent respectively. Note that employment per establishment decreased in all the four industrial groups.

Table 3.6: Employment and fixed capital per establishment

Industrial Group	Employment per establishment	F. Capital per establ. ('000 USD)
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REPORT ON THE ETHIOPIAN ECONOMY

	1996/97- 2001/02	2002/03- 2007/08	Change %	1996/97- 2001/02	2002/03- 2007/08	Change %
<i>Food products & beverages</i>	113	93	-18.1	905	846	-6.5
<i>Sugar and S. confectionery</i>	682	573	-15.9	6635	5230	-21.2
<i>Malt liquors and malt</i>	488	472	-3.1	7392	10460	41.5
<i>Tobacco products</i>	865	847	-2.1	3863	13127	239.8
<i>Textiles</i>	707	542	-23.3	2689	2039	-24.5
<i>Wearing apparel except fur</i>	150	150	-0.3	283	442	56.5
<i>Tanning and dressing of leather</i>	271	223	-17.7	1826	1886	3.3
<i>Footwear</i>	88	84	-4.7	494	511	3.4
<i>Wood & W. products, except furniture</i>	74	60	-18.7	55	32	-40.7
<i>Paper & P. products and printing</i>	95	77	-19.4	277	285	2.9
<i>Chemical & C. products</i>	102	109	7.5	1274	850	-33.3
<i>Rubber and plastic products</i>	107	111	3.9	1309	945	-27.8
<i>Non-metallic mineral products</i>	80	49	-38.7	639	539	-15.7
<i>Cement, lime and plaster</i>	262	274	4.6	2983	8934	199.5
<i>Basic iron and steel</i>	154	128	-17.0	1073	2366	120.4
<i>Fabricated metal products, exc. M. & Eq.</i>	46	51	10.7	407	364	-10.5
<i>Machinery and equipment</i>	22	30	34.1	97	174	80.0
<i>Motor vehicles</i>	107	104	-2.6	1035	974	-5.9
<i>Furniture</i>	34	28	-16.3	105	76	-28.0
<i>Total average</i>	119	88	-25.8	735	625	-15.0

Source: Based on information from CSA, 'Report on Large and Medium Scale Manufacturing and Electricity survey, various issues.

A simpler way of expressing this relationship, however, is to show capital-labor ratio as depicted in Table 3.7. Again, except in the Textiles where capital per employment during the second period (2003-2008) has shown little or no change (-1.2 percent) from that of the first (1997-2002), it has increased substantially in the other prioritized industries by 56.9, 25.6 and 8.5 percent respectively. There is no ambiguity in this case that these industries are moving increasingly towards capital- rather than labor-intensive mode of production. And currently government is heavily investing in the Textiles

industry to up-grade their technology capacity, which would, inevitably, increase capital per head of employee in the near future.

Table 3.7: Capital per employee (USD)

Industrial group	1996/97- 2001/02	2002/03- 2007/08	Change %
Food products & beverages	7980	9103	14.1
Tobacco products	4464	15498	247.2
Textiles	3806	3761	-1.2
Wearing apparel except fur	1879	2948	56.9
Tanning and dressing of leather	6727	8448	25.6
Footwear	5622	6100	8.5
Wood & W. products, except furniture	736	537	-27.0
Paper & P. products and printing	2921	3728	27.6
Chemical & C. Products	12544	7781	-38.0
Rubber and plastic products	12211	8486	-30.5
Non-metallic mineral products	7973	10975	37.6
Cement, lime and plaster	11401	32644	186.3
Basic iron and steel	6954	18474	165.6
Fabricated metal products, exc. M. & Eq.	8779	7099	-19.1
Machinery and equipment	4378	5878	34.3
Motor vehicles	9671	9342	-3.4
Furniture	3091	2658	-14.0
Total average	6202	7104	14.6

Source: Based on information from CSA, 'Report on Large and Medium Scale Manufacturing and Electricity survey, various issues.

The implication is clear. The inevitable trend for these prioritized industries is to shift from labor- to capital-intensive production, as industries are required to meet competition challenges both at home and abroad. Capital (technology) is a critical factor for enhancing productivity and competitiveness. In this context, the two criteria: competitiveness and labor intensiveness don't seem to be compatible.

It should also be noted that not only in prioritized industries, but also in most industries, capital per labor increased significantly since 2002. And with markets given the central role of economic management, and also given that the government is aspiring to be a member of the WTO, the future trend would inevitably be shifting from labor- to capital-intensive production approach.

3.6. Efficiency and productivity levels in prioritized industries

The preceding section shows that prioritized industries tend to increase the value of fixed capital per unit of labor employed. Given the key role of capital in enhancing productivity and efficiency, one expects improvement in the performances of these industries with respect to these variables, though this might require longer time to show.

A couple of ratios are used as proxies to measure efficiency and productivity. Value added as a proportion of the gross value of production (VA/GVP) of industries as a measure of efficiency and Value added per unit of labor or of wage bill (VA/L or VA/W) as indicators of the movement of productivities.

3.6.1. Efficiency measures

As shown in Table 3.8, in nearly all industries, the efficiency of enterprises to create new values from inputs, indicated by the ratio of value added to the gross value of production, is extremely low. The minimum proportion (VA/GVP) in efficient industries at international standard is about 60 percent. The only industry in Ethiopia of this efficiency standard is Tobacco, with a ratio of about 60 percent. The next industry with a relatively better performance, with a proportion of 50 percent, is wood and wood products. All other

industries have efficiency ratios of less than half. Considering prioritized industries, the Leather tanning is the least of all industries with a proportion of 17 percent. Textiles too is among the 4 least efficient industries with a ratio of 27 percent, implying that the yearly newly added value of production is, on average, only about a quarter of the total value of production. Wearing apparel and Footwear industries generate a value added nearly a third of the respective gross value of production.

Not only are these industries least efficient, particularly Leather and Textiles, but their efficiency also is deteriorating overtime. As shown in the same table, efficiency in the Textiles and Leather industries deteriorated by 3.9 and 3.6 percentage points during the second half of the period (2002/03-2007/08). This is much worse than the average for all industries (-1.5). However, efficiency in the Wearing Apparel Industry improved by 3.6 percentage points and in the Footwear, by a low margin of 0.8.

Table 3.8: Efficiency and productivity levels

Industries	Value added per GVP (%)			Value added per labor (USD)			Value added per wage bill		Wage per labor (USD)	
	1996/07-2001/02	2002/03-2007/08	Change P. points	1996/07-2001/02	2002/03-2007/08	Change %	1996/07-2001/02	2002/03-2007/08	1996/07-2001/02	2002/03-2007/08
<i>Food and beverages</i>	51.2	46.8	4.4	8288	15582	13.6	7.7	6.5	945	1284
<i>Tobacco</i>	64.7	61.7	-3.1	33028	57955	32.5	14.8	9.8	1669	3348
<i>Textiles</i>	31.5	27.6	-3.9	1338	2421	23.6	1.9	2.0	572	778
<i>Wearing apparel</i>	31.1	34.7	3.6	1257	1852	111.5	1.2	1.6	518	808
<i>Leather tanning</i>	21.1	17.5	-3.6	3999	7763	6.3	3.1	3.2	1172	1273
<i>Footwear</i>	33.4	34.2	0.8	2662	5028	12.5	3.2	3.6	742	739
<i>Wood and W. products</i>	51.2	50.0	-1.2	2213	4373	2.5	2.9	2.7	751	817
<i>Paper and P. products</i>	42.8	39.8	-3.0	4744	8040	43.9	3.3	3.8	996	1257
<i>Furniture</i>	41.6	41.2	-0.4	2111	3666	35.8	2.4	2.9	656	722
<i>Chemical and C. products</i>	32.7	31.3	-1.4	5720	10304	24.8	5.4	4.7	838	1228
<i>Rubber and plastic products</i>	38.0	36.4	-1.7	5764	11430	1.7	5.8	6.0	979	958
<i>Non-metallic mineral products</i>	43.1	49.4	6.3	9230	13892	98.0	5.6	7.9	817	1162
<i>Basic iron and steel</i>	27.1	25.6	-1.5	17109	26553	81.2	7.0	10.0	1334	1715
<i>Fabricated metal products</i>	37.9	38.2	0.3	5889	8450	130.0	2.9	5.4	867	1102
<i>Machinery and equipment</i>	41.3	24.7	-16.7	4037	5248	233.3	1.9	3.0	633	1344
<i>Motor vehicles</i>	20.5	22.8	2.3	8390	18971	-20.7	8.2	4.4	1328	1903
<i>Total</i>	41.1	39.7	-1.5	5786	9997	37.4	5.1	5.3	818	1093

Source: Based on information from CSA, 'Report on Large and Medium Scale Manufacturing and Electricity survey, various issues.

3.6.2. Productivity levels

Unlike trends in the earlier decades, productivities, represented by proxy variables, such as value added per labor or per wage bill, have shown substantial rise in almost all industries during the decade ending in 2008.¹³ For instance, during the second period (2002/03-2007/08), value added per unit of labor, for all industries, increased, on average, by 37.4 percent over that of the previous one (Table 3.8).

Over the same period of time, productivities also increased in prioritized industries. However, the levels are small. For instance, between 2002/03 and 2007/08, average value added per unit of labor in the Textiles (\$2421) and Wearing apparel (\$1852) figured the smallest in the sector. The level in the Textiles is less than a quarter and that of Wearing apparel less than a fifth of the average for all industrial groups (\$9997). Productivity level in the Footwear industry (\$5028), though higher than that in the Textiles, Wearing apparel, and a couple of other industrial groups, remains smaller than all other industries. Value added per unit of labor in the Leather tanning is much better than in few industrial groups, though smaller than the average.

An alternative unit of measurement of productivity levels is value added per wage bill (Table 3.5). Looking at the figures in the same table, value added per wage bill remains a mirror image of value added per labor. In this version too, productivities in the prioritized industries are one of the lowest in the sector. For instance, during the second half of the period, value added per wage bill in the Textiles (2.0) and Wearing apparel (1.6) represent the smallest in all industries. In the Leather tanning and Footwear, corresponding ratios, though

¹³ Value added and wages are given in dollar values to partly account for the high inflationary pressure in the country.

greater than those in the Textiles, Wearing apparel, and few other industries, still stand smaller than those in all other industries and the average for all industries (5.3).

Note that such low productivity levels are expected to correspond to low wage rates. This is the case in these prioritized industries. From the same table, wage rates, wages per unit of labor, are relatively small in these industries. However, since labor productivities are much smaller than the corresponding wage rates, both in relative and absolute terms, value added per wage bills, i.e., productivities, appear to be quite smaller than those in other industrial groups.

3.7. Export capacity and import intensity of prioritized industries

3.7.1. Export capacity

Even by low income countries' standard, exporting capacity of Ethiopia is highly limited. For instance, for the five years period (2005-2009), the average merchandise export as a proportion of GDP in Ethiopia (6.4 percent) is two to five times less than that in other developing countries in the neighborhood, including Kenya (15.6 percent), Uganda (13.7 percent), Tanzania (12.6 percent), and Mauritius (28.5 percent) (UNCTAD). Manufactured Merchandise export in particular is insignificant. For instance, in 2008, where export earning was one of the highest of all times, the total export earning was only Birr 1013 million (US \$ 142 million considering the exchange rate in the period) (Table 3.9). This is equivalent to only 6 percent of total sales proceeds of manufactured goods in the same year. Given a least developed and dwarf manufacturing sector, this is no surprise. Moreover, even at establishment,

except perhaps for the Leather tanning industry, all the industries were not meant to cater for foreign markets. Right at the outset, their target was, and still is, the local market.

Table 3.9: Export earning and relative share of manufacturing industries

Industries	Export earning 2006		Export earning 2008	
	Value ('000 \$)	Share %	Value('000 \$)	Share %
Food and beverages	69267	46.7	28381	20.0
Tobacco	-----	-----	161	0.1
Textiles	10939	7.4	10132	7.1
Wearing apparel, except fur	88	0.1	10054	7.1
Leather tanning and dressing	64868	43.7	79544	56.1
Footwear	1337	0.9	9971	7.0
Chemical and C. products	-----	-----	2816	2.0
Non-metallic mineral products	1566	1.1	410	0.3
Fabricated metal products, except M & Eq.	101	0.1	-----	-----
Furniture	274	0.2	310	0.2
Total	148440	100	141779	100

Source: Based on information from CSA, 'Report on Large and Medium Scale Manufacturing and Electricity survey, various issues.

But, over a long time, and as a result of both internal and external favorable policies, some industries have started exporting. For instance, as a result of the favorable quota and duty free policy of the EU, Ethiopia has been exporting sugar to the EU since the last decade, in a, relatively, significant volume. Today, the Leather tanning and Sugar industries account for nearly three-fourth of the total manufactured export-earning. As shown in Table 3.9, irrespective of the value of export, only about five industries export consistently every year. But still growth (in real terms) in manufactured export is nevertheless stagnant.

As noted in the previous sections, export potential is one of the criteria for setting priorities. The four industrial groups under consideration, i.e., Leather tanning, Textiles, Wearing apparel, and Footwear are export-oriented and are increasing their share, though very gradually. However, the volume of export, of the latter three in particular, is still small. Moreover, as shown in Table 3.10, despite the fact that they are export-oriented, their share of export earning in total sales revenue, with the exception of the Leather tanning industry, have been quite marginal. It is only since 2007 that the three industries (Textiles, Wearing apparel and Footwear) have begun to increase their revenue from external markets. Still, the export earning share of each industry is quite marginal, less than 10 percent.

Table 3.10: Share of export earning in total sales revenue (%)

Industries	1997/ 98	2000/ 01	2003/ 04	2004/ 05	2005/ 06	2007/ 08
Food and beverages	7.3	6.3	3.1	6.9	11.	3.1
Tobacco	---	---	---	---	---	0.3
Textiles	2.6	11.	11.	9.0	10.	14.1
Wearing apparel, except fur	0.4	2.2	1.3	0.3	1.1	26.1
Leather tanning and dressing	80.	75.	84.	80.	77.	74.4
Footwear	0.2	1.1	0.7	11.	5.0	25.5
Chemical and C. products	0.1	---	0.1	---	---	1.6
Rubber and plastic products	---	---	---	0.1	---	---
Non-metallic mineral products	0.1	0.1	1.0	0.9	0.8	0.1
Fabricated metal products, except M & Eq.	---	---	0.4	---	0.2	0.8
Furniture	0.2	---	---	0.5	0.9	---
Total	8.8	9.7	7.1	8.4	9.1	6.1

Source: Based on information from CSA, 'Report on Large and Medium Scale Manufacturing and Electricity survey, various issues.

So, currently, manufactured goods export is dominated by two industries – Leather tanning and Sugar. And, as noted above, the latter is driven more by EU's favorable policy rather than domestic drive. Moreover, leather tanning is still limited to the low value added aspect of up-stream activities (exporting wet-blue leather) of the sector, leaving the high value added activity (tanning to the finish) to importing countries. Hence in general, irrespective of the priority, these industries are still engaged in activities they use to do decades ago.

3.7.2. Import intensity

Least industrialization implies foreign dependency for manufactured goods, both intermediate and final. While industries dealing with agricultural raw materials processing are largely dependent on domestic supply for inputs, they are import dependent for intermediate inputs. All other non-agricultural goods processing industries are heavily dependent on imports.

For the sector as a whole, it is import dependent for about 50 percent of its inputs (Table 3.11).

Table 3.11, shows average annual import intensity for the periods before and after the launch of the strategy. Naturally, all commodity processing industries such as Sugar, Textiles, Wearing Apparel, Leather Tanning, and also Cement Manufacturing, have relatively lower import intensity. For instance, Textile industry is import dependent for nearly one-third of its inputs value; Wearing apparel for less than one-third; and Leather tanning for much less than one-fourth (Table 3.11). Among prioritized industries it is only the Footwear industry that has relatively high import intensity – about a half. All other industries, not engaged in primary commodity processing, have, on average, import intensity greater than 80 percent.

Table 3.11: Average import share in total inputs (percent)

Industries	1997-2002	2003-2008
<i>Food and Beverages</i>	22.9	22.7
<i>Tobacco</i>	77.9	59.2
<i>Textiles</i>	31.5	35.3
<i>Wearing Apparel</i>	23.2	30.7
<i>Tanning and Dressing of Leather</i>	18.5	12.7
<i>Footwear</i>	48.1	51.5
<i>Wood and W. products, except Furniture</i>	54.6	45.4
<i>Paper and P. products and printing</i>	66.1	76.7
<i>Furniture</i>	34.7	47.0
<i>Chemical and C. products</i>	75.8	80.9
<i>Rubber and Plastic products</i>	94.5	90.2
<i>Non-Metallic Mineral products</i>	26.9	16.8
<i>Basic Iron and Steel</i>	98.9	87.5
<i>Fabricated Metal Products, except M & Eq.</i>	88.9	85.9
<i>Machinery and Equipment</i>	65.3	96.0
<i>Motor Vehicles</i>	89.9	93.6
All Industries average	45.9	49.8

Source: Based on information from CSA, 'Report on Large and Medium Scale Manufacturing and Electricity survey, various issues.

Since the launch of the strategy, the degree of dependency has not declined even in prioritized industries. In fact, in most, it has increased. The average import intensity for all industries has also increased by about 4 percentage points. This is obvious, because the industrialization strategy has no element or mechanism for enhancing structural linkages between different locally established manufacturing industries. In other words, priorities are attached only to exporting, not to foreign exchange saving, industries. This is a major loophole that renders any industrialization strategy less meaningful. Export promotion and import substitution are complementary strategies that are equally important.

The general conclusion on the performance of prioritized industries is that, irrespective of years of export experience of the Leather tanning industry and despite the expected potential to export of the other three industries, the levels of efficiency and productivity are quite low even by domestic standard, i.e., relative to other domestic industrial groups, let alone by international standard. This implies that expanding the export capacity (competitiveness) of prioritized industries requires a great deal of effort on improving their productivity levels.

3.8. Concluding remarks

The industrial development strategy basically focuses on the development of agriculture rather than industry per se. It does not address the industrial sector but only few industrial groups mainly having close linkages with agriculture. Even then, industries said to have high priorities for their strategic importance, i.e., for having close linkage to agriculture, export potential, and labor intensive production method, are not entitled to any additional benefit, i.e., more than that for non-prioritized industrial groups. Of course, certain government measures, such as establishing specialized training institutes, attempt to provide external market information, etc. to actors in some of these prioritized industries are commendable, though by far too small and too little to make a significant positive impact industry-wide. Government's main focus of upgrading and expanding state-owned enterprises such as Textiles and Leather tanning, Cement, Breweries, etc. could hardly bring about significant growth and improvement in efficiency, productivity, competition, and capacity in the sector at large and on a sustainable basis. It might bring about some improvement in some of the specific firms targeted for state investment.

The performances of prioritized industries, since the strategy has been launched, do not live up to expectations. In fact, in many cases, their performances are even inferior to that of non-prioritized industries. For these strategic industries to develop, it is essential to attach performance based incentives, effective enough to motivate the private sector to invest heavily in these industries. From countries' experiences, such industries as Textiles, Wearing apparel, Leather tanning, Footwear, Cement, Brewery, etc., neither need heavy investment capital nor have long-gestation period to deter private sector investment. The key for their development is not intensive public investment but effective incentive package to attract more private sector investment.

Chapter 4

Supply-Side Constraints to Leather and Leather Products Exports: Survey Findings

4.1. Introduction

The country's export is dominated by primary agricultural commodities. According to the World Bank (2009), the share of Ethiopia's manufactures export in the total export is only 9.0 percent (implying primary agricultural commodity to be 91 percent) while that of China is 94 percent. The agricultural sector, in turn, operates at the mercy of nature and the effects of nature on the sector are directly transmitted onto the performances of the export sector. Historical data show that the performances of the export sector (volume of export) drastically declined during the drought years resulting in volatility in export earnings and their consequent negative impact on the economy.

Export earnings have been increasing for the last decade. They have increased from 481.7 million USD in 1999/00 to 2003.1 million USD in 2009/10 indicating an average annual increase of 31.6 percent over the period. Despite the increase witnessed in export earnings, their import cover has continued to decline due to the faster increase in the import bill of the country. The merchandise export earnings import cover which was about 30.2 percent in 1999/00 has declined to 24.2 percent in 2009/10 indicating slower growth in exports earnings compared to imports (NBE, Various issues).

Despite the market access opportunities by developed countries across the globe, Ethiopia has not been able to exploit it by increasing its export supply,

improving its export product quality and adding value (processing) to primary commodities. This suggests the sources of the problem to export to be supply side rather than demand.

The constraints hindering the growth of the export sector are enormous. The major ones are Infrastructures, dominance of small scale producers, Poor product quality, nature dependence, large informal sector, weak institutions, inability to attract FDI, poor communication network, risk averse nature of producers, production not aimed for market, absence of vibrant public-private dialogue and low product promotion and market search.

For Ethiopia to effectively exploit the global market access opportunities (such as EBA, AGOA and other preferences), the supply side constraints that handicapped the country's exporting potential should be identified and addressed. To this end, an in-depth study has been conducted by EEA in 2010 so as to identify the key supply side constraints and suggest recommendations that would help to address them. In this section of the report of the findings of the survey the results on the leather and leather products are presented.

This section will briefly present the production, value and volume of exports and country of export destination of leather and leather products, conclusions and policy implications.

4.2. Production

According to UNIDO and MOTI (2005), the raw hides and skins production from cattle, sheep and goats were 2.7 million pieces, 8.1 million pieces and 7.5

million pieces, respectively. In spite of the high livestock endowment, the availability of hides and skins to be processed into leather is low mainly due to the low off-take rate. The off-take rate in bovines, sheep and goats are 6.6 percent, 32.4 percent and 32.6 percent respectively (see Table 4.1).

Table 4.1: Ethiopian Production of Raw Leather and off-take ratio

	Population (in 000 heads)	Share in total population (in %)	Raw Leather Production (in Million pieces)	Off-Take Rate
Cattle	40,800	45.9%	2,7	6.6%
Sheep	25,000	28.1%	8,1	32.4%
Goats	23,000	25.9%	7,5	32.6%

Source: UNIDO and MOTI, 2005

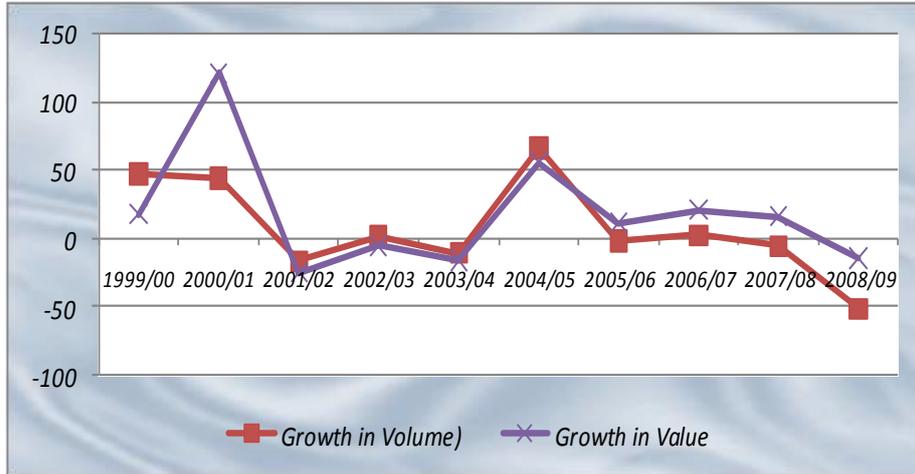
The main sources of hides and skins are in rural areas where the major proportion of slaughtering is carried out at the household level or in backyards that are not equipped with any amenities for undertaking and following proper slaughtering, ripping and flaying procedures. A considerable number of the raw leather is obtained from slaughter slabs. Municipal slaughterhouses, local and export abattoirs and meat and meat products processing plants are other sources of hides and skins.

4.3. Exports and country of destination

The volume of export has increased from 8.6 thousand tons in 1999/00 to reach 17.8 thousand tons in 2006/07 but declined to 7.3 thousand tons in 2008/09 depicting an average annual growth of 7.7 percent. Export receipts from hides and skins (leather and leather products) has also increased from birr 286.5 million in 1999/00 to Birr 784.2 million in 2008/09 indicating an annual average growth rate of 18.2 percent over the period. The growth in the

receipt is higher than the growth in the volume thereby implying increased price of the product (see Figure 4.1).

Figure 4.1: Growth in the volume and value of exports of leather and leather products



Source: NBE (various issues)

Ethiopian leather and leather products have been exported mainly to Europe and Asia with respective shares of 68.7 percent and 26.3 percent in the two-year period (2007/08 - 2008/09). Among partner countries, Italy stood first importing over 39.3 percent of the total leather exports; followed by Germany (15.4 percent) and China 11.4 percent the major three countries taking about two-thirds of leather exports (Table 4.2).

Table 4.2: Exports of leather and leather products by destination, share in %

2007/08				2008/09			
QI	QII	QIII	QIV	QI	QII	QIII	QIV

SUPPLY SIDE CONSTRAINTS TO LEATHER AND ...

<i>Sudan</i>	3.91	-	2.20	1.86	2.52	2.42	0.55	-
Africa, Total	4.11	0.93	12.25	2.20	3.74	2.70	1.17	0.29
<i>France</i>	6.58	5.13	1.68	2.08	2.39	2.20	1.92	-
<i>Germany</i>	0.83	4.00	25.63	16.44	19.30	21.35	20.44	15.41
<i>Hungary</i>	2.16	2.13	1.36	1.72	3.19	-	3.10	1.12
<i>Italy</i>	52.72	46.68	40.41	32.66	28.27	45.50	33.27	34.56
<i>United Kingdom</i>	4.64	4.68	3.84	5.02	6.99	2.77	2.40	0.20
Europe, Total	71.84	67.01	73.62	64.22	62.85	79.41	64.66	66.19
<i>United States</i>	2.44	4.15	0.53	2.02	0.53	0.30	1.14	0.63
America, Total	2.54	4.15	0.56	2.09	0.56	0.42	1.14	0.76
<i>China, Mainland</i>	2.87	7.99	1.31	18.71	12.68	5.57	24.28	18.14
<i>Hong Kong</i>	6.16	4.81	-	1.26	6.25	7.05	-	-
<i>Japan</i>	7.42	8.62	7.03	3.56	4.78	1.02	3.60	2.44
Asia, Total	21.51	27.92	13.57	31.49	32.85	17.47	33.02	32.71

Source: Computed based on data from NBE

4.4. Survey findings

The leather and leather products survey are conducted in Addis Ababa and Oromiya regional state. The total sample size is 170. Of which samples from Oromiya constitute 15 (8.82 percent) while that of Addis Ababa is 155 (91.18 percent). The sampled sub-sectors include Factory (95), tannery (14), wholesale collectors (12), retail collectors (31), abattoirs (7) and leather wholesalers (11).

According to the survey, the average number of workers operating in a leather and leather products firm is estimated at 58.23 persons while the average number of skilled workforce in a firm is estimated at 17.79 persons. Hence, the ratio of skilled to total employment is 29.5 percent thereby indicating the

dominance of unskilled labor force in the sector which, in turn, has limited the improvement in the quality of the products and hence export of the sector (Table 4.3).

Table 4.3: Total and skilled workforces in leather sector

	N	Minimum	Maximum	Sum	Mean	Std. Deviation
Total number of workers	150	1	1300	8734	58.23	169.409
Total number of Skilled Workers (certificate and above)	145	0	700	2579	17.79	81.339

Source: EEA Survey, October-November 2009

Although Ethiopia is believed to have immense potential, mainly due to its huge animal resource, in the production and export of leather and leather products, the sector has not managed to realize this potential. Compared with potential, the number of leather manufacturing firms is very low. Despite the existence of few leather processing industries, their installed capacity is very low. According to the responses of the majority (75.1 percent), the sector did not fully operate in the preceding fiscal year due to various factors (Table 4.4).

Table 4.4: Operation capacity of leather processing firms in 2001

Sub sectors	Yes	No	Total
Factory	26 27.1%	70 72.9%	96 100.0%
Tannery	3	11	14

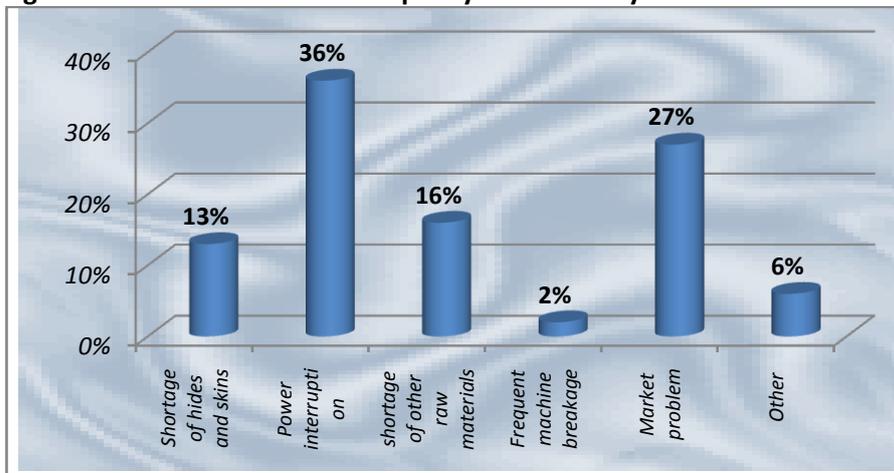
SUPPLY SIDE CONSTRAINTS TO LEATHER AND ...

	21.4%	78.6%	100.0%
<i>Wholesale collectors of hides and skin</i>	4	8	12
	33.3%	66.7%	100.0%
<i>Retailer collectors of hides and skin</i>	6	25	31
	19.4%	80.6%	100.0%
<i>Abattoir</i>	1	6	7
	14.3%	85.7%	100.0%
<i>Leather whole seller</i>	3	8	11
	27.3%	72.7%	100.0%
Total	43	130	173
	24.9%	75.1%	100.0

Source: EEA Survey, October-November 2009

Of the reasons given by respondents, power interruption (36 percent), market problem (27 percent), shortage of chemical raw materials (16 percent) and shortage of raw hides and skins (13 percent) are the pressing ones in order of importance. Given few numbers of industries and their low capacity utilization, shortage of raw hides and skins should not have been the case. As the result of the overlapping of survey year with the year in which electric rationing was practiced, power interruption is found to be the gravest problem explaining under capacity utilization (Figure 4.2).

Figure 4.2: Reasons for under capacity utilization by the sector



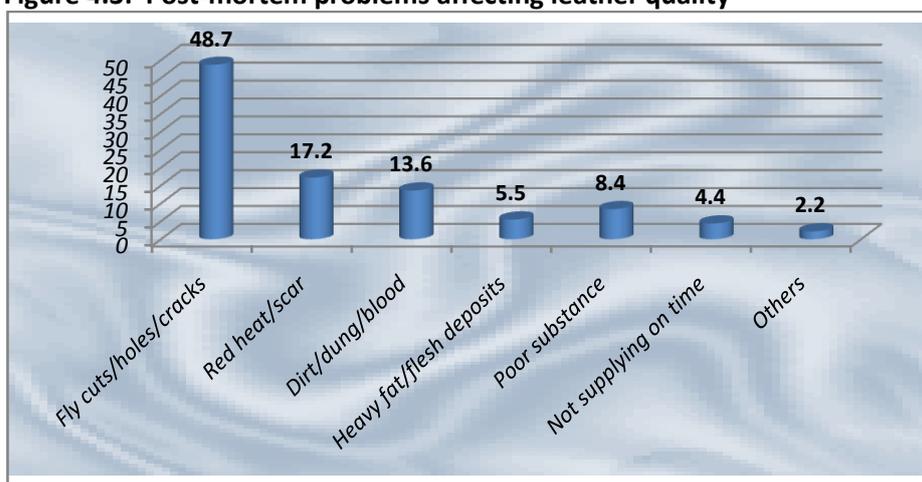
Source: EEA survey, October-November 2009

Of the supply side problems, the poor quality of export product is the major one. The quality problem emanates from various sources, including the quality of raw hides and skins and the poor processing/finishing by domestic manufacturing industries. According to the survey, the sources of poor leather and leather products quality originate from both pre-mortem (the period covering before the animal is slaughtered) and post mortem (the period from the slaughtering and thereafter) problems. However, although pre-mortem plays significant role in affecting the quality, according to the survey, the greater quality deteriorating influence appears in the post- mortem period—the activities from flaying to processing of the end product.

Of the pre-mortem problems affecting the quality of hides and skins, animals’ skin disease takes the major blame as described by 68.2 percent of respondents, followed by the problem due to lice and others. Of the post-mortem problems affecting the quality of leather, the major ones according to respondents include,

fly cuts/holes, red heat scar, dirt/dung/blood and poor substance which are the critical ones in order of importance (Figure 4.3). Indeed, both the pre and post mortem problems that have been reducing the quality of Ethiopian leather and leather products are preventable.

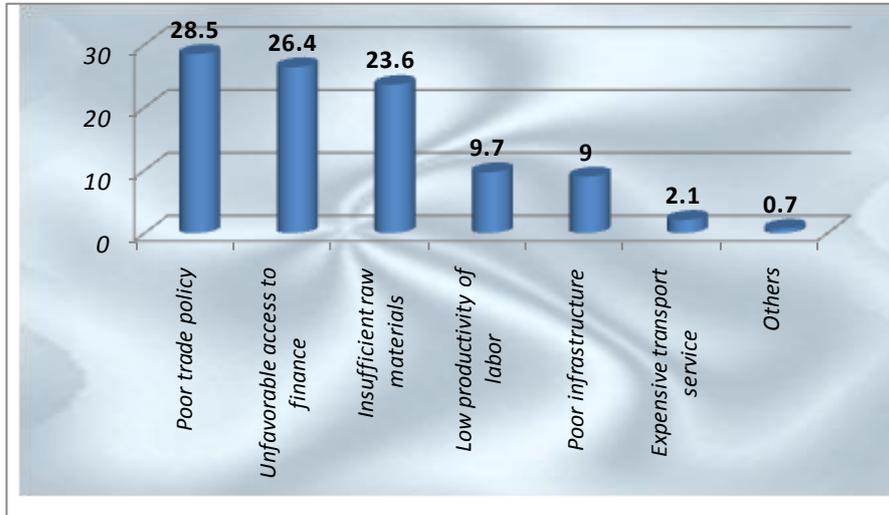
Figure 4.3: Post-mortem problems affecting leather quality



Source: EEA Survey, October-November 2009

Respondents were also asked whether there is an enabling domestic environment that could encourage exporting and seizing the market access opportunities. According to the responses of the majority, there is no enabling domestic environment for the sector. Evidently, the enabling environment for businesses in the export sector could vary from one sub-sector to the other. For an environment to be regarded as enabling, it should offer a number of services that businesses require for their smooth operation. According to respondents, the domestic enabling environment is affected by poor trade policy, unfavorable access to finance, insufficient raw materials and poor infrastructure in order of importance (Figure 4.4)

Figure 4.4: Factors deterring firms from joining export market



Source: EEA survey, October-November 2009

Despite the existence of huge potential, the sector cannot realize it due to varieties of constraints. In this connection, respondents were asked to rank the various problems facing the sector in order of importance. According to respondents' ranking, the first most important problem constraining the growth and development of the leather and leather products sector and obstructing it from realizing its potential and fetching higher export revenue is financial constraint (22.4 percent) followed by physical infrastructure (21.3 percent), institutional problems (21.2 percent) and land (16.1 percent) in order of importance (Table 4.5).

Since identification of specific constraints within each broader constraint has paramount importance in helping policy makers to come up with specific policy intervention, respondents were further asked to identify the specific problems underlying the broader constraints they have ranked at the top of

the list. Specific constraints within finance, infrastructure, institutions, manpower, technology and land are discussed in the next paragraphs.

Table 4.5: Respondents' rankings of major constraints

Constraints	Frequency	Percent
Physical infrastructures	127	21.3
Finance	133	22.4
Institutional	126	21.2
Policy	35	5.9
Manpower	35	5.9
Technology	41	6.9
Land	96	16.1
No problem	2	.3
Total	595	100.0

Source: EEA Survey, October-November 2009

Within the financial constraint, the specific problems are access to credit due to collateral requirement, high transaction cost, high interest rate and low credit selling which handicapped establishment of large scale factories; these are the major ones in order of importance (Table 4.6).

Within the physical infrastructure constraints, power is the topmost important factor (77.8 percent), followed by problem of water (7.8 percent) and transport service (5.9 percent) (Table 4.6).

Within the institutional constraints, absence of capable support institutions (73.0 percent) and inefficient regulatory measures are the major ones. The respondents have suggested the critical institutions that are needed for the development of the sector. These include an agency that provides export market information, a research center which focuses on leather and leather

products, a specialized educational institution on leather, agency that identifies the technical gap and helps to transfer technology to the sector and public-private forum that regularly meets to address the problem of the sector and suggests policy measures (Table 4.6).

Skilled manpower plays detrimental role in industries which produce for the export market. According to the survey, the major manpower problems of the sector are lacks of skilled manpower in the sector and the high wage rate demanded by skilled labor from the sector. This impacted the quality negatively and lowers competitiveness.

Table 4.6: Specific finance, infrastructure and institutional problems

Finance		Infrastructure		Institutions	
Specific problems	%	specific problems	%	specific problems	%
High transaction cost	22	Road	3.3	Inefficient regulatory measures	18.2
High interest rate	15	Transport service	5.9	Law enforcement	2.5
Access (due to collateral)	48	Electricity	77.8	Corruption	2.5
Low credit ceiling	12	Water	7.8	Bureaucracy	3.8
Foreign exchange component of credit	2	Telecom	5.2	Absence of support institutions	73
Bureaucracy	1				

Source: EEA Survey, October-November 2009

Technology is the critical element in such a sector where further processing of raw materials takes place. According to the respondents, the technological backwardness of the sector is mainly due to lack of latest machines to work with, which in turn is due to high cost of getting it, inability to access

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appropriate modern technology and lower technology absorption capacity, which in turn is due to lack of skilled manpower in the sector (Table 4.7).

The sector requires industrial land. According to the respondents, Land-related problem of the sector is access to land (63.4 percent) and the cost of land (35.1 percent) (Table 4.7).

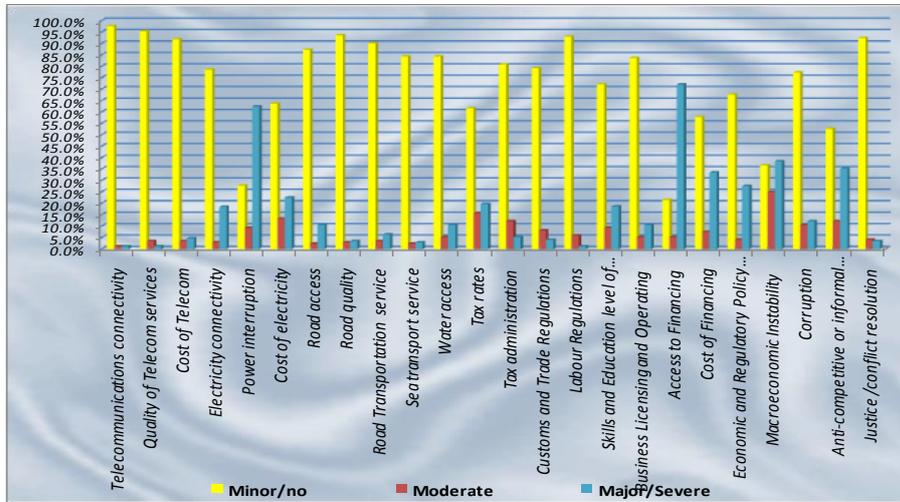
Table 4.7: Specific technological and land constraints

	Frequency	Percent
Technology		
Access to technology	16	31.4
Cost of technology	19	37.3
Low technology absorption capacity	16	31.4
Total	51	100.0
Land		
Access	85	63.4
Cost	47	35.1
Shortage of sufficient working space	1	0.7
They request collateral	1	0.7
Total	134	100

Source: EEA Survey, October-November 2009

Attempt is made to include questions that could help to evaluate the overall business environment from the sector's perspective. Overall, the finding shows that the business environment is enabling evidenced by the respondents' confirming of absence of problems in 21 out of 24 of the business environment assessing variables. However, access to finance, power interruption and macro-economic instability (high inflation rate, exchange rate, etc) are the three factors identified to label the business environment so unfriendly in the sector (Figure 4.8).

Figure 4.5: Business environment in leather sector by variables



Source: EEA Survey, October-November 2009

4.5. Conclusions

Despite the sector’s huge potential and market access opportunities, the leather and leather products sector cannot seize the opportunities offered across the globe due to various supply side constraints.

In order to increase the revenue from exports of leather and leather products, the country has to increase its production of leather and leather products and improve the quality. Volume is constrained by the low off take rates of cattle, sheep and goats. The quality problems witnessed in the sector’s output emanate from both the pre-mortem and post-mortem activities. Of the pre-mortem problems, animal skin diseases are the major ones while of the post mortem problems flay cut/hole/scratch is the major one. In reality both problems are preventable if appropriate measures are taken.

According to the findings of the survey, the first most important problem constraining the growth and development of the leather and leather products sub-sector is access to finance/credit followed by lack or poor physical infrastructure, institutional and access to and cost of land.

4.6. Policy recommendations

- ❁ In order to increase the volume of leather and leather products production and export, the country has to improve the off take rates of cattle, sheep and goats.*
- ❁ In order to improve the quality of leather and leather products, the pre-mortem constraints have to be addressed by preventing and treating animal skin diseases and advising breeders not to hit their animals by tools that could damage their skins.*
- ❁ With regard to the post-mortem problems, provide training to backyard flayer service providers regarding the proper flaying of animals' hides and skins, provide advices to the primary collectors of hides and skin regarding the appropriate care they should give while drying or storing raw hides and skins and improve skills of those workers engaged in producing final leather products.*
- ❁ Provide the necessary infrastructure. Establish new and strengthen the existing support institutions for leather and leather products. Institutions that develop the skills of workers, that undertake researches on the development of the sector and that try to transfer technologies to the country, etc.*
- ❁ For the expansion of an industry, access to finance is critical. Hence improve the sector's access to finance by revisiting the low credit ceiling level set by banks so that large industries could be established.*

Chapter 5

An Overview of the Ethiopian Educational System

5.1 Introduction

Human resources development forms the foundation upon which material development can happen, and education represents a major form of human resources development. Needless to say that educated and qualified manpower equipped with modern research, technical, managerial and leadership competence is indispensable for the economic development of any country. It has been a long time since the role of education for economic development was recognized. Schultz (1961) was one among many who conducted an empirical research to show the link between education and level of income. His study found that the returns to investment in education explain a remarkable portion of the rise in earnings in the United States during the 1930s to 1950s.

Using data from the Ministry of Education (MoE) annual abstracts, this chapter briefly assesses the performance of the educational sector in Ethiopia for the period 1999/00 to 2008/09. More specifically the chapter makes a review of the educational structure, and the status of the educational sector in terms of access, equity, quality and efficiency.

5.2. Background: The Ethiopian educational system

Even though it has been over a century since modern education was introduced in Ethiopia, overall enrollment ratio is still one of the lowest in Sub-

Saharan African countries. For instance before the revolution in 1974, it was only fifteen percent of the school age children who were attending primary schools. During this same period countries like Somalia, the Sudan, Zimbabwe and Zambia had 50%, 51%, 72% and 95% primary school Gross Enrollment Ratio (GER) level while Tanzania and Kenya already achieved universal primary school coverage (UNESCO, 1981). Even after the revolution the performance in terms of quality, access, equity, efficiency and relevance of education in the country has been very low.

To change this quandary, the government of Ethiopia recognized education as a significant component of human resource development in its poverty reduction strategy that the country follows. Along with roads, agriculture and natural resources, and health sectors, education is the priority sector in the government's poverty reduction policy. The government has promulgated different social and economic policies to improve performance in the sector. To this end, the government launched a series of national Education Sector Development Programs (ESDPs) which started in 1997. Achieving universal primary education being the main target, the ESDPs also work to improve education quality, efficiency, equity, and relevance to the country. Following the Education and Training Policy (ETP) devised in 1994, there have been three ESDPs all of which believe that every school age child must have primary education¹⁴. The concerted effort of the government has brought about quantitative changes in the consecutive years. To say the least, the general enrollment ratio increased by four-fold at primary level, more than twice in secondary education, by about 20 times in training and vocational schools, and about 12 times in tertiary education between the years 1994/95 to

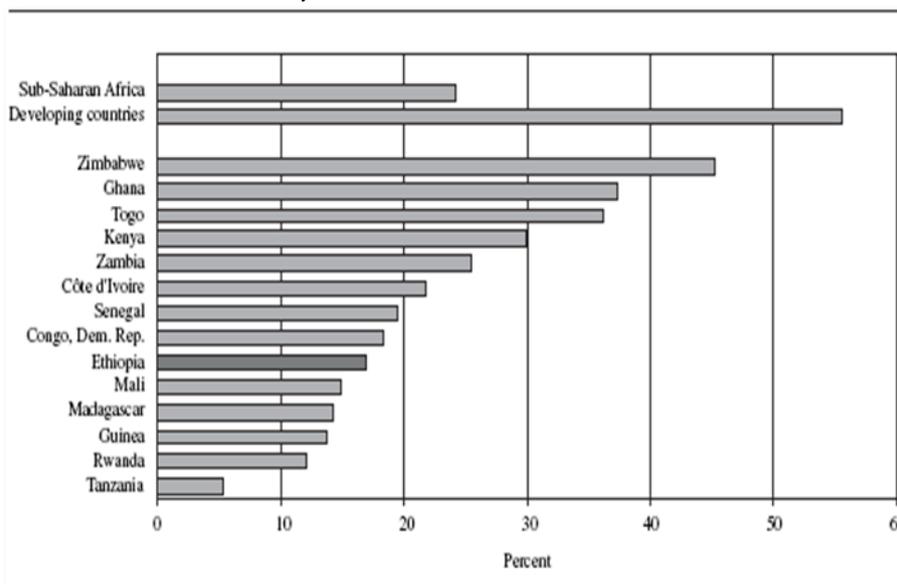
¹⁴ *The first ESDP was from 1997/98 to 2000/01, ESDP II runs from 2000/01 to 2004/05 and deliberately covered the last two years of ESDP I in order to be in line with the general five-year government plan. The program is now in its third phase covering the period 2005/06 to 2010/11.*

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2004/05. The gross enrollment rate at the end of the second development program reached 79.8% from about 35% in 1990 (MoE, 2004/05).

Though this is a phenomenal achievement in the Ethiopia’s education history, the GER still remains low in cross-country comparison.

Figure 5.1: Secondary school GER for Ethiopia and selected African countries, circa 2000.



Source: Adopted from World Bank report, 2005

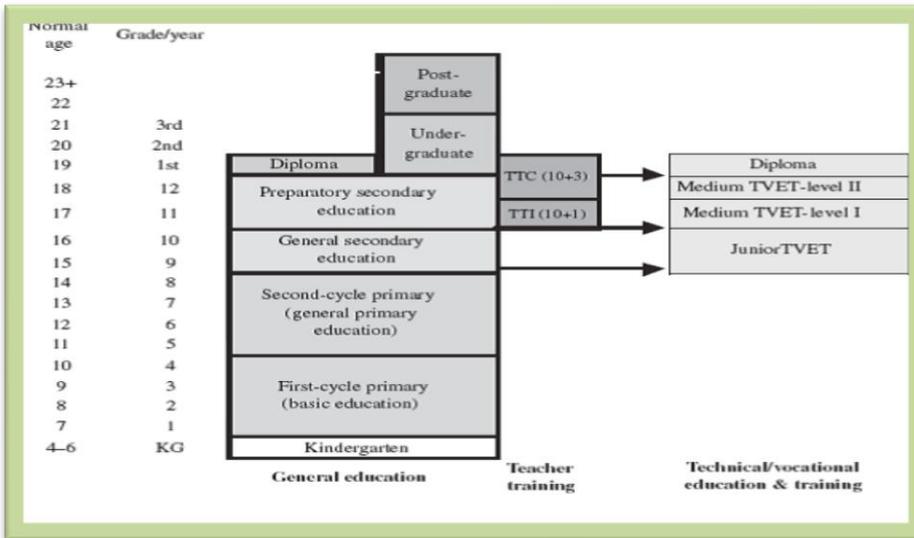
The primary school GER of Ethiopia is slightly ahead of the Democratic Republic of Congo, Sudan, Guinea and Sierra Leone during the beginning of ESDP II, 2000-01. At secondary school level, however, Ethiopia is performing much lower than the average GER level for developing countries and still lower than the average GER for Sub-Saharan African countries (World Bank, 2005).

Figure 5.1 shows the position of Ethiopia in terms of gross secondary enrollment relative to selected African countries.

5.3. Structure of the education system

Since 1962 to the formulation of the ETP in 1994 the education system had a three-cycle 6-2-4 structure: six years of primary education followed by a two years junior and four years of senior secondary education cycles. Students are promoted from one cycle to the next based on their results on the national examinations at the end of each cycle. The present education system which is the result of the ETP in 1994 has 4-4-2-2 structure: eight-year primary education composed of four years each of basic and primary education cycles followed by two years each of general and preparatory secondary education cycles. The new structure of the education system can be depicted as shown by Figure 5.2 below.

Figure 5.2: Structure of the Ethiopian educational system in 2009/10



Source: MoE

The main motivation of the new structure was to make the education system suitable to the contextual conditions of the country and to address equity, access, efficiency and relevance issues that the country has been performing poorly. Although it is arguable that they are met, the objectives for each cycle were clarified in the ETP document. For instance the principal purpose of the primary cycle is to provide functional literacy while the general and preparatory secondary schools are meant to prepare students for technical and vocational schools and/or for studies in higher institutions.

5.4. Overview of performance in the educational sector

This section reviews the achievement in the educational sector in line with the Educational Sector Development Program (ESDP) objectives which include

expanding access, increasing equity (with focus on gender) and improving the quality and efficiency of education.

5.4.1. Access to education

5.4.1.1. Overview of enrollment at primary and secondary schools

There has been a paramount growth in enrollments at all levels of education throughout the country. Access to education is commonly measured by the gross enrollment ratio, which is defined as the ratio of all enrolled students to the population in the official age range for that cycle. Net enrollment ratio (NER) is another commonly used measure that supplements GER¹⁵. The country has made a sizeable progress in terms of access to education at all levels since the late 1980s. The number of schools increased by more than 50% between the late 1980s and the early 2000s; general student enrollment tripled at the turn of the century; and teachers nearly doubled during the same period (Lasonen et al, 2005).

As can be noted from Table 5.1 the country has achieved over a 40 percentage points increase in primary GER between the years 2000 and 2009, which are the beginning and the final years of ESDP II and ESDP III respectively. This is composed of an increase of about 50 and 37 percentage points in female and male primary enrollment ratios, respectively. This suggests that the development programs are bringing substantial changes in terms of gross enrollment for both genders.

¹⁵ NER is computed in the same way as GER except that the numerator consists of only students in the official age range.

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Table 5.1: Enrollment in primary school (grade 1-8) at national level

Year	GER				NER			
	Male	Female	Total	Annual Gr. Rate (%)	Male	Female	Total	Annual Gr. Rate (%)
1999/00	60.9	40.7	51.0	-	-	-	-	-
2000/01	67.3	47.0	57.4	12.5	-	-	-	-
2001/02	71.7	51.2	61.6	7.3	-	-	-	-
2002/03	74.6	53.8	64.4	4.5	-	-	-	-
2003/04	77.4	59.1	68.4	6.2	62.9	51.8	51.8	-
2004/05	88.0	71.5	79.8	16.7	73.2	63.6	68.5	32.2
2005/06	92.9	78.5	85.8	7.5	78.0	69.8	73.9	7.9
2006/07	98.0	85.1	91.7	6.9	82.6	75.5	79.1	7.0
2007/08	98.0	91.0	94.0	2.5	84.6	81.3	83.0	4.9
2008/09	98.0	91.0	94.0	0	84.6	81.3	83.0	0

Source: Data from the MoE Annual abstracts, 1999/00-2008/09; and author's calculations

- Data not available at time of writing

There are, however, 17% of primary school age children who do not go to school during the 2008/09 school year. Nearly 20% female and above 15% male primary school- age children do not go to school at the end of the 2008/09 school year. Measured in terms of NER, the universal primary education target in 2015 can only be achieved with a lot of effort. The fact that there was no growth in both enrollment ratio measures for both genders from 2007/08 to 2008/09 school years makes the achievement of the target more doubtful.

Table 5.2: Enrollment in secondary school (grade 9-12) at national level, GER

Year	First cycle secondary (Grade 9-10)				Preparatory secondary (Grade 11-12)			
	Male	Female	Total	Annual Gr. rate (%)	Male	Female	Total	Annual Gr. rate (%)
1999/00	-	-	-	-	12	8.5	10.3	-
2000/01	-	-	-	-	14.8	10.9	12.9	25
2001/02	20.4	13.7	17.1	-	-	-	-	-
2002/03	24.0	14.3	19.3	13	-	-	-	-
2003/04	28.2	15.9	22.1	15	-	-	-	-
2004/05	34.6	19.8	27.3	25	-	-	-	-
2005/06	41.6	24.5	33.2	22	23.9	13.4	18.7	-
2006/07	45.7	28.6	37.3	12	26.8	16.4	21.7	16
2007/08	44.0	32.0	38.0	2	26.7	18.4	22.6	4
2008/09	44.0	32.0	38.0	0	26.7	18.4	22.6	0

Source: Data from the MoE Annual abstracts, 1999/00-2008/09; and author's calculations.
 - Data not available at time of writing

Though the progress is not as impressive as in the primary cycle, gross secondary enrollment more than doubled between the years 1999/00 and 2008/09. Gross enrollment reached 38% in general secondary and 22.6% in preparatory secondary schools towards the end of the third ESDP. As it can be noted from Table 5.2, gross enrollment of female students is 12 and 8.3 percentage points behind male gross enrollment in first cycle and preparatory secondary schools, respectively, during the same period.

Although there is an outstanding progress in enrollment at national level, the regional variation shows that there is a lot to do to achieve the universal primary education in 2015 and to bring equity among regions. While the majority of the regions have already surpassed the target level of primary education in terms of GER, regions like Afar and Somali are far from the target level (Table 5.3). As of 2008/09 school year, Oromiya and Dire Dawa reached

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92.1% and 88.9% GER from which universal primary education can be said is in the achievable distance. In terms of NER, however, it is only Amhara that has already achieved 100% enrollment ratio during the same period. However, the trend in the gap between the best and worst achieving regional states reveals a consistently declining trend in the last ten years (2006/07 school year is an exception).

Table 5.3: Access to primary education at regional level in terms of GER

Year Region	2000/ 01	2001/ 02	2002/ 03	2003 /04	2004/ 05	2005/ 06	2006/ 07	2007/ 08	2008/ 09
Tigray	73.9	77.6	73.7	80.6	91.0	100.9	104.8	107.1	107.1
Afar	11.5	12.6	13.8	14.8	20.9	21.9	22.2	31.2	31.2
Amhara	53.3	58.1	58.5	61.8	75.9	56.4	93.1	112.5	112.5
Oromiya	57.9	62.4	66.9	72.7	87.5	89.8	91.4	88.9	88.9
Somali	10.6	13.1	15.1	15.1	23.3	30.3	38.6	35.0	35.0
Ben. Gumuz	88.5	89.1	98.4	100.	107.4	109.7	127.9	112.1	112.1
SNNP	63.8	67.5	71.8	74.2	78.9	85.6	97.8	101.0	101.0
Gambella	95.8	102.	124.6	106.	127.4	137.1	181.4	112.5	112.5
Harrari	105.	107.	105.7	104.	92.4	103.1	116.8	107.9	107.9
Addis Ababa	118.	128.	135.4	142.	150.2	148.5	146.6	109.2	109.2
Dire Dawa	75.7	80.2	78.6	83.2	83.9	79.5	80.0	92.1	92.1
Max./Min.	11.2	10.2	9.8	9.6	7.2	6.8	8.2	3.6	3.6

Source: Data from the MoE Annual abstracts, 1999/00-2008/09; and author's calculations

Similarly the first cycle secondary school enrollment ratio is one of the lowest in Afar and Somali regions with an average GER of 5.7% and 3.8% respectively, between the years 2001/02 and 2008/09. Addis Ababa achieved an average GER of 90.5% whereas more than half of the general secondary school-age students in the other regional states do not go to school during this period (Table 5.4).

Table 5.4: Access to 1st cycle secondary education at regional level in terms of GER

Year Region	2001/ 02	2002/ 03	2003/ 04	2004/ 05	2005/ 06	2006/ 07	2007/ 08	2008/ 09
Tigray	38.3	26.2	30.5	34.8	40.8	45.4	50.0	50.0
Afar	4.2	5.1	5.0	4.6	6.6	6.8	6.7	6.7
Amhara	12.0	12.6	15.7	22.4	30.3	38.1	42.9	42.9
Oromiya	15.9	19.1	22.9	28.9	35.6	37.9	40.0	40.0
Somali	2.3	3.3	3.3	3.8	3.8	4.9	4.4	4.4
Ben. Gumuz	16.6	19.5	28.4	35.6	43.4	47.1	46.3	46.3
SNNP	13.2	18.7	20.0	24.1	29.1	32.4	32.0	32.0
Gambella	16.7	33.7	28.9	36.8	67.7	54.7	43.5	43.5
Harrari	59.6	56.1	72.5	73.2	20.5	86.4	40.4	40.4
Addis Ababa	69.3	78.1	86.6	93.9	101.9	108.2	81.5	81.5
Dire Dawa	33.2	50.3	47.2	57.1	47.8	66.3	62.4	62.4
Max/Min	30.1	23.7	26.2	24.7	26.8	22.1	18.5	18.5

Source: Data from the MoE Annual abstracts, 1999/00-2008/09; and author's calculations

The enrollment ratio at preparatory secondary schools is very low in all the regions. Table 5.5 shows the variation in GER of the different regions in Ethiopia. Here again Somali and Afar registered an average low GER of 2.4% and 3.8% while Addis Ababa achieved slightly more than 50% of gross preparatory school enrollment during the years 1999/00 and 2008/09.

Generally, the overall gross secondary school enrollment in all the regions (Addis Ababa being an exception for 1st cycle secondary school) is very low. This implies that government and nongovernmental institutions should put more effort to improve access to secondary schools.

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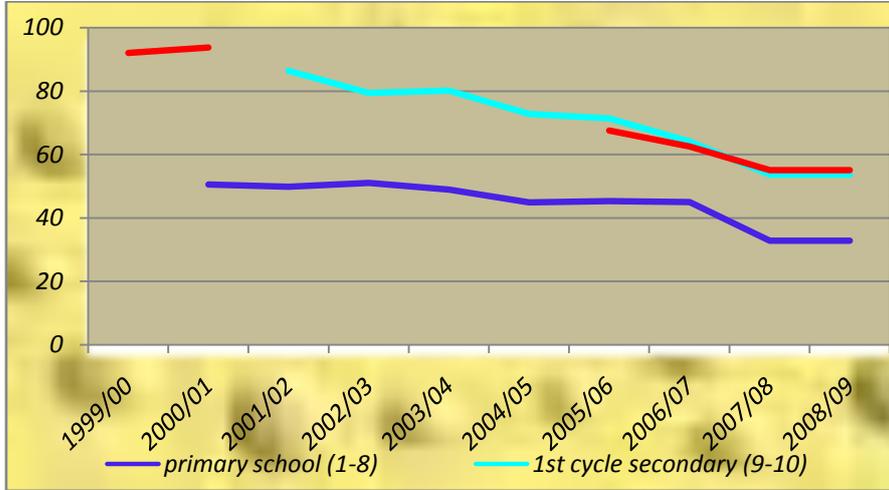
Table 5.5: Enrollment in preparatory secondary school at regional level in terms of GER

<i>Year</i> <i>Region</i>	<i>1999/ 00</i>	<i>2000/ 01</i>	<i>2005/ 06</i>	<i>2006/ 07</i>	<i>2007/ 2008</i>	<i>2008/ 2009</i>	<i>Average</i>
<i>Tigray</i>	12.8	23	24.0	28.6	31.4	31.4	25.2
<i>Afar</i>	2.3	3.3	3.7	4.6	4.3	4.3	3.8
<i>Amhara</i>	8.1	9.5	17.7	22.4	25.3	25.3	18.1
<i>Oromiya</i>	9	10.8	19.8	21.5	23.1	23.1	17.9
<i>Somali</i>	0.7	0.7	2.8	3.6	3.3	3.3	2.4
<i>Ben. Gumuz</i>	8.7	10.1	24.3	27.0	26.9	26.9	20.7
<i>SNNP</i>	8.8	9.7	16.0	18.3	18.5	18.5	15.0
<i>Gambella</i>	15.6	17.9	34.3	28.9	23.6	23.6	24.0
<i>Harrari</i>	40.1	50.2	10.6	50.6	28.3	28.3	34.7
<i>Addis Ababa</i>	45.6	60.7	52.6	60.6	51.6	51.6	53.8
<i>Dire Dawa</i>	25.2	32	23.1	39.4	38.5	38.5	32.8
<i>Max/Min</i>	65.1	86.7	18.8	16.8	15.6	15.6	22.4

Source: Data from the MoE Annual abstracts, 1999/00-2008/09; and author's calculations

The coefficient of variation (CV) for enrollment ratios among the different regional states shows a declining trend at all levels of education in the country. The implied trend in Figure 5.3 below shows that the disparity in the general enrollment ratio among the regions is declining at a faster rate at secondary school level in the last ten years. The figure also shows that variations in the 1st cycle secondary and preparatory schools are declining with almost the same rate.

Figure 5.3: CV for enrollment ratios (GER) at different levels of education among regions.



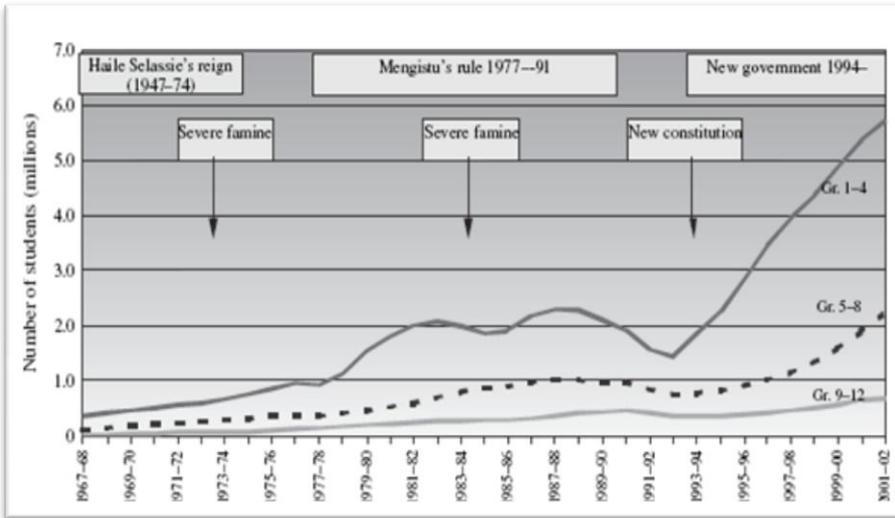
Source: Data from the MoE annual abstracts; and author’s calculations

The increase in enrollments was not consistent due to major political turbulence and famines since 1967/68 (Figures 5.4 & 5.5). General enrollments from grades 1-12 were growing at annual rate of 12% during 1967 to 1977 with no/little disturbance by the 1973/74 severe famine.

Though it was short-lived, enrollments at all levels fell by 2% when the ‘Derg’ military regime was in power in 1977/78. However, the major downward swing in general enrollments was during the overthrow of the Derg regime in 1991. Enrollments in the subsequent 2 to 3 years were over 30% lower than what they were during the late 1880s.

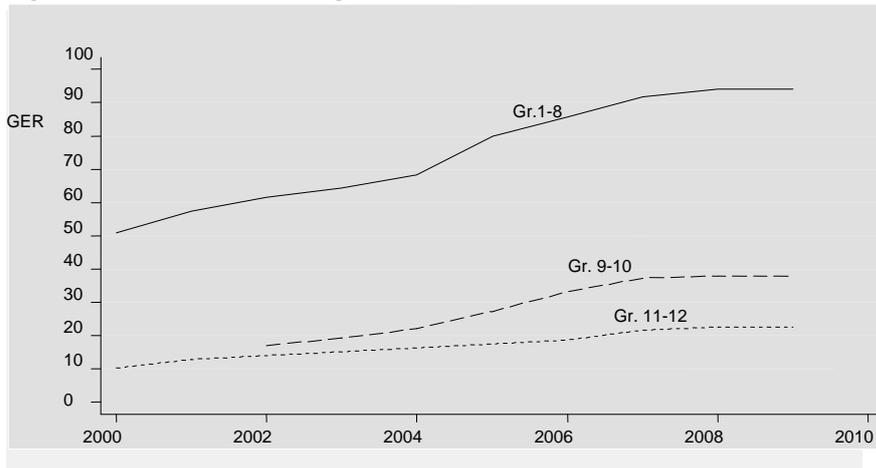
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Figure 5.4: Enrollments from grades 1-12, 1967-2002.



Source: Adopted from World Bank Report, 2005

Figure 5.5: Enrollments in grade 1-12, 2000-2009.



Source: Data from the MoE annual abstracts, 1999/00-2008/09; and author's calculations

Growth of enrollments has been following a smooth path since 1994 under the current government. General enrollments from grades 1-12 has been growing at a sustained pace of about 9 percentage points since the formulation of the 1994 ETP.

5.4.1.2. Growth in the number of schools

The number of schools at different levels of education is another indicator of access to education in the country. The educational development program has given more emphasis on expanding education in rural parts of the country. Table 5.6 presents the distribution of schools (both primary and secondary) between rural and urban areas in different regions of the country. We can see that the school distribution substantially varies both by region and between rural and urban areas of the country. Though the number of schools at national level is low relative to the population size, the corresponding figures for the emerging regions (Afar, Somali, Gambella, and Benishangul Gumuz) are lagging far behind the others.

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Table 5.6: Number of primary and secondary schools in different regions of the country

Year Region	1999/00		2000/01		2001/02		2002/03		2003/04		2004/05		2005/06		2006/07		2007/08		2008/09	
	Urban	Rural	Urban	Rural	Urban	Rural	Urban	Rural	Urban	Rural	Urban	Rural	Urban	Rural	Urban	Rural	Urban	Rural	Urban	Rural
Tigray	157	726	168	757	193	774	202	812	199	902	209	1077	218	1320	239	1493	235	1627	242	1760
Afar	28	101	31	106	46	103	60	103	60	134	70	143	50	226	49	239	50	249	39	295
Amhara	350	262	350	2656	392	2668	415	2684	440	2823	616	3570	695	4433	603	4760	677	5209	697	5771
Oromiya	734	375	751	3850	760	3971	772	4142	877	4380	912	5817	102	6777	109	7193	1271	8439	1416	9085
Somali	130	101	135	125	142	144	142	173	141	174	159	579	161	578	161	578	161	578	132	555
Ben. Gumuz	28	254	29	266	33	254	34	254	38	279	47	288	55	285	58	293	74	296	70	309
SNNP	311	204	315	2074	348	2088	367	2150	422	2215	483	2492	516	3032	527	3333	595	3811	660	4092
Gambella	13	122	13	129	22	128	22	134	21	140	23	146	24	146	26	163	28	160	35	155
Harrari	27	22	28	22	28	24	28	24	29	24	30	24	32	24	35	25	40	26	28	27
Addis Ababa	316	0	335	1	360	1	369	1	399	0	445	0	558	3	629	13	798	2	783	6
Dire Dawa	32	25	33	27	32	33	36	38	41	38	51	38	50	40	63	39	75	40	80	40
Total	2126	9774	2188	10013	2356	10188	2447	10515	2667	11109	3045	14174	3383	16864	3483	18129	4004	20437	4182	22095
Ann. Growth	-	-	2.9	2.4	7.7	1.7	3.9	3.2	9.0	5.6	14.2	27.6	11.1	19.0	3.0	7.5	15.0	12.7	4.4	8.1

Source: Data from the MoE annual abstracts, 1999/00-2008/09; and author's calculations

Of the new schools built since 2002/03, more than 85% of the primary and about half of the secondary schools have been in the rural areas. The larger proportion of primary schools in rural areas is a mirror image of the population distribution between rural and urban areas in the country. Nevertheless, despite the rapid expansion of construction of schools in the rural areas, the secondary schools are still concentrated in the urban areas (MoE, 2008/09) (see Table 5.7). There is, however, a general increasing trend in the proportion of both primary and secondary schools in rural areas over the past decade.

Table 5.7: Percentage of primary and secondary schools in urban and rural areas

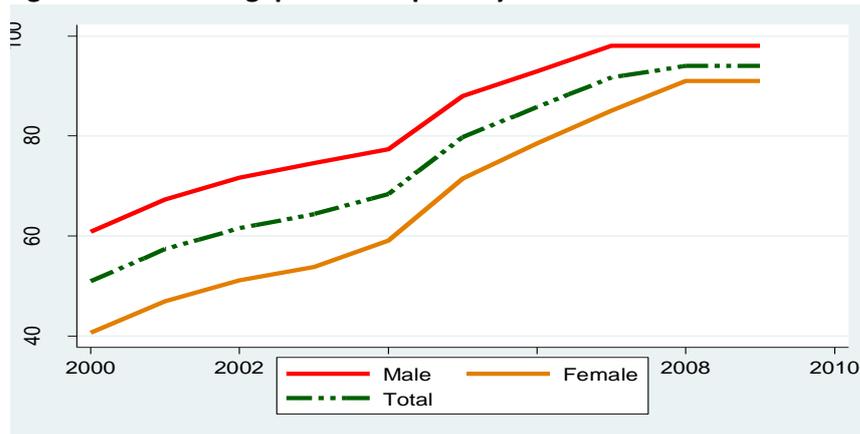
Year	Primary Schools		Secondary Schools	
	Urban	Rural	Urban	Rural
1999/00	15.2	84.8	92.9	7.1
2000/01	15.2	84.8	93.2	6.8
2001/02	16.0	84.0	93.6	6.4
2002/03	16.0	84.0	91.4	8.6
2003/04	16.2	83.8	89.6	10.4
2004/05	14.7	85.3	87.4	12.6
2005/06	13.8	86.2	84.7	15.3
2006/07	13.0	87.0	84.3	15.7
2007/08	13.3	86.7	83.2	16.8
2008/09	12.8	87.2	82.4	17.6

Source: Data from the MoE annual abstracts, 1999/00-2008/09; and author's calculations

5.4.1.3. Gender disparity

Besides the disparity in terms of the number of schools by regions and areas, access to education substantially varies by gender. Although improvements in access to education have been made with greater equity, large gender gaps still remain in both rural and urban areas throughout the country. More extreme gender disparity exists at tertiary level of education compared to primary and secondary education (Lasonen et al., 2005). Access to education for women is recognized as human right and gender equity is one of the priority areas for the country's education development strategy. The ESDPs that Ethiopia formulated as part of the 20 year plan has put gender parity as one of its main targets. Cognizant to this, the government designed and formulated different strategies to increase females' participation in education and other key development areas. Figures 5.6 to 5.8, based on data from the MoE Annual abstracts (1999- 2009), show the gender gap trends at different educational levels between the school years 1999/00 and 2008/09.

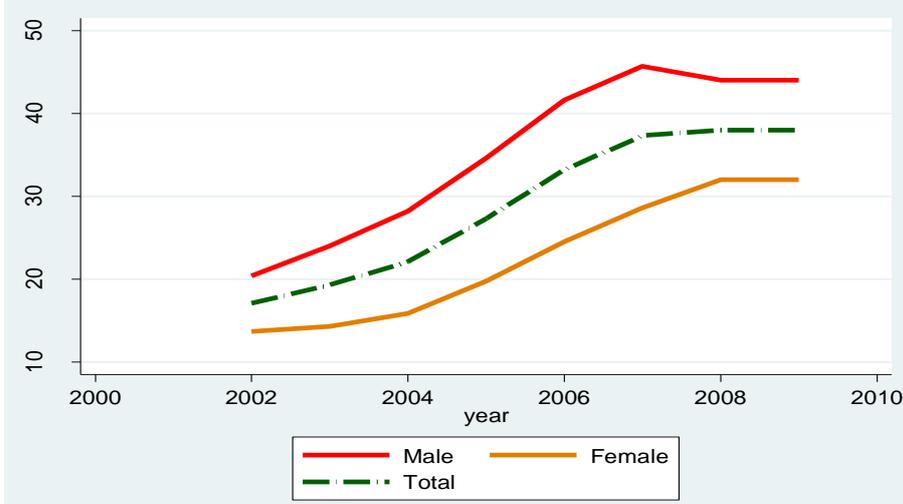
Figure 5.6: Gender gap trends in primary schools in terms of GER



Source: Data from the MoE annual abstracts, 1999/00-2008/09; and author's calculations

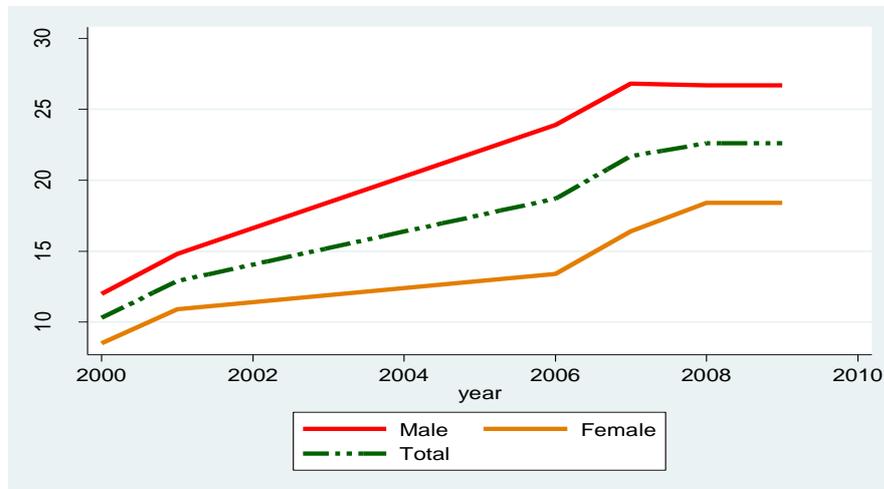
At primary level of education, the country has not only achieved an outstanding expansion in access to education but the achievement is also accompanied by a greater movement towards gender equity. Figure 5.6 above shows that the gender gap which was about 20 percentage points in 1999/00 school year has been reduced to less than 10 percentage points in 2008/09. However, the story is different for secondary level education. The gender gap has not shown any significant improvement. It rather increased for the school years 2004/05 to 2006/07 compared to the early 2000 for the first cycle secondary school (Figure 5.7). The trend is even worse for the preparatory secondary school (Figure 5.8).

Figure 5.7: Gender gap trends in 1st cycle secondary school in terms of GER



Source: Data from the MoE annual abstracts, 1999/00-2008/09; and author's calculations

Figure 5.8: Gender gap trends in preparatory secondary school in terms of GER



Source: Data from the MoE annual abstracts, 1999/00-2008/09; and author's calculations

The disparity in access to education between boys and girls is commonly measured by Gender Parity Index (GPI). GPI is the ratio between female and male values for a given indicator, which in our case is the number of female and male students at different levels of education. Despite significant shift towards greater parity at primary level, Ethiopia is far from achieving GPI of one in 1st cycle secondary and preparatory secondary education (Table 5.8). The GPI for primary education in 1999/00 was 0.67% indicating that participation of girls is by 33 percentage points lower than boys. After eight years, however, during 2007/08 school year girls' participation in the education system is only 7 percentage points lower than boys. Addis Ababa and Tigray regions have already achieved the target GPI of one during this period. For secondary education, however, the parity index has not shown any improvement. Girls' participation at the early 2000s is the same percentage points lower than that of boys as is during the 2008/09 school year. There are

about 1.4 times more boys than girls at secondary education at national level (GPI \approx 0.70). Though gender parity is low at national level, larger gaps prevail in the emerging regions compared to the other regions.

Table 5.8: GPI at national level for primary and secondary education

Year	Gender Parity Index (GPI)		
	Primary (Grade 1-8)	1 st Cycle Secondary (Grade 9-10)	Preparatory Secondary (Grade 11-12)
1999/00	0.67	–	0.71
2000/01	0.70	–	0.74
2001/02	0.71	0.70	–
2002/03	0.72	0.60	–
2003/04	0.76	0.60	–
2004/05	0.81	0.60	–
2005/06	0.84	0.60	0.56
2006/07	0.87	0.60	0.61
2007/08	0.93	0.70	0.69

Source: Data from the MoE Annual abstracts, 1999/00-2008/09; and author’s calculations
 – Data not available at time of writing

5.4.2. Educational quality and efficiency

5.4.2.1. Educational quality

While one might appreciate the progress made in expanding educational access and equity, the progress made to improve its quality is quite limited. It is very intricate for any country to maintain quality standards while achieving rapid expansion in enrollment rate. Looking forward to the rise of concerns regarding educational quality, the government has set up quality and relevance assurance agency to evaluate and monitor quality achievements, and to put standards when problems are detected. The government also recently launched General Education Quality Improvement Program (GEQIP) to improve the quality of general education (Grades 1-12) throughout the

country. The project aims to support Ethiopia's effort to improve the quality of general education through, among other things, improvements in teaching and learning conditions in primary and secondary schools as well as management planning and budget capacity of the Ministry of Education and regional education bureaus. The quality assurance package in the Ethiopian higher education is another project which shows the commitment of the government to bring quality improvement in the sector.

However, measuring educational quality is not easy since it is a relative concept. The quality of education is mainly measured in terms of teachers' qualification, student and teacher ratios, educational expenditures and students' achievement. According to the World Bank report, almost all the inputs related to indicators of quality have moved in the wrong direction. These include textbook availability, teacher-pupil ratio, section size, and per capita recurrent expenditure on non-salary budget items (World Bank, 2005).

Teachers are the main inputs in the education process. It is less likely that poorly qualified teachers produce qualified students. Though achieving universal primary education creates shortage of teachers, the target itself calls for more and certified teachers. Available data, however, suggest that a large proportion of teachers in all educational levels lacks adequate academic and pedagogical qualifications. The situation is worse at secondary and tertiary levels.

At the turn of the century, 96.6% of the 1st cycle primary school teachers meet minimum national standards, whereas only 23.9% and 36.5% of 2nd cycle primary and secondary school teachers, respectively, meet the required standard (Table 5.9). During the 2008/09 school year, 10% of the 1st cycle primary school teachers do not meet the specified national standards. This is

due to the increasing number of students going to primary school which in turn requires more number of teachers relative to the 2000/01 school year. There are improvements in the proportion of certified teachers in 2nd cycle primary and secondary schools. For instance, 71.6% of the 1st primary and 75.2% of the secondary school teachers meet the national minimum standards during the 2008/09 school year.

Table 5.9: Percentage of certified primary and secondary teachers

Year	Primary		Secondary
	Grades 1-4	Grades 5-8	Grades 9-12
2000/01	96.6	23.9	36.5
2001/02	95.6	25.5	33.7
2002/03	97.1	30.9	39
2003/04	96.5	32.1	44.5
2004/05	97.1	54.8	40.6
2005/06	98	59	49.6
2006/07	96.3	53.4	49.8
2007/08	97.3	66.3	63.9
2008/09	90	71.6	75.2

Source: Data from the MoE Annual abstracts, 1999/00-2008/09; and author's calculations

The following table illustrates the proportion of certified male and female primary and secondary teachers at regional level in 2008/09 school year. Besides the unequal distribution of certified teachers among education cycles, the distribution is also uneven among the regional states. The less developed regions receive less proportion of certified teachers in particular at 2nd cycle primary and secondary schools. While the percentage of certified teachers in Tigray, Addis Ababa, Dire Dawa, and Amhara is well above 60% at 2nd cycle primary and above 80% at secondary schools, it is the lowest in Somali and Gambella regions. For instance, only 1.9% female and 4.5% male 2nd cycle primary school teachers are qualified in 2007/08 school year in the Somali region.

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Table 5.10: Percentage of certified primary and secondary school teachers by regions and gender in 2008/09

Region	1 st cycle primary (1-4)			2 nd cycle primary (5-8)			Secondary (9-12)		
	Male	Female	Total	Male	Female	Total	Male	Female	Total
Tigray	93.7	94.4	94.1	79.7	83.8	80.9	89.5	86.4	89.1
Afar	55.9	70.8	61.7	57.5	50.8	56.3	79.4	71.4	79.1
Amhara	97.8	98	97.9	61.5	73	65.2	83.2	77.6	82.4
Oromiya	91.1	93.2	92	66.2	83.6	71	64.1	64.9	64.1
Somali*	91.6	91.7	91.6	4.5	1.9	4.2	33.1	0	32.4
BenGumuz	95.1	97.4	96.1	43.6	26.9	40.2	75.7	55.3	74.3
SNNP	87.4	90	88.3	86.1	88.2	86.6	72.7	74.3	72.9
Gambella	95.7	93.1	95.1	62.3	59.1	61.8	44	37.5	43.8
Harrari	84.2	89.4	86.9	65.9	47.8	59.6	72.7	72	72.7
Addis	23.5	35.4	30.2	67.2	47.8	60.7	85.4	84.9	85.3
Dire Dawa	67	65.4	66.3	68.9	57.8	66.3	89.1	85.7	88.8

Source: Data from the MoE annual abstracts, 1999/00-2008/09; and author's calculations.

*2nd cycle primary data is for 2007/08 school year

Average class size is another gauge for educational quality. The large class size observed in the Ethiopian education system at all levels is obviously not conducive for apposite teaching-learning process. Though the national standard pupil-teacher ratio (PTR) is 50 for primary and 40 for secondary education, the increment in enrollment rates has made the standard far from realization. Likewise, the pupil-section ratio (PSR) can be taken as a quality indicator. In reality there are often 100 students for one teacher in a class. Table 5.11 shows that both PTR and PSR have been increasing in all levels in the last decade with a bounce back in recent years.

Table 5.11: Pupil-teacher and pupil-section ratios for primary and secondary schools, 1999/00 to 2008/09

Year	Pupil-teacher ratio		Pupil-section ratio	
	Primary (1-8)	Secondary (9-12)	Primary (1-8)	Secondary (9-12)
1999/00	56	43	66	75
2000/01	60	46	70	78
2001/02	63	49	73	80
2002/03	64	45	73	77
2003/04	65	48	74	79
2004/05	66	51	69	78
2005/06	61	54	69	82
2006/07	59	48	64	79
2007/08	57	43	62	74
2008/09	54	41	59	68

Source: Data from the MoE annual abstracts, 1999/00-2008/09; and author's calculations

Besides the above enrollment figures, it is important to probe other education quality indicators like students' achievement in education. According to Lasonen et al. (2005), on average, 72% of the girls and 58% of the boys in Addis Ababa secondary schools score a Grade Average Point (GPA) of 1.8 or lower in a 4.0 scale grading system in 2001/02.

As much expanding access to education is important, raising its budget share is equally crucial. Since the education system is at its early stage, it is predictable that its financial requirement grows. Educational quality is strongly associated with education expenditure. There are only modest facilities in most of the Ethiopian schools. Most of the schools do not have water and proper latrines let alone counseling and clinic services. Based on data from MoE, aggregate national public expenditure on education rose from 1.4 billion birr in 1995/96 to 11.3 billion birr in 2008/09, which is an increase of

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8.2 times in 15 years. This is composed of a proportional increase in both public recurrent spending and capital investments. The general education budget share from the total public spending has increased from about 14.5% to 23.6% during this period. Several other factors directly or indirectly determine educational quality. Availability of student text books, teaching materials, clean water, and good teachers' working conditions are only few to mention.

The above facts show that achievements in expanding access have not been accompanied by adequate improvements in quality. In many areas we observe a declining trend in education quality indicators following the expansion in access. For instance the 2007 National Learning Assessment (NLA) for grades 4 and 8 revealed that performance of students has deteriorated in the expansion period. According to the NLA the composite scores in grades 4 and 8 have declined to 41% and 37% respectively in 2007 compared to the corresponding scores of 48% and 41% during 1999/00, the baseline assessment period. Table 5.12 below compares mean scores of grade 4 and grade 8 students for two subjects and their respective composite scores based on three national assessments.

Table 5.12: Comparison of mean scores between three NLAs

	2000	2004	2007
Grade 4			
Maths	39.3	39.7	40.3
English	40.5	38.7	36.5
Composite score	47.9	48.5	40.9
Grade 8			
Maths	38.2	40.9	34.1
English	38.7	41.1	38.4
Composite score	41.1	39.7	35.6

Source: MoE

The following table hints at the progress in educational quality improvement during the third phase of the ESDP. One can observe from the table that almost all of the quality indicators pointed out below have not been met at the end of the third ESDP. For instance, the status of the percentage of primary and secondary qualified teachers and the pupil to section ratios is a lot lower than the target set for the period. The educational budget share is probably the only quality indicator which met its target level. The explanation for this slow educational quality improvement might be, among other things, too ambitious target, too much focus on increasing access at the cost of quality, poor management in the sector or lack of financial capability.

Table 5.13: Progress in educational quality indicators during the last five years (2004/05-2008/09)

Indicator	Beginning of ESDP III (2004/05)	Status at 2008/09	Target set for ESDP III (2008/09)
Primary Pupil Teacher Ratio	66	54	50
Secondary Pupil Teacher Ratio	51	41	40
% of Qualified Teachers (Grade 1-4)	97.1	90	99.8
% of Qualified Teachers (Grade 5-8)	54.8	71.6	95
% of Qualified Teachers (Grade 9-12)	40.6	75.2	88
Primary Pupil Section Ratio	69	59	50
Secondary Pupil Section Ratio	78	68	50
Primary Drop Out (Grade 1), %	22.4	22.9	9.5
Repetition Rate (Grade 1-4), %	3.8	6.7	2.3
Repetition Rate (Grade 5-8), %	5.3	8.0	2.93
Education Share of the National Budget (%)	16.7	23.6	20.20

Source: MoE

The rapid expansion of the educational system has also left a considerable financing gap between available funds and the anticipated cost of investments

needed to improve and maintain quality. Based on the MoE report, the indicative budget for the ESDP III was Birr 53 billion, but the budget provided for in the Plan for Accelerated Sustained Development to End Poverty (PASDEP) was short of this amount by Birr 16 billion (MoE, 2006). Moreover, about 90% of the recurrent budget in the general education is allocated to teachers' salaries. This has the effect of holding back the accessibility and availability of resources for other inputs critical to support effective teaching and learning (e.g., training, textbooks and other materials, assessment, monitoring and evaluation systems, etc.) to boost learning outcomes. Another problem in the education sector is the fact that the capacity to plan, manage, evaluate and monitor is weak in the sector. Based on the approval from the MoE, it is the responsibility of regions and woredas to manage and finance primary and secondary education in the country. Weak institutional capacity, inadequate strategic planning and management capacity, and limited monitoring and evaluation system in regions and woredas made the quality improvement process in the sector highly challenging.

After reviewing the progress in the overall educational sector performance within the ESDP framework, the government has recently given high emphasis and priority to quality improvement at all levels of education. Cognizant of this fact, the government launched GEQIP with strong emphasis on the general education (grade 1-12) in all the 9 regions and in the 2 city administrations. GEQIP takes a holistic approach to improve the quality of general education by adapting the concept of the school effectiveness model (World Bank, 2000). The school effectiveness framework is particularly suitable for GEQIP given the politically and fiscally decentralized structure of the Ethiopian educational system, paired with the government's recent efforts to implement a broad sector reform to improve the quality of education through a set of integrated interventions. GEQIP is expected to be implemented in two phases over a

period of eight years through an International Development Association (IDA) financed Adaptable Program Loan (APL). While the first phase which covers the period 2009-2013 is currently underway and is focusing on setting standards and foundations for quality improvement reforms, the second phase will have a duration of four years (2013-2017) and will scale up the program to have full coverage and scope.

The GEQIP has basically six components to achieve during the stipulated period. These include the implementation of teacher development program that includes the English proficiency improvement program as a sub-component; curriculum, textbooks and assessment; management and administration program with a sub-component of education management information system; school improvement program with a school grants sub-component; civics and ethical education; and information communications technology. The GEQIP gives emphasis to quality reforms such as new curriculum implementation, textbook development and provision, school grants to enhance school-based development reforms, as well as institutional development at the federal, regional and woreda levels. In general the GEQIP intervention concentrates on two broad categories. On the one hand the GEQIP focuses on quality improvement for general education through a curriculum reform for Grades 1-12 in all subjects, followed by the provision of textbooks and teacher trainings compliant to the designed curriculum. The other major emphasis is on capacity development to effectively plan, manage and monitor service delivery at the federal, regional, and woreda levels. This second category works to improve the institutional quality and planning and management capacities of regions and woredas involved in the education sector at different parts of the country.

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The government proposes to track progress of the program against set indicators. Many of the indicators are proposed to be captured through the regular education management information system database, and some others through a periodic NLA which is conducted in a sample of schools. However, there is limited data collected on the teaching and learning processes that occur in the classroom. Even though the resulting effects/impacts on quality of the GEQIP are to be seen in the meantime, it is expected that the implementation of the program will be highly challenging. For instance, it does not seem appropriate to frequently change educational curriculums in poor countries like Ethiopia since it has social, educational and economic implications. Moreover new curriculum means new textbooks which leads to wastage of a huge amount of money spent on existing textbooks, and spending huge amounts of money for new textbooks which could be allocated for other quality improvement projects. For that matter the estimated cost of new textbooks for the GEQIP is above \$140 million. Related to this is the implementation problem in distributing the textbooks compliant to the new curriculum to the schools throughout the country. There are occasions in which some primary and secondary schools in emerging and far-away regions do not get the new textbooks some three or four years after the other schools in the country.

The GEQIP, if properly implemented, can bring substantial impact on education quality in the country. However, there are a lot of potential challenges that may appear in the project's implementation process. The scope of the first phase of the GEQIP is very ambitious and complex, requiring effective coordination and implementation capacity at each level of government. Weak planning and implementation capacity; poor coordination between the different government levels; lack of incentives of different implementing agents to efficiently work for the project; and the large number

of institutions handling the project by itself are some of the issues that make the implementation and effectiveness of the program more challenging. Since the Ministry of Education (MoE), Ministry of Finance and Economic Development (MoFED), Regional Education Bureaus (REBs), Bureaus of Finance and Economic Development (BoFEDs), Woreda Education Office (WEO), Woreda Office of Finance and Economic Development (WoFED), and individual schools are involved in the project implementation process, the substantial capacity gap between these institutions will be an obvious impediment for the effectiveness of the program. Moreover, since the GEQIP does not provide support for the improvement and expansion of infrastructure for primary and secondary schools, poor physical conditions are likely to be a major risk for the achievement and sustainability of the project's development objective. Since GEQIP is a multi-donor project harmonization and donor coordination issues are other potential challenges that might appear in the implementation process. Notwithstanding these challenges, the program is capable of bringing significant improvement in the quality of the country's general education.

5.4.2.2. Educational efficiency

Educational efficiency is another concern that the ESDPs give emphasis to. Efficiency is commonly measured through students' dropout rates and repetition of classes. Educational efficiency is highly correlated to quality. For instance, high student drop-outs are experienced in the lower grades when the class size is very large. High drop-outs and repetition rates imply inefficiency and wastage of resources, and this is a major problem in developing countries like Ethiopia.

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Table 5.14 describes the national repetition and drop-out rates for primary education for the period 1999/00 to 2008/09. The repetition rate has increased in the last five years. During this period, slightly more boys than girls repeat the same grade for more than one school year. However, the gender difference in repetition rates has a declining trend except for the recent two years. For instance, 7% of the boys and 6.7% of girls remain in the same grade for more than one school year in 2008/09. The table also shows that a significant number of students do not achieve a passing grade, nor do they have a grade required to remain in the same grade. Although there has been a slight improvement in drop-out rate during the last decade, about 15% of the students left formal schooling in 2008/09 school year. The drop-out rate is slightly higher for boys than for girls during the review period.

Table 5.14: Repetition and drop-out rates at national level from 1999/00 to 2008/09

Year	Repetition rate			Drop-out rate		
	Male	Female	Total	Male	Female	Total
1999/00	7.0	10.1	8.2	—	—	17.8
2000/01	8.4	11.5	9.7	16.2	16.3	16.2
2001/02	8.6	11.7	9.9	16.7	17.8	17.2
2002/03	5.9	7.7	6.7	19.8	18.5	19.2
2003/04	3.6	4.0	3.7	14.9	13.6	14.4
2004/05	3.8	3.7	3.8	12.3	11.3	11.8
2005/06	6.4	5.7	6.1	12.6	12.1	12.4
2006/07	6.6	5.7	6.1	13.1	11.6	12.4
2007/08	7	6.3	6.7	15.9	13.2	14.6
2008/09	7	6.3	6.7	15.9	13.2	14.6

Source: Data from the MoE annual abstracts, 1999/00-2008/09; and author's calculations

It is expected that educational efficiency is closely related to the quality measures. The simple statistical associations of primary school repetition and

drop-out rates to some of the measures of educational quality are described under Annex 4 to 7.

5.5. Conclusions

Although the beginning of modern education is related to the influx of overseas missionaries in the 19th century, Ethiopia has a long and rich history of indigenous education. There was a comprehensive scheme of education established by the Ethiopian Orthodox Church since about the 4th century. It was, however, during the turn of the 20th century that Emperor Menelik introduced secular education to the country. Though it was in a lethargic pace, modern education continued to expand during the Haile Sellassie and the communist governments.

The education sector was suffering from multifaceted problems when the current government took power in 1991. The government attempted to address the problems by devising educational and training policy in 1994. Fifteen years after the education and training policy was launched, we observe remarkable achievements in many aspects of education. There has been an outstanding achievement in the aggregate enrollment rates at all levels of education during the recent years. Measured in terms of GER, many regional states have already achieved universal primary education. The expansion in access to education (especially primary education) has also been accompanied with greater movement towards gender parity during the last decade. For instance, the gender gap in terms of access to primary education has been reduced by 20 percentage points between the years 1999/00 and 2007/08. Although the achievements are not as imperative and even deteriorated in many aspects, extensive effort has also been made to deal with educational quality and efficiency. The most notable and recent effort by the government

is the General Education Quality Improvement Program (GEQIP). With an overall objective of improving general education (grades 1-12) throughout the country, GEQIP addresses many other specific and quality-related issues. Curriculum reform for grades 1-12 for all subjects and development of planning, managing and monitoring capacities of participating institutions are only two specific objectives of the program. Passing through a lot of potential challenges GEQIP is expected to bring substantial improvement to the deteriorating quality of the general education throughout the country.

Despite the notable achievement in the educational sector under the Ethiopian People's Revolutionary Democratic Front (EPDRF) government, a number of problems do still exist mainly due to lack of material and human resources. There are still millions of children who do not go to school. Enrollment rates have not grown in balance with the growth in the relevant age group. Regional and gender disparities do still persist. A large number of slum children, children with special needs, HIV/AIDS orphans, and in general the children of the urban and rural poor are at high risk of dropping out of school. A large number of dropping out students result in low percentage of students completing primary school. These high drop-out and repetition rates lead to inefficient use of the country's scarce resources. And still Ethiopia's literacy, women's inequality, access to education, educational quality and efficiency are below the averages of the other sub-Saharan countries.

The task of availing quality education to all is a very challenging endeavor for the government to attempt to achieve on its own. The government should continue engaging and encouraging the private sector to play its role in the sector. In particular educational policies and directives should be consistent, predictable and participatory of the private sector. If such policies and directives are sudden and inconsistent, they will negatively influence the

private sector's decision regarding long-term planning, investment and commitment. Policies should build the confidence of investors in the sector to commit their capital, energy and time for the improvement of the sector.

To bring the desired educational quality in Ethiopia, due attention must be given to integrating effective incentive mechanism in the system. The willingness and full participation of students and teachers in particular is vital. Therefore, the government and other stakeholders must pay due attention to motivate students and teachers to commit themselves to the betterment of education in Ethiopia and to work hard towards this goal. The incentive for students may be in terms of future prospects, financial support (university scholarship, cost-sharing exemption, etc.) as well as national and regional awards that give them recognition. Teachers on the other hand could be given motivation based on their performances, including but not limited to financial benefits, improvement of their living standards in the form of better pay as well as other social benefits (such as health, priorities in further studies, tax exemption, cost-sharing exemption benefits for their children, etc.)

PART II

FINANCIAL SECTOR DEVELOPMENT IN ETHIOPIA: PERFORMANCE, CHALLENGES AND POLICY ISSUES

Summary

The financial sector is one of the building blocks of a national economy. Efficient functioning of this sector is crucial for lubricating the real sector of the economy. The role of the financial sector is especially more pronounced in developing countries as it has to be innovative enough to finance development projects. This requires the efficient flow of resources, ideas and incentives in a well functioning policy framework and institutions. Over the years the technology and performance in global financial system have tremendously grown making the financial markets the most dynamic markets signaling incentives to the rest of the economy.

The financial sector in Ethiopia is dominated by the banking sector. Currently there are over 13 commercial banks operating in the country, ten of which are private banks. Despite the long history of banking industry in the country, the sub-sector is not dynamic as it should be and financial products provided by the banks are archaic, traditional and not differentiated. Although the insurance industry is equally old, the industry has yet to meet standards in terms of serving as a mechanism for risk management. Given the depth and intensity of poverty in Ethiopia, micro financing is one of the ideal tools for securing livelihood and fighting poverty. Micro financing in Ethiopia have transformed significantly over the last two decades. However, the industry still

serves only 3 percent of the population. Improving the coverage and services of microfinance institutions remain as a crucial challenge.

The following chapters of the report (Chapter Six to Nine) deal in depth with the role, structure and state of the financial sector and identify core issues for policy intervention.

Chapter six covers the overall position of the financial sector in the economy by assessing the share of financial intermediation to GDP, its employment creation and contribution to government revenue. The results show that the share of financial intermediation to GDP has been increasing sharply since 1992 following the liberalization of the economy. Value added by the financial intermediation accounted for 2.4 percent of GDP and 4.4 percent of growth in GDP for the period 2005/06 – 2009/10. The employment creation by the sector has been growing significantly most importantly due to the expansion of the private financial institutions. The banking sector alone employs close to 20 thousand workers in 2009 followed by micro-finance institutions with 9,472 workers. The insurance sector employs close to 3000 people by 2009.

Chapter seven reviews the policy aspects by covering the monetary policy framework in the country. The objectives of monetary policy in Ethiopia is price and exchange rate stability and the central bank (National Bank of Ethiopia) targets reserve money as an operating target and broad money supply as an intermediate target. However, due to underdeveloped financial markets in the country, the indirect monetary policy instruments have not been functional. This has led the Bank to resort to direct monetary policy instruments like bank by bank credit ceiling since 2009 in an attempt to curb high inflation. This policy option has been criticized for being distortionary.

Assessment of the different components of the financial sector is made in Chapter Eight by taking industrial organization analysis tools including assessment of the structure, concentration, conduct and performance issues. In addition the infrastructure, technology, product offering, manpower in the different sub-sectors have been assessed.

The banking sector in Ethiopia has grown significantly over the last two decades. Currently there are 13 Banks with a total of 666 branches. This contrasts to only 3 banks and 181 branches in early 1990s. There are still significant gaps in some respects that should be filled by the sector to meet even the African standards. The current government has taken a number of measures to liberalize the banking sector that has resulted in the formation of private banks since 1996. The sector is however very much dominated by the state owned Commercial Bank of Ethiopia that holds well over half of the assets in the sector. In some areas, however, the government banks are found to be more efficient in allocating financial resources than the private banks. The government banks have dual objectives of profitability and developmental focus. Bank concentration ratio is higher than Sub-Saharan African average. Most of the loans given out by banks are collateralized and this has to be improved to expand outreach. This can be done by building the capacity of banks to understand inherent risks in the different sectors especially rural or agricultural sector. Focusing on building financial infrastructure and technology is another area to be explored by banks. On the regulatory front building systemic fitness to eventually allow the entry of foreign banks should be given priority. Low competition in the sector was probably the reason for the limited products in the sector. Enhancing competition in the sector would help in introducing new products in the sector.

The results of the analysis of the insurance sub-sector show that insurance services are very limited in the country covering only 0.1 percent of the population. The services in the sector are elitist with motor vehicle insurance taking the large proportion of all insurance services. There are problems designing and providing insurance products for low-income households. Awareness creation and education about insurance is another necessary issue that needs to be taken up by the insurance sector in addition to designing appropriate insurance products to lower echelon of the society. The assessment stresses the importance of micro-insurance for agricultural producers in the rural areas. So far other than the credit provided by Micro-finance institutions micro-insurance has not been done except for some attempts by few insurance companies and some micro-finance institutions. This, of course, requires appropriate legal and regulatory framework that the National Bank should work on.

Assessment of deposit taking microfinance institutions is made across time in comparison to some Sub-Saharan African countries. Normally, microfinance institutions face higher risk when compared to commercial banks. Therefore, the sector requires prudential regulation. In Ethiopia a rather more restrictive prudential regulation is put in place on micro-finance institutions. In spite of such restrictive regulations, growth of micro-finance institutions in all aspects is tremendous. In value of assets these institutions now outperform the insurance sub-sector. Products currently provided by these institutions include, loan, savings, micro-insurance (at a small level), and money transfers. Since there is vast demand for the services of micro-finance institutions, they provide supply driven services. Although there is lack of fierce competition among the institutions, their financial performance operational efficiency and profitability have improved over the years. However, there is still a need to diversify products provided by micro-finance institutions.

Starting from the Imperial regime there have been different policies and frameworks to establish and guide financial cooperatives in the country. Financial cooperatives are critical institutions to address the financing needs of particularly excluded groups and to reach grassroots level of the society. In the development strategy of the country, financial cooperatives are expected to provide financial services to the poor by linking up with the formal banks and micro-finance institutions. Financial cooperatives are playing a significant role in imports of fertilizer to the farmers. Food security project funds are also channeled through these financial cooperatives. Primary products of financial cooperative include savings. Loan access is usually available after a year of membership in a saving and Credit Cooperative through savings. In 2010, a total of close to 720 thousand members participate in both rural and urban cooperatives. Urban members accounted for 55 percent of total members. This is something to be improved as most of the population resides in the rural areas. Establishing cooperative banks and federation of financial cooperatives would help addressing the institutional problem of accessing more finance and helps in improving regulations.

The Chapter also identifies missing markets, institutions and products in the financial sector. Highlighting the importance of a modern financial sector, it can be seen that product development is something that is deficient in the different components of the financial sector. Different products including certificate of deposit, repurchase agreement, commercial paper, consumer lending and mortgage loans and other financial derivatives such as futures and options are identified to be missing in the financial market in Ethiopia. In identifying pre-requisites for a well-functioning financial sector, market based prices, proper legal and policy frameworks, expanding investor base, macro-economic stability and establishing relevant institutions are deemed to be important.

Chapter nine investigates the relationship between money and growth. A robust estimation reveals that stability is compromised by economic growth and that monetary growth has contributed to the instability in the economy as shown by the high inflation. There is, however, a positive relationship between money growth and economic growth. The result points out that growth and stability decisions should be made optimally so as to sustain growth in the framework of stability. The implication to the financial sector is that financial institutions should finance long term development projects beyond financing short term trade.

Chapter 6

Overview of the Financial Sector

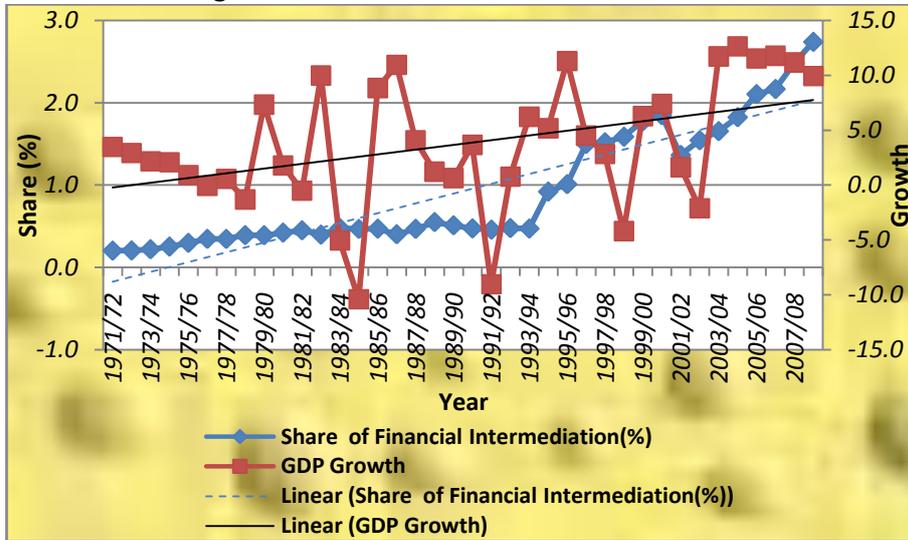
6.1. The contribution of the financial sector to GDP, employment and government revenue

Apart from its role as a lubricant to the Ethiopian economy, the financial sector contributes to the economy through employment creation, increasing government revenue and value added in the GDP. This section of the report attempts to review the importance of the financial sector.

6.1.1 Contribution of the financial sector to GDP

As part of a modern service sector in the economy, the financial sector (the financial intermediation services in the national accounts) in Ethiopia has contributed to the value added in the economy. The value added GDP of this sector is estimated from the financial statements of the institutions which includes the actual service charges (including actual and imputed service charges). According to the data obtained from the Ministry of Finance and Economic Development, the structure of value added of the Ethiopian financial sector has grown significantly in the past decade.

Figure 6.1: Share of financial intermediation in total value added GDP and GDP growth



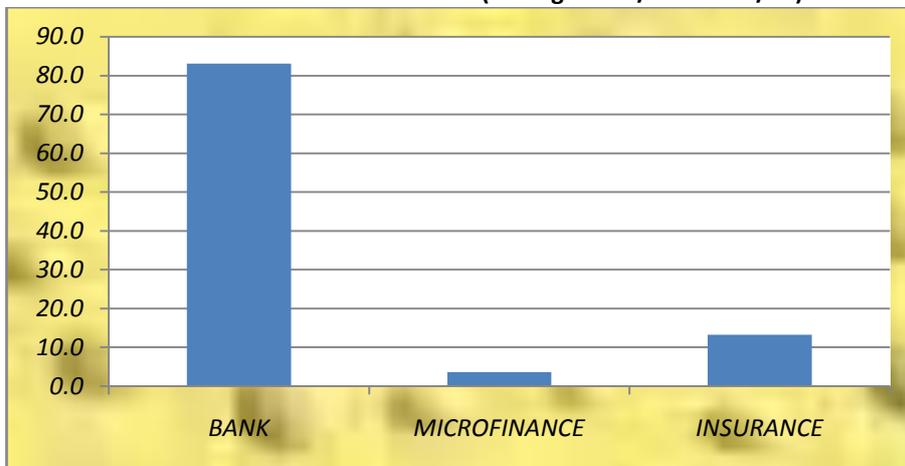
Source: MoFED

As illustrated in Figure 6.1, the share of financial intermediation in total value added (when seen inter-temporally) has increased since 1992. The positive trend is the result of a shift of policy towards a more market-oriented economy where financial intermediation finds a significant role. The share of the sector declined only in 2002/03 when there was a general slowdown in the macro-economic performance of the economy because of the drought during the year. Figure 6.1 reveals that the value added of the financial sector is closely linked to the activities and growth of the real sector, expressed in GDP growth. This indicates, without showing causality, that with the growth of the economy, the value added of the financial sector in Ethiopia has been increasing much faster. The detailed relationship between the financial sector and growth will be dealt with in the 9th Chapter.

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Regarding the components of the sector, the banking sector accounts for 82 percent of total value added of the financial sector (Figure 6.2). This is followed by insurance (13 percent) and micro-finance institutions (3.6 percent). For an economy with a massive agricultural sector, the outreach of the micro-finance should take a significant portion of the value added in the financial sector. Although there has been a significant improvement in terms of performance and outreach of the micro-finance sub-sector, its share still remains low. Moreover, urban biased delivery of financial services is observed, particularly in banking and insurance sub-sector.

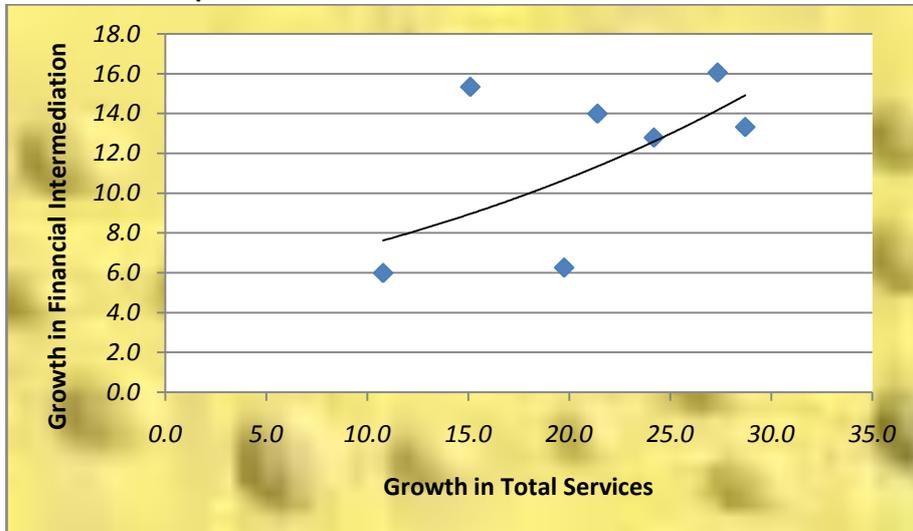
Figure 6.2: Share of the components of financial sector in total value added of financial intermediation (average 1995/96 – 2005/06)



Source: MoFED

The growth of the financial sector has been strongly related to the growth of the real sector, particularly agriculture. Figure 6.3 indicates that the output of financial intermediation services are directly related with the growth rates of the different sectors or growth of total service.

Figure 6.3: Scatter plot relating the output of financial intermediation with output of total services



Source: MoFED (own computation)

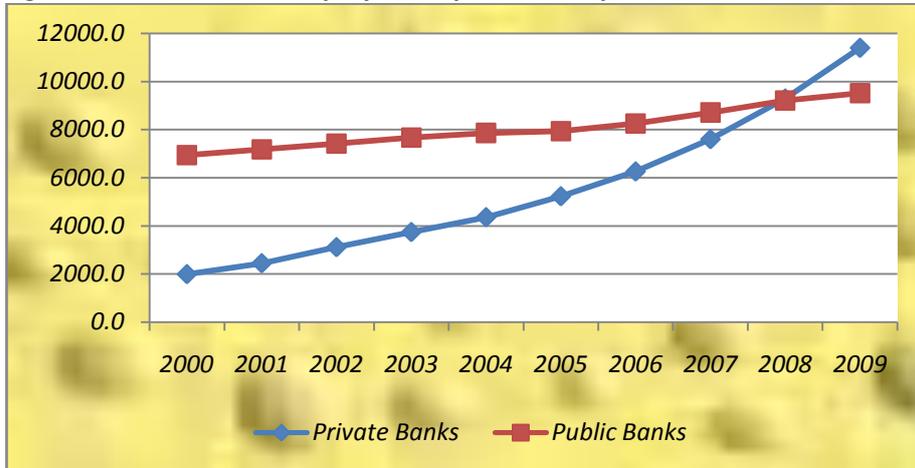
6.1.2 Employment creation

The number of people being employed by the financial sector has increased significantly in the last ten years (Figure 6.4). The increase in employment has been the result of branch network expansion of both government-owned and private banks, insurances and micro-finance institutions. However, since most of the private banks are at their takeoff stage, their fast expansion in branch networking has contributed to the increase in employment creation compared with the public banks. Although employment in the financial sector has been increasing substantially, the number of people engaged in financial intermediation services is only 0.2 percent of the total employed persons in Ethiopia (CSA, 2005 labor force survey). It should be also noted that, due to

limitation of data, the contribution of the cooperatives to total value added, employment, and government revenue is not included in the analysis.

Banking sector: *The growth in employment in the banking sector has been significant. Employment in the banking sector increased from 8,936 in 2000, to 20,906 by the end of 2009. It has increased at an average rate of 10 percent per annum. In 2001, publicly owned commercial banks accounted for 77 percent of the total employment of the banking system. In 2009, the share of publicly owned commercial banks in terms of employment creation reduced to 45 percent, which indicates the significant increase in the contribution of the private commercial banks (in terms of branch networking and employment expansion). Even though the private banks have relatively smaller assets compared to the publicly owned banks, they have provided more employment compared to public banks. The contribution of banks in terms of employment is very much linked with the expansion of branch networking. Although private banks are at a nascent stage of development in Ethiopia, their growth is expected to be much faster in terms of financial indicators in the coming years. Obviously with opening of new private banks and expansion of branch network, they will employ more people in the near future. It is also important to note that employment by publicly owned banks has shown an increasing trend, at lower pace (Figure 6.4).*

Figure 6.4: Number of employees in private and public banks



Source: Different annual reports of Commercial Banks

Since 2000, the number of employees of private banks grew, on average, by 21%, while that of the public banks grew by only 3 percent. The number of branches of these category of banks remained relatively the same in the last ten years. This has a direct implication on the growth of employment and employment creation of public banks. For example, in June 2010, the largest bank, Commercial Bank of Ethiopia (CBE), had only 209 branches. However, in the last four months, August – December 2010, CBE opened 94 new branches. The new strategy of branch expansion will have a direct impact on employment creation.

Insurance: As of June 30, 2010, the total number of people employed in the insurance sector has reached 3,099 persons. Out of the total employment, the Ethiopian Insurance Company S.C. takes the lion’s share, accounting for 40 percent of the total employment creation in the insurance sector. Similar to

that of the banking sector, the number of employees is directly related to branch expansion of insurance companies.

Micro-finance: Although there is relatively little information (like that of the insurance sector), the Association of Ethiopian Micro-finance Institutions (AEMFI) has regularly collected information on 23 micro-finance institutions (MFIs), out of the existing 30 MFIs. Employment created by the 23 micro-finance institutions reached 9,472 persons. The growth in employment generation has increased significantly by 21 percent in 2007 and by 10 percent in 2009. However, the four MFIs account for 75 percent of the total employment creation in the sector, indicating that there are giants in the sector. Out of this, the largest MFI, namely Amhara Credit and Saving S.C (ACSI), accounts for 28 percent of the total employment creation (with close to 2500 employees) at the end of 2008. This is followed by Dedebit Credit and Saving S.C (DECSI) accounting for 19 percent of the employment in the micro-finance sector.

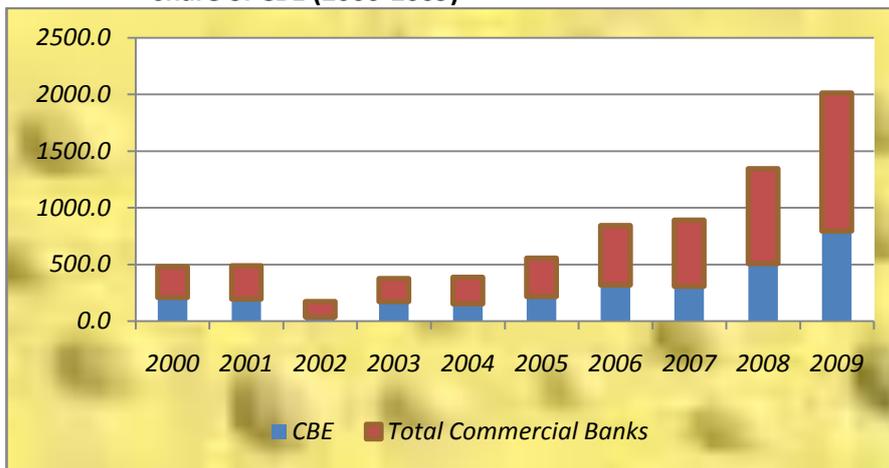
6.1.3. Contribution to government revenue

The primary contribution of the financial sector to government revenue is through taxes. Tax payment by the banking system has increased dramatically over the past ten years. There are different types of taxes that banks pay to the government. Since banks are share companies, they are subject to double taxation. First they pay business profit taxes on their profits and secondly the shareholders pay taxes when they receive dividend. Moreover, employees of all financial institutions pay income tax to the government on monthly basis.

Although the data for profit taxes that banks and other financial institutions pay are easily accessible, the data on income taxes of both employees and

shareholders are estimates. The income tax on employees of financial institutions is estimated by taking an average income tax rate applied on the salaries and benefits of their employees. However, this has a problem of aggregating the tax payments while ignoring what part of the income is taxable by how much. The data on the income tax of shareholders from dividends are estimated by assuming a fixed percentage of the total dividends paid by the commercial banks.

Figure 6.5: Trends in total profit tax payment by commercial banks and the share of CBE (2000-2009)



Source: The National Bank of Ethiopia

Figure 6.5 shows that publicly owned banks, compared with private banks, contributed a significant proportion of the profit tax paid by financial institutions. CBE alone has contributed, on average, 62.3 percent of the total profit tax collected from the sector since 2000. However, the share of CBE declined from 76 percent in 2000 to 65 percent in 2009.

Chapter 7

Monetary Policy in Ethiopia

Monetary policy refers to actions taken by a central bank to manage liquidity in the financial system in an effort to achieve a certain stated goal. In trying to manage liquidity central banks may employ direct or indirect methods. Most central banks around the world have increasingly resorted to using indirect methods of liquidity management as opposed to direct ones. The transition from using direct methods to indirect ones has not been easy in countries where the level of development of the financial system is low as the level of development of the financial system in an economy highly influences the extent to which indirect methods of liquidity management are employed.

The financial system in Ethiopia is underdeveloped. Even if more than a decade has passed since the financial sector was opened up to the private sector state-owned institutions still dominate the sector. The role of informal financial institutions has also remained to be very significant. In general, the financial sector is characterized by very limited number and rudimentary type of institutions and products. Given this state of the financial sector it is obvious that the conduct of monetary policy would be very challenging.

This chapter focuses on examining the conduct of monetary policy in Ethiopia. For this purpose, attempts are made to look at the objective of monetary policy and the instruments against the defined targets. The report assesses the effectiveness of monetary policy and the challenges for effective monetary policy conduct. Before going into the discussion of the conduct of monetary

policy in Ethiopia, there is a need to provide a brief conceptual framework of monetary policy.

7.1. Framework of the monetary policy

Different central banks have stated different objectives for their monetary policy. The objectives of monetary policy have included price stability, promoting growth, achieving full employment, smoothing the business cycle, preventing financial crisis and stability of interest rate and exchange rate. However, as a result of the growing empirical evidence on the adverse impacts of a sustained and volatile inflation rate on the decisions on investment, saving and economic growth, the objective of low inflation has been accepted as the primary objective of central banks (Khan, 2010).

Aside from the general objectives of their monetary policy, central banks also set targets that would help them achieve their objectives. Although achieving the targets is not an end by itself, central banks, at the end of the day, are expected to achieve price stability, growth, full employment, reduction of inflation, etc. Monetary policy targets are of two types: intermediate targets and operating targets. Intermediate targets are variables that affect the ultimate objective of monetary policy but are not under the direct control of the central bank. In contrast, operating targets are variables that are under the control of the central bank, which are closely related to the intermediate target.

The most common intermediate targets used by most central banks include monetary aggregates such as money supply or some credit aggregate and exchange rate. The use of monetary aggregates as intermediate targets for monetary policy assumes that there is a predictable relationship between

money supply and inflation which is the final objective of monetary policy. The basis for using monetary aggregates as an intermediate target is the quantity theory of money which holds only if there is a stable demand for money. However, the fact that demand for money has been found to be unstable in many countries means that the usefulness of monetary aggregates as intermediate targets for monetary policy is limited. Moreover, finding an appropriate measure of money which is closely related to economic activity and prices has become difficult because of financial liberalization and innovation. As a result, many central banks especially those in advanced economies have significantly reduced the use of monetary aggregates as an intermediate target.

The exchange rate may also serve as an intermediate target for monetary policy. In this case, the central bank pegs the nominal exchange rate to the currency of a country with low inflation or to a basket of currencies. The advantage of an exchange rate target is that it provides a clear and easily monitored anchor for price expectations. However, it severely limits independence of monetary policy as the pursuit of other objectives using monetary policy would be restricted. Maintaining fiscal discipline is also very crucial if an exchange rate target is to serve as an effective monetary policy anchor. Lax fiscal policy threatens the sustainability of the exchange rate peg by creating inflationary pressures which would lead to current account imbalances.

Operating targets employed by central banks can either be reserve money or a short-term interest rate. The choice between a reserve money target and an interest rate target depends on the level of development of the financial system. In the absence of a well developed financial market, finding reliable information on prices of financial products is very difficult. Moreover, in poorly

developed financial markets, the linkage between short-term rates and monetary aggregates and inflation is not clearly understood. Thus, in such situations, setting a reserve money target may be the preferred option (IMF, 2005).

Central banks use monetary policy instruments to affect their operating target. Monetary policy instruments can be broadly categorized as direct and indirect instruments. The use of direct instruments involves giving instructions to commercial banks on their deposit and lending activities. Administrative setting of interest rates, bank-by-bank credit ceilings and directed lending are the most common types of direct monetary policy instruments. Although direct instruments can be highly effective, they create distortions in the economy including financial repression and they also promote financial disintermediation.

Indirect monetary policy instruments, on the other hand, involve the use of market-based instruments to affect commercial banks 'liquidity'. Such instruments include reserve requirements, open market operations (including central bank auctions of government or its own bills) and central bank standing deposit and lending facilities. Central banks use these instruments to inject or absorb liquidity in the financial system. Following financial liberalization measures, many countries have shifted from the use of direct instruments to indirect ones. However, the extent to which indirect monetary policy instruments are used depends on the level of development of the financial system.

Another important aspect of monetary policy is the transmission mechanism which refers to the process that links monetary policy actions to the ultimate objectives of monetary policy. The channels through which monetary policy

affects economic activity include the interest rate channel, the exchange rate channel, the asset price channel and the credit channel. The standard analysis of monetary transmission mechanism is based on the assumption of a well-developed financial system. The transmission mechanism of monetary policy in countries where the financial system is in a poor state of development is not well known (Mishra, 2010).

The fiscal policy stance of the government is also a very important aspect of consideration for monetary policy. The degree of coordination between fiscal and monetary policies heavily influences the effectiveness of monetary policy. In countries where financial markets are shallow, governments usually rely on direct financing from the central bank which creates fiscal dominance. This situation makes it difficult for the central bank to manage liquidity in the banking system using indirect instruments since its degree of control of its own balance sheet would be limited. In such cases, central banks resort to using administrative measures to control liquidity. The central bank's independence in terms of setting its own monetary policy targets and using appropriate monetary policy instruments would also be compromised in a situation of fiscal dominance.

7.2. Monetary policy in Ethiopia

7.2.1. Objectives of monetary policy

In Ethiopia, the National Bank of Ethiopia (NBE) as the central bank of the country is given the responsibility of formulating and conducting monetary policy. According to the 2008 amended National Bank of Ethiopia Establishment Proclamation No. 591/2008, the main purpose of NBE is to maintain stable rate of price and exchange, to foster a healthy financial

system and undertake other related activities conducive to rapid economic development. Under these generalized objectives, NBE's more specific objectives include maintaining single-digit core inflation (defined as non-food inflation) and keeping the exchange rate of the Birr close to the equilibrium exchange rate.

From these two specific objectives, the objective of maintaining single-digit inflation is clearer and easily verifiable. However, a question arises on whether focusing on non-food inflation only is appropriate in a country where food prices account for 57% of the Consumer Price Index (CPI). The rationale for choosing non-food inflation as the objective of monetary policy is obviously based on the argument that the controllability of food inflation is less as food prices are highly influenced by exogenous supply shocks because of the heavy reliance of the country's agriculture on weather conditions. However, with food prices representing such a significant portion of the CPI, leaving food inflation out of the objective of monetary policy severely impairs the relevance of monetary policy to economic agents as economic decisions of economic agents are based on overall price levels and not just non-food inflation. Moreover, the existence of administratively set prices in the non-food CPI (e.g. fuel, electricity, water, etc.) raise further doubts on the relevance of non-food inflation as the objective of monetary policy.

The objective of keeping the exchange rate of the Birr close to its equilibrium, on the other hand, is rather vague and very difficult to verify. It is not stated in the objective how the exchange rate is defined and whether it is going to be met in the short-run or in the long-run.

Until recently, the NBE didn't have a documented monetary policy framework that shows the prioritization of the objectives of monetary policy and its

intermediate and operating targets. A monetary policy framework of the NBE was posted on its official website in February 2010. This document, however, still lacks prioritization of objectives and includes all those objectives mentioned above as the objectives of monetary policy. The intermediate target of monetary policy, according to this document, is broad money supply (M2) which is defined as the sum of narrow money supply (M1) and quasi money (saving and time deposits). In this respect, the target is to ensure that money supply growth is in line with nominal GDP growth. On the other hand, the operating target of NBE's monetary policy is stated as the growth of base money or reserve money which includes currency in circulation and commercial banks' reserves at the NBE.

7.2.2. Instruments of monetary policy

The number of monetary policy instruments that NBE has at its disposal is very limited. One of its major policy instruments is reserve requirement. NBE imposes reserve requirements on commercial banks which are not remunerated. Although, this instrument can be effective in curtailing banks' lending activities, its relevance for short-term liquidity management is extremely limited as it cannot be altered regularly in a short-period of time since doing so creates uncertainty on banks. The NBE only uses this instrument occasionally. In fact, the reserve requirement ratio was changed twice only recently from its long-time level of 5%. It was raised to 10% in July 2007 and further to 15% in April 2008 which is the prevailing requirement ratio. The NBE also imposes liquidity requirements on banks. The liquidity requirement ratio was changed only once from 15% to 25% in April 2008.

Another monetary policy instrument employed by the NBE is setting the minimum deposit rate. Although the NBE liberalized lending rates in 1998, it

has still retained its control on the setting of the minimum deposit rate. This instrument is also rarely used by the NBE. The NBE changed the minimum deposit rate only twice in more than ten years. The minimum deposit rate which was set at 6% in 1998 was lowered to 3% in 2002, raised to 4% in 2007, and currently (as of December 1, 2010) the rate was increased to 5%.

As there is no secondary market for securities in the country, the NBE doesn't have the option of using open market operations as a monetary policy instrument. The absence of a liquid and developed government securities market also limits the use of other open market type operations. The NBE considers the primary Treasury bills auction market as one of its monetary policy instruments. However, considering the shallow nature of the market, the use of the primary T-bills market as an active monetary policy instrument is highly questionable.

Recently, the NBE resorted to the use of direct monetary policy instruments in an effort to curb the inflation rate which had been rising at an accelerating rate during the past few years. It introduced a bank-by-bank credit ceiling starting from March 2008 which still remains in effect. This shows the limited capacity of the NBE to manage liquidity using market-based methods.

7.2.3. The conduct of monetary policy

Central banks have to conduct regular monetary policy operations in order to stir their intermediate targets to the desired level. In this process, the existence of a liquid and active inter-bank market, in which banks borrow and lend short-term funds, is essential as it allows the central bank to intervene in such a market and influence banks' liquidity.

In Ethiopia, an active inter-bank market is lacking. Although the NBE established an inter-bank market in a directive issued in 1998, the market has not become functional. As commercial banks are sufficiently liquid and since there is no liquid government securities market, there have been a very little number of transactions in the market since its establishment. Consequently, the NBE has not been able to use this market for the conduct of its monetary policy.

Central banks may also use standing facilities to conduct monetary policy operations. Standing facilities allow banks to deposit funds with or borrow funds from the central bank at their discretion. The use of these operations, however, is initiated by the banks and thus is not in the direct control of the central bank. In other words, the central bank cannot conduct such operations whenever it wants since the standing facilities have to be initiated by the banks. However, although the NBE doesn't have a standing facility for deposits, it has established a discount window facility for banks since 2001. This facility allows banks to access central bank funding when they face liquidity shortages. This facility has also been very rarely used by the banks limiting its usefulness for the conduct of monetary policy operations.

The absence of a functioning inter-bank market and the non-utilization of central bank standing facilities imply that the only mechanism that the NBE can use to conduct its monetary policy operations is the primary T-bills market. This is an auction market in which short-term government securities are auctioned fortnightly. Currently, securities with three types of maturity i.e. 28, 91 and 182 days are offered for auction. Although the primary purpose of these auctions is to raise financing for the government, the NBE also uses it to conduct monetary policy operations. The draw-back in using such an instrument for monetary policy operations is that it only serves as a liquidity

absorbing mechanism. It doesn't give the NBE the ability to inject liquidity if it needs to do so.

Although the introduction of the T-bills market dates back to 1995, it has remained very shallow. Participation in the auction has been limited to a very few number of public financial and non-financial institutions that have large amount of idle funds. As a result, the yield on T-bills has remained very low which made it difficult to attract the participation of private commercial banks and the other private sector in a meaningful manner. The T-bills yield has not been able to serve as a good benchmark for short-term interest rates. It has rather distorted the interest rate structure as it is allowing the government to borrow at rates that are significantly below market interest rates. The shallow nature of the T-bills market coupled with the excess liquidity stance of the banks reduces the importance of the T-bills auction for monetary policy operations.

As can be seen from the above discussion, the NBE has almost no mechanism that enables it to conduct monetary policy operations. The conduct of monetary policy has, therefore, been limited to the use of the reserve and liquidity requirement ratios, the minimum deposit rate and more recently bank-by-bank credit limit.

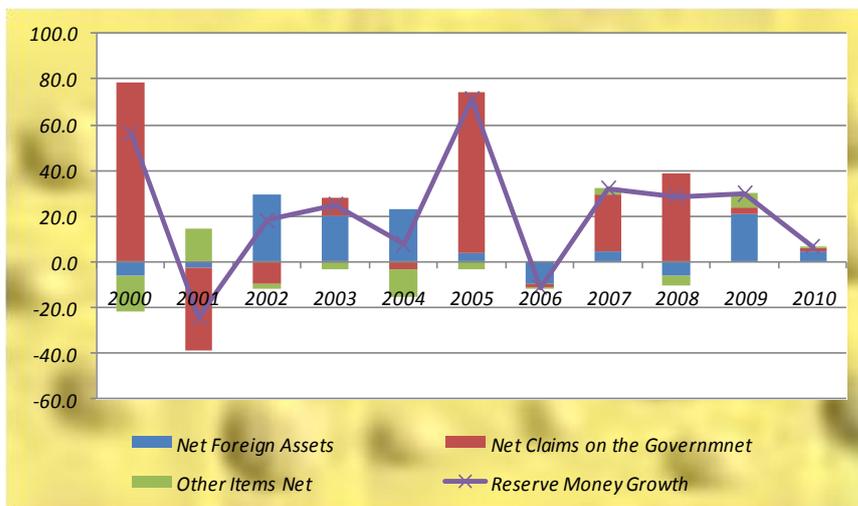
7.2.4. Effectiveness of monetary policy

We have seen earlier that the objective of NBE's monetary policy is to maintain price stability which was specified as keeping non-food inflation within single digits. In order to achieve this objective, the NBE uses reserve money as an operating target and broad money supply as an intermediate target. An attempt is made in this section to assess the effectiveness of

monetary policy in terms of controlling the operating target and achieving both the intermediate and the final targets.

Figure 7.1 shows growth rate in reserve money and the contribution of its major determinants during the past ten years. As can be seen from the graph, growth rate in reserve money has been erratic. During the past four years, however, there was a persistently high growth rate of reserve money. The major contributing factor for the growth in reserve money has been net credit to the central government. The NBE gives credit to the government mainly in the form of direct advances. The contribution of NBE's foreign exchange operations to the growth in reserve money has been limited especially during the past four years.

Figure 7.1: Contribution to reserve money growth

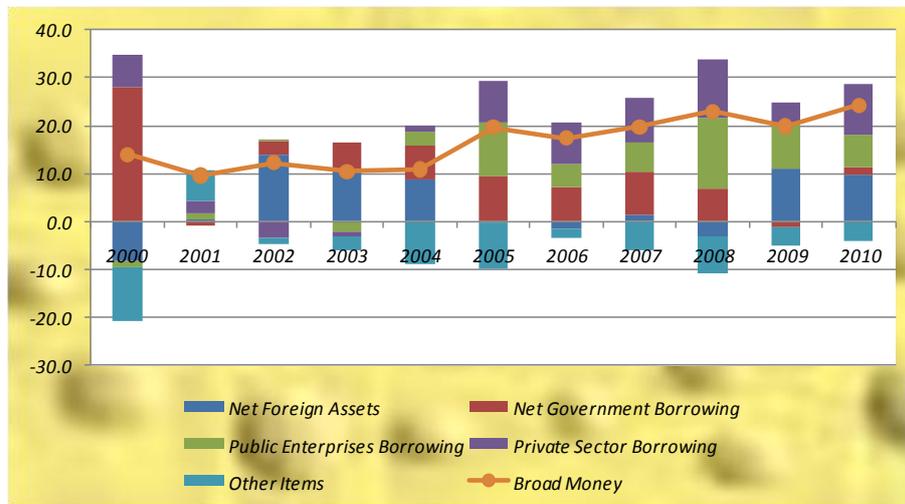


Source: National Bank of Ethiopia

The fact that growth in reserve money was mainly driven by NBE’s lending to the government implies fiscal dominance over monetary policy. Over the past two years, growth in reserve money has gone down significantly following significant decline in the growth of NBE’s lending to the government as part of the government’s efforts to tackle the accelerating rate of inflation.

As the growth in reserve money is essentially dictated by NBE’s net lending to the government, the government’s fiscal stance plays a very crucial part in whether the NBE meets its reserve money target or not. Given the limited independence of the NBE, this implies that the degree of control that NBE has on its operating target is dependent on the government’s borrowing decisions.

Figure 7.2: Contribution to growth in broad money supply



Source: National Bank of Ethiopia

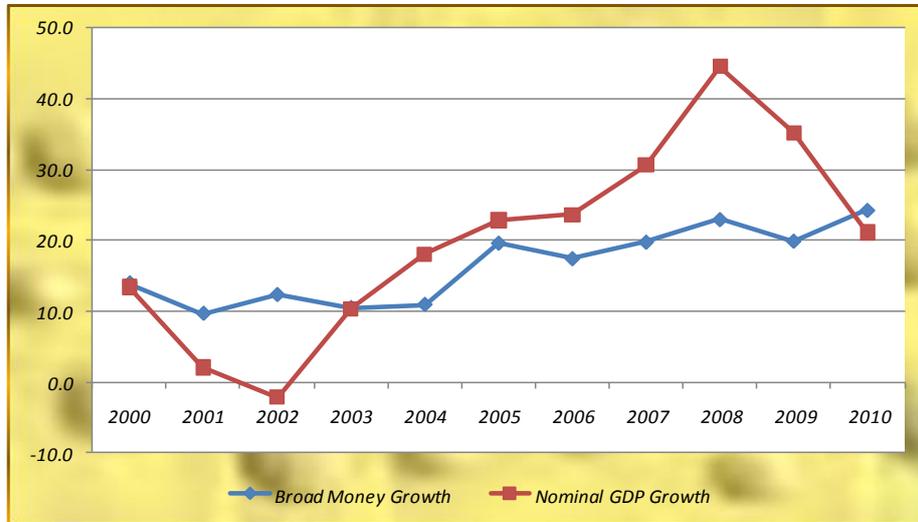
As indicated earlier, the NBE’s intermediate target for monetary policy is broad money supply. The choice of this target presupposes that this monetary

aggregate is closely related to the ultimate target of monetary policy, which is inflation. Some studies have found out that monetary factors contribute to inflationary pressures in Ethiopia. For example, Loening and Takada (2008) found out that accommodative monetary conditions triggered the rise in inflation rate and inflationary expectations over the past few years.

Looking at the source of monetary growth over the past ten years, we can see that domestic credit has been the major contributing factor (Figure 7.2). Credit to the public sector (including the government and public enterprises) has been taking the major chunk of domestic credit over the past six years contributing significantly to monetary growth. Borrowing by public enterprises has especially become an important source of monetary growth over this period. More recently, however, the contribution of public sector borrowing to monetary growth has somehow declined reflecting the government's reduced borrowing from the banking system over the past two years in an effort to contain the rising inflation.

NBE's target for money supply is to keep its growth in line with the growth rate of nominal GDP. Figure 7.3 compares the growth rates of nominal GDP and broad money supply over the past ten years. As can be seen from the graph, growth in broad money supply has not been in line with that of nominal GDP. Especially over the past few years, growth in nominal GDP has been persistently higher than growth in money supply as velocity was rising significantly over the period associated with the acceleration in the inflation rate.

Figure 7.3: Growth rates of money supply and nominal GDP



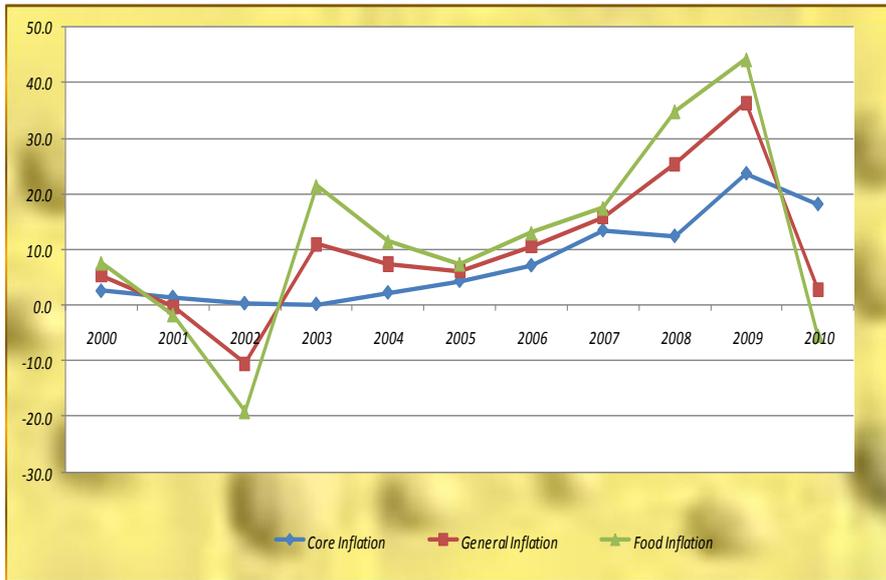
Source: National Bank of Ethiopia

Trends in inflation in Ethiopia have been largely associated with growth in agricultural output. Inflation rates peaked when agricultural output significantly dropped following the occurrence of a drought. On the other hand, in times of bumper harvest food prices collapsed and the general price level plummeted. However, there has been an accelerating trend in the general price level over the past six years despite growth in agricultural output. Several factors have been forwarded to explain this unusual trend in the general price level. Most of the studies conducted on the issue have indicated monetary growth as an important explanatory factor.

Non-food inflation which is the major concern of NBE's monetary policy has been at a very low level until recently. It has, however, been consistently picking up since 2004 and it surpassed NBE's target of a single digit in 2007 and is still above the target (Figure 7.4). Although general inflation sharply

declined in 2009/10 mainly driven by significant drop in food prices, non-food inflation remained high.

Figure 7.4: Trends in inflation



Source: National Bank of Ethiopia

The other objective of NBE’s monetary policy is to maintain exchange rate stability which is defined as keeping the exchange rate close to its equilibrium level. As was pointed out before, it is very difficult to evaluate whether this objective was achieved or not since the objective doesn’t specify how the equilibrium exchange rate is defined and whether the objective refers to the nominal or real exchange rate.

As the exchange rate of the Birr is not pegged, it cannot serve as an anchor for monetary policy. The exchange rate regime in Ethiopia is described as a

managed floating one. The exchange rate of the Birr is determined in a daily inter-bank foreign exchange market. Over the past ten years, the exchange rate showed very little fluctuations. The exchange rate of the Birr against the US dollar has been showing slow but steady depreciation. The rate of depreciation, however, started to pick up in recent years as a result of NBE’s policy measures to depreciate the exchange rate (Figure 7.5).

Figure 7.5: Official and parallel market exchange rates of Birr against the US dollar



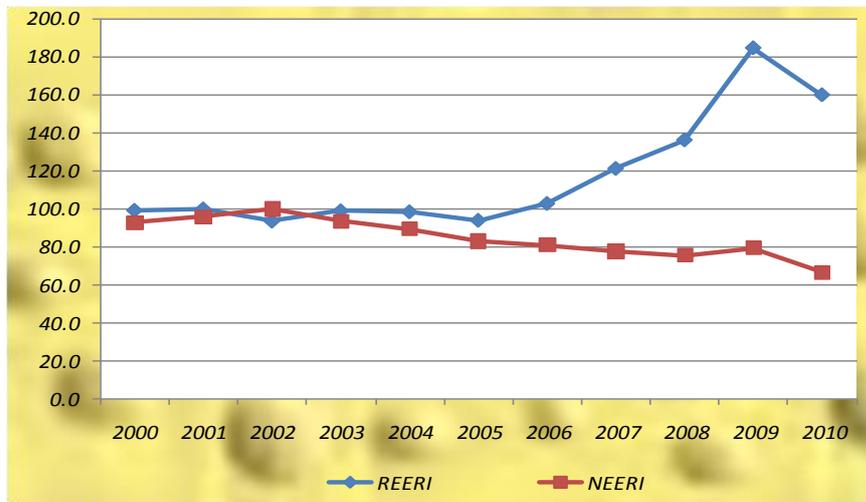
Source: National Bank of Ethiopia

One way of assessing whether the official exchange rate of the Birr has been at an appropriate level is to compare it with the exchange rate in the parallel foreign exchange market. As can be seen from Figure 7.5, although the premium between the official and parallel market exchange rates has been relatively low it has shown an increasing trend during recent years. The real effective exchange rate of the Birr has also shown an appreciating trend over

the past five years reflecting the inflation differential with trading partners following the acceleration in domestic inflation during this period (Figure 7.6).

In summary, the degree of control that NBE has on its operating target (i.e. reserve money) is limited and that the intermediate target for monetary policy has largely been off-target. The NBE has also not been able to achieve its final monetary policy objective of keeping non-food inflation within single digits over the past five years. The objective of maintaining exchange rate stability cannot also be said to have been met considering the widening premium between the official and parallel market exchange rate and the appreciating trend of the real exchange rate.

Figure 7.6: Nominal and real effective exchange rates of the Birr



Source: National Bank of Ethiopia.

7.3. Issues

Monetary policy in most countries has been made to focus primarily on the achievement of low inflation. The policy instruments that central banks use to achieve this objective have increasingly become market-based rather than rules-based. Central banks have also been given more and more autonomy in setting their targets and using appropriate instruments to achieve those targets.

The main objective of monetary policy in Ethiopia is maintaining stable prices and exchange rate. In order to achieve these objectives the NBE has chosen reserve money as its operating target and broad money supply as its intermediate target. However, NBE's control on the growth of reserve money has been extremely limited as its credit to the government has been the major driving force of reserve money growth. According to IMF (2010), this central bank financing of the government is the major factor that led to excess liquidity in the financial system.

The excess liquidity in the financial system has made the inter-bank money market and NBE's discount window facility non-functional which in turn has extremely limited NBE's ability to effectively use indirect monetary policy instruments. NBE's inability to effectively use indirect instruments has made it to resort to the introduction of bank-by-bank credit ceiling to curb inflation. However, this kind of administrative measure creates distortions since it limits competition. It also discourages deposit mobilization and promotes financial disintermediation.

Therefore, the major challenge for monetary policy is the reliance of the government on central bank financing. As long as NBE continues to provide

direct financing to the government, its control on the growth of reserve money would remain extremely limited. Without an effective control of reserve money, the conduct of monetary policy would be forced to be limited to the use of highly distortionary direct instruments and administrative measures.

Chapter 8

The Development of the Financial Sector in Ethiopia

A sound financial system is central for sustainable economic growth in Ethiopia. Financial sector development is desirable both as an end in itself and as a means to an end. It is desirable as an end in itself because it is an important provider of employment, source of tax revenue, etc. It is desirable as a means to an end because a well functioning financial system serves as an important foundation for sustained economic development and reduction of poverty. The financial sector helps in channeling resources to the most productive sectors of the economy thereby enhancing productivity that would bring growth in production and creating a robust and competitive private sector. Although there are bi-directional relationships between financial access and growth, emphasis is given to the independent and causal role of financial sector development in promoting economic growth. It is also considered as pro-poor in the sense that it is “associated with more rapid growth in the incomes of the poor, helping them catch up with the rest of the economy as it grows” (for a comprehensive review, see Levine 1997, and 2005; Demirguc-Kunt 2006). Sustained access to needs-based financial services also improves household food security (level, stability and quality of food consumption) either indirectly through income gains from credit use (i.e. increased income level and diversity of income sources) or directly through consumption loans. The development of the financial sector will require expanding and establishing sustainable financial institutions that provide production credit, saving facility, consumption credit, inter-temporal insurance mechanism and efficient and affordable payment system.

In the Ethiopian context, there are a number of issues which affect the development of well-functioning financial sector. These include: (i) creating stable macro-economic policy and strong legal and information systems; (ii) promoting a contestable financial sector (i.e. low entry barriers, less regulatory restrictions, greater freedom in banking) so as to improve its depth, efficiency and access; (iii) regulation that empowers the market through enforcement of accurate and timely disclosure of information and provision of appropriate incentives for market participants to be vigilant; and (iv) facilitating broad access to financial services by expanding availability of a range of financial services to corporate customers; micro, small and medium enterprises; farmers; wholesalers and retailers, etc through diverse finance providers.

The Ethiopian financial sector has different kinds of players such as banks, insurance companies, MFIs and cooperatives, government and donor programs and semi-formal and informal financial services providers. Banks, insurance companies and MFIs can be state or private-owned. There are however MFIs that are owned by NGOs. Cooperatives are member-based or owned organizations which can be multipurpose or financial cooperatives serving different kinds of clients. Although there are informal finance providers and government and donor programs which provide financial services to the unbanked population, special attention is given in this report to formal finance providers. Although there are informal finance providers and government and donor programs which provide financial services to the unbanked population, special attention is given in this report to formal finance providers.

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Table 8.1: The share of financial institutions in the total national financial assets in 1998 and 2008 (Million Birr)

Financial Institutions	1998		2008	
	Value	%	Value	%
Commercial banks	28,177.0	96.2	82,004.0	91.5
Insurance Companies	887.0	3.0	2,300.1	2.6
Microfinance Institutions	239.0	0.8	5,340.6	6.0
Total	29,303.0	100.0	89,644.7	100.0

Source: National Bank of Ethiopia (NBE).

The total asset of the financial sector reached Birr 82 billion in 2008 increasing three fold compared to its 1998 status. Commercial banks in Ethiopia take up 91.5 percent of total asset of the financial sector declining from 96 percent in 1998. There has been a major shift in the asset composition of financial institutions in the last 10 years. Microfinance institutions have increased significantly in size and number as their total assets increased from Birr 239 million in 1998 to Birr 5.3 billion in 2008. By the end of 2008, microfinance institutions account for 6 percent of total financial assets in the country increasing from 0.8 percent in 1998. This growth is not surprising given that the majority of the population lives in the rural areas and access to finance is still very limited. The asset of insurance companies increased from Birr 887 million in 1998 to about Birr 2.3 billion in 2008. Although the asset of insurance companies has increased significantly in the last ten years, their relative contribution to total asset of the financial sector has declined from 3.0% in 1998 to 2.6% in 2008. This is the result of the relatively higher growth of banks and micro-finance sub-sectors.

8.1. The banking sector

The modern banking sector in Ethiopia is relatively a recent phenomenon. Its history dates back to the beginning of the 20th century. Through this short period of history, the banking sector has passed four distinct phases. The first phase which is the period of introduction of modern banking, started with the establishment of the first bank (Bank of Abyssinia) in Ethiopia by Emperor Menelik II in 1905. This era lasted up to 1963 when the functions of central bank and commercial banks separated and private banks and insurance companies started to emerge. The financial sector entered into its second phase of development (1964 -1974) referred as the takeoff stage which accelerated growth until it was hampered by the nationalization measures of the socialist government. Following this, like the rest of the economic sector, the banking/financial sector too entered its third phase (1975 – 1991) which was referred as the stagnation period. The 1991 free economic policy of the country has brought the sector to its current historic period that is characterized as revitalization of the banking business (Green Bell Consultancy 2000).

With the aim to open the economy to the private sector and encourage private investment participation in the development of the economy, the Ethiopian Government since 1991 has formulated market-led economic development policies, strategies and programs. The objective of the new economic policy is to attain a relatively fast, broad-based and equitable economic growth within a stable macro-economic framework. Accordingly, the Government has implemented an Agricultural Development-Led-Industrialization, rural development policy, industrialization policy, micro and small enterprise development strategy, etc with the aim to enhance balanced and integrated growth in both urban and rural areas. Different measures were taken to

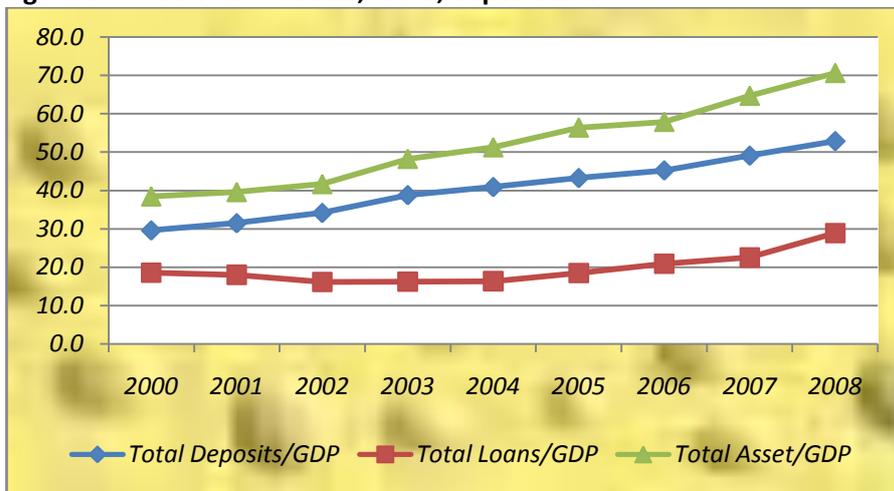
restructure the Ethiopian financial sector from rather stagnant state-monopoly banking system to a private sector oriented business. Moreover, In order to correct price distortions, the overvalued exchange rates of the official currency (Birr) were devalued gradually starting 1992, adjusted to the rate through the foreign exchange auction market. The participation of the private banks has encouraged competition in the financial sector. Interest rates were gradually liberalized and currently, only minimum deposit interest rate is set at 5% leaving the rest to be determined by the banks.

8.1.1. Macro-economic stability and development of banks

Stable macro-economic conditions and relatively low inflation support the growth of banks. For example, since agriculture in Ethiopia is the key driver of growth, any negative change in rainfall or price of export products such as coffee will have a significant impact on the performance of the banking sector. However, macro-economic stability and growth, although important, are not by themselves, sufficient conditions for the growth of sustainable finance providers and expand their outreach. There are poorly performing banks in countries with stable macro-economic conditions. Despite the high inflation in Ethiopia starting 2005 and the acute shortage of hard currency in the country, high fuel prices and the world financial/economic crisis, the economy was growing by 11 percent in the last five years. Between 2005/6 and 2009/10, agriculture grew by 8% per year, followed by the service (14.5%) and industrial sectors (10) (MoFED 2010). The high growth recorded by the agricultural sector is partly explained by the commitment of the government as reflected by the allocation of relatively higher budget for the sector. About 25% of government expenditure in the country is geared towards rural infrastructure, agriculture and rural development, one of the highest shares in the world

(World Bank 2009)¹⁶. Moreover, meeting the targeted economic growth and Millennium Development Goals (MDGs) in Ethiopia entirely depends on the performance of agricultural sector. In order to attain the targeted 10.4% annual economic growth and thereby, meeting the MDGs in the coming five years, the financial, extension, rural infrastructure, marketing and distribution systems need to be addressed. In spite of the observed growth in agriculture, which started from a low base, the sector continues to be of subsistence nature and fails to produce enough agricultural output that can ensure national food security.

Figure 8.1: Ratio bank assets, loans, deposit to GDP



Ratio of the financial sector service (banking and insurance) output to GDP provides a broad measure of the significance of the financial sector within the economy. This ratio increases as the financial development of an economy

¹⁶ The country has also registered a remarkable growth in expanding physical and social infrastructure in the last seven years. The paved road network has increased by 43%, power generation capacity has nearly doubled, primary school enrollment has increased from 5.2 million to 13 million (World Bank 2009).

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increases. The sector disbursed approximately Birr 25.5 billion in loans in 2008/2009, an 11% increase versus prior period.

Figure 8.2: Credit growth to the private sector (private credit to GDP)

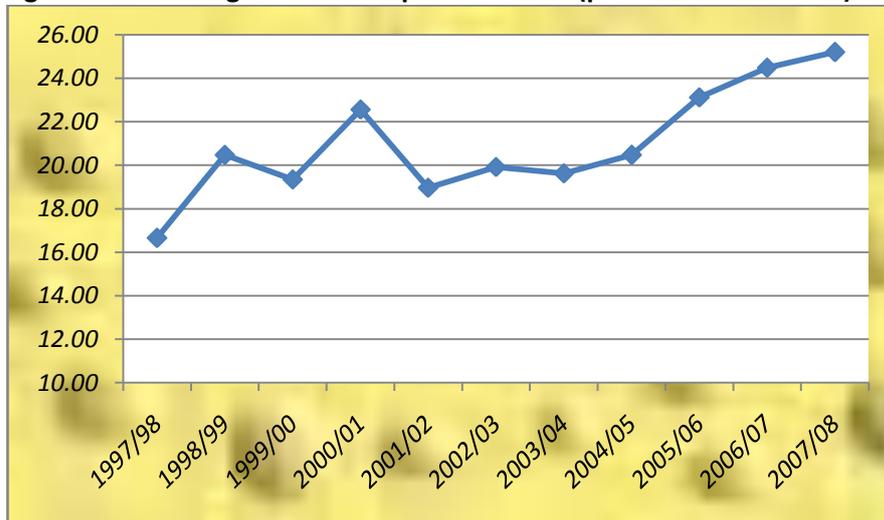
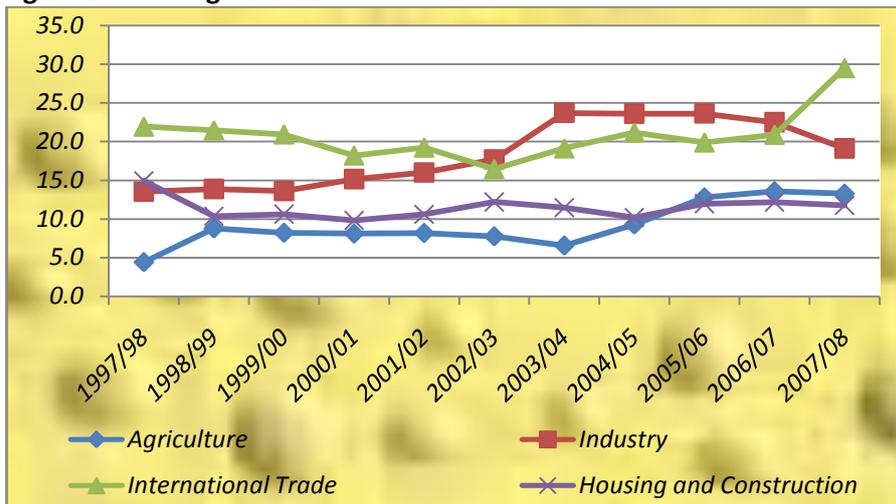


Figure 8.2 shows that loans, deposits and assets of banks in Ethiopia have increased in the last nine years. The volume of loans disbursed to the private sector has also shown an increasing trend. Despite the loan caps and high reserve requirement introduced by NBE to reduce the inflation challenge, the actual loan disbursed by banks has grown significantly in the last three years. The high economic growth helped to boost the growth in private sector lending. As a result of the high demand, private credit grew from Birr 12 Billion in 2000 to Birr 29.2 billion in 2009. The growth of the economy is expected to continue presenting opportunities for the financial sector to expand its client base. However, the existing banks have very limited capacity to meet the huge unmet demand. This is a result of a host of factors. One of the major reasons is the low level of monetization in the country. Other reasons include the very

traditional collateralized loans and products offered by banks in the sector, lack of enough competitiveness in the sector and state domination. Figure 8.4 indicates that there has not been significant change in the sectoral disbursement of loans. However, despite the directives of NBE which guides banks to provide loans primarily to manufacturing, agriculture and export in the last two year, the growth rate of loan to industry has shown a declining trend.

Figure 8.3: Changes in sectoral allocation of credit



Although the Ethiopian economy has been affected by the global financial crisis, the impact has not yet been properly researched. Given the limited exposure of Ethiopia’s financial sector to the sophisticated foreign financial instruments, policy makers initially concluded that the global financial crisis has very limited impact on the country’s financial system. Moreover, Ethiopian banks and borrowers don’t have access to line of credit from non-domestic sources. On the other hand, it will be important to take into account that

Ethiopia has a highly concentrated export markets such as coffee, hides and skin, oilseeds, etc. which are affected by the 'second round effects' which reduce Ethiopia's exports. It is believed that the external factors such as the financial crisis and imported inflation such as high fuel prices have indirect impact on the performance of the financial sector in Ethiopia.

8.1.2. Policies, legal and regulatory framework and governance

The various policies, directives and the legal and regulatory framework designed to guide and monitor the activities of finance providers have direct impacts on outreach and performance of banks. Ensuring the safety of depositors and building healthy finance providers for the development of the financial sector requires prudential regulation, supervision, and governance compatible with the objective condition of Ethiopia.

Policies

After the new government took power in 1991, there has been a drastic change in policy towards building a market-led economic system, which influenced the development of the banking sector. The government decided to undertake a cautious approach towards liberalizing and reforming the financial sector with the objective of increasing savings, investments, economic growth, ensuring macro-economic stability and competition. The key policy changes that have direct impact on development of the banking sector in Ethiopia are summarized as follows:

- ✿ *Private banks and insurance companies were permitted to function and ended state monopoly in the financial sector through Proclamation no. 84/94. Banks and insurance companies, as per the Proclamation have to be licensed as share companies (NBE approving the share ownership transfer)*

to carry out banking and insurance activities. It also states that banks and insurance companies should be wholly owned by Ethiopian nationals. The law encourages banks to respond to market needs by mobilizing and allocating savings on the basis of commercial considerations.

- ✿ The Monitoring and Banking Proclamation (No. 83/94) was issued to reinstate the institutional autonomy of the National Bank and to enable it supervise financial institutions operating in the country.*
- ✿ The NBE introduced a moderate restructuring and established the Banking and Insurance Supervision Departments in 1996.*
- ✿ The exchange rate of the official currency (Birr) was devalued from 2.07 Birr to 5 Birr per one USD in 1992 and thereafter adjusted through the foreign exchange auction market. A foreign exchange auction system was introduced in 1993. The bi-weekly foreign exchange retail auction was replaced by a weekly wholesale foreign exchange auction. In 2001, the Interbank Foreign Exchange Market was established to replace the weekly foreign exchange auction system. Exchange rates started to be determined through averaging the trade in the interbank market. NBE issued a directive (No. NBE/INT/98) which lifted the ceilings of deposits and lending interest rates in January 1998 to be determined by the banks themselves. However, NBE sets the minimum saving rates. Since then, the floor deposit rates were reduced from 6% to 3%, 4%, and currently 5% (since December 2010).*
- ✿ A government security market was established in January 1995 by the introduction of a monthly (later made bi-weekly) auction of 91-days treasury bills, with 28-day and 182-day bills added in December 1996.*
- ✿ In June 2002, NBE issued a directive that set a higher minimum paid up capital for commercial banks. As per the directive, all banks are expected to attain a minimum paid up capital of 75 million Birr.*

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- ✿ *Restructuring of government-owned banks was introduced to improve governance, re-capitalize and improve their solvency and their managerial autonomy. This involved the conversion of non-performing loans of state farms into non-interest bearing government bonds.*
- ✿ *A foreclosure law on property collateral for non-performing loans was enacted in September 1997 for the commercial banks.*
- ✿ *Inter-bank money market, aimed at facilitating lending from banks with excess liquidity, was introduced in December 1998.*
- ✿ *The NBE designed and implemented the Export Credit Guarantee Scheme to assist private sector investors and entrepreneurs who are engaged in the export sector.*
- ✿ *The revised banking proclamation was issued in 2008 focusing on improving governance and management of banks; transparency and disclosure; ensure safety, soundness, stability and reducing volatility of the economy; protect depositors and shareholders; and ensure compliance of banks with the directives. As per the new banking act, those banks, board members and management staff who fail to comply with the proclamation and directives of NBE will receive punishment, including long years of imprisonment.*
- ✿ *To improve the efficiency of banks, NBE tightened prudence and supervision of banks. To this end, NBE issued a number of directives on liquidity requirement, reserve requirement, classification of Non-Performing Loans (NPL) and provisioning, etc.*
- ✿ *To reduce the inflation in the country, NBE introduced the increase in the reserve requirement of commercial banks and introduced a preferential treatment to agriculture, manufacturing and export. The government seems to follow an activist approach, where it plays an active role in guiding the financial resources to productive sectors. However, there hardly*

exists a clear financial sector development strategy to guide the development of the sector.

The major breakthrough in the development of the banking sector in Ethiopia was allowing the operation of privately-owned domestic banking institutions in 1994. Thereafter, the NBE developed various directives to guide the development of the banking sector. Since enforcing contracts were difficult, the government issued the foreclosure law for banks in 1997 to facilitate their banking operation. In 1998 the NBE introduced the liberalization of lending rates -maintaining floor on deposit rates and foreign exchange operations. For example, market determination of forex rates and interbank forex markets were introduced.

Prudential regulation and supervision

Proclamation No.84/1994, Licensing and Supervision of Banking Business, states that incorporated institutions may conduct banking business only if they are licensed by the NBE to do so. The proclamation precludes a foreign national from undertaking banking business in Ethiopia, and no person is permitted to own more than 5% of a banking company's shares. This law also applies to the MFIs. Obviously, this prohibits foreign banks from bringing expertise in banking practices, management and improved technology, more efficient services; increase in the inflow of capital and competition. On the other hand, the regulators argue that given the limited experience, capacity and expansion of newly established private banks and the limited capacity of NBE to regulate foreign banks, allowing foreign banks in Ethiopia would have a negative impact on the ability of the expansion of young private banks owned by Ethiopian nationals. Thus, before allowing foreign banks to invest in the country, enough time should be given to strengthen private banks owned by Ethiopian nationals. However, since prohibiting banks limits competition,

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efficiency and transfer of technology to local bank, there should be a specific timetable showing when foreign banks will be allowed to operate in the financial sector.

During the Derg era (1975-91), since banks and insurance companies were owned by government, there was no need to have an institutional structure or department within the NBE to supervise the financial sector. The role and responsibility of NBE was restricted to the enforcement of administrative control. However, with the emergence of private banks, insurance companies and MFIs, the need for prudential supervision was clear. To this end, the supervision department of the NBE was established in 1994 to supervise banks, insurances companies and MFIs. Currently there are three supervision directorates to supervise banks, insurance companies and MFIs.

Table 8.2 indicates that the regulatory framework of the banking sector in Ethiopia is in line with regional standards. It has been effective in attracting the private sector to invest in the banking business. Thus, entry barriers are relatively low compared with Kenya, Uganda and Tanzania. However, with respect to meeting international Basel II standards, there are many dimensions that still need improvement. However, there is a need to revisit the regulatory framework of banks such as introducing the deposit insurance, preparation to increase 'systemic fitness' before allowing foreign banks in Ethiopia and building the capacity of the NBE to effectively supervise and support banks, including foreign banks.

Table 8.2: Key regulations in Ethiopian financial sector

	Ethiopia	Kenya	Uganda	Tanzania
Minimum Capital to establish a Bank	4.6 million USD	0.3 million USD	1.7 million USD	10.2 million USD
Minimum capital adequacy requirement	8% of total capital (since 1994)	8% of core, 12% of total capital (since 2000)	8% of core, 12% of total capital (since 1999)	10% of total capital
NPL classification	5 categories, NPLs: overdue 90 days	5 categories, NPL's overdue 90 days	4 categories NPL's overdue 180 days	5 categories,
Provision requirement	1% for pass, 3% for special mention 20% for substandard, 50% for doubtful, 100% for loss	1% for normal risk and watch, 100% for doubtful or loss (in between flexible)	1% for performing loans, 20% for substandard, 50% for doubtful, 100% for loss	N/A
Collateral	Net recovery value to be deducted from outstanding loan, land accepted as collateral	Net recovery value to be deducted from outstanding loan	Collateral not deductible for provisioning	Collateral not deductible for provisioning

1 pass: overdue less than 30 days; special mention: 30-90 days; substandard: 90-180 days; doubtful: 180-360 days; loss: more than 360 days

Source: IMF (2005)

Corporate governance

Corporate governance is the set of processes, customs, policies, laws, regulations and institutions affecting the way a company (where separation of ownership and control prevail) is directed, administered or controlled and

defines the relationship among various stakeholders (board, management, shareholders, etc). Governance defines a system of checks and balances where a board is established to oversee the management of banks. However, the size and ownership structure of banks require different sets of complexities and government structure. Unlike other businesses, the corporate governance of banks in Ethiopia involves prudential regulation; shareholders, board and management; and policies, systems and procedures. Governance is a serious issue both in government and private banks which include board composition and election; board qualification; board tenure; board committee; board documents; conflict of interest; and board performance and evaluation.

In the last three years, it has been alleged that some private banks have been facing a serious governance problem as a result of the direct interference of their major shareholders in the day-to-day operations of the banks. Since the previous directives of NBE allowed a single shareholder to own a maximum of 20% of total subscribed capital, the influential shareholders allegedly used this opportunity to access loans to their own/sister companies. The influential shareholders were also believed to have involved in micro-managing the private banks, by firing and hiring the presidents and senior management staff. It is argued that this has been aggravated by the competition to sit on the board of private banks in order to gain relatively higher sitting allowance and profit at the end of the year. There were incidents where the national bank had to intervene, by taking the responsibility of calling a general assembly of shareholders to elect the board of directors as per the law. Moreover, the NBE issued a new directive in 2010 (SBB/47/2010) which forces shareholders to reduce the share of a single shareholder to five percent or less, which also applies to those shareholders who jointly own the share with a spouse, a child, a parent, or siblings. In August 30, 2010, the NBE wrote a letter to all private banks stating that they are given three years to implement

the directive (Fortune 2010). The whole objective of the directive is to improve corporate governance of private banks by reducing the influence of individual shareholders. Improving the governance of banks in Ethiopia will have a significant influence on growth, performance, managing risks. This requires effective prudential regulation, developing systems and procedures, building the capacity of banks and empowering boards and management to discharge their duties and responsibilities.

Enforcing contracts

A well-functioning legal framework is a necessary condition for secured lending. This includes making it possible for all types of assets to be collateralized, effective notice and registration rules to be adapted to all types of property, and clear rules of priority on competing claims or interests in the same assets. Although the NBE does not directly require banks to have collateral for all disbursed loans, the provision reduces the collaterals in the provisioning requirement which indirectly encourages collateralized lending.

Lenders in Ethiopia accept immovable and partly movable assets (such as vehicles registered under the transport authority) as collateral. The personal guarantees and corporate guarantees, depending upon the strength of the groups, are used as collateral. Although leased urban land can be used as collateral, rural land is not used as collateral. The regional governments are issuing user rights in the name of the individual occupying the land in rural areas, which cannot be mortgaged. The use of machinery and other movable assets as collateral requires issuing a legal framework and a registry system.

8.1.3. The structure of the banking sector

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The Ethiopian banking sector consists of one state-owned development bank (Development Bank of Ethiopia, DBE), two state-owned commercial banks (Commercial Bank of Ethiopia - CBE, Construction and Business Bank - CBB), and 13 private commercial banks (about 5 are under formation). As of September 2008, the private banks had 304 branches and a total paid-up capital of Birr 3.8 billion, compared to 264 branches and a paid-up capital of Birr 6.7 billion of the three public banks. Private banks participation has increased gradually since 1996. From 1998 to 2006 the bank assets of the private sector grew from Birr 1,350mn to 16,400mn.¹⁷ As of June 2009, private banks had 363 branches and a total paid-up capital of Birr 4 billion compared to public banks with 273 branches and capital of Birr 7 billion.¹⁸ The number of private banks in Ethiopia has consistently grown since they were allowed to enter the banking market in 1996. Currently, the number of bank branches increased to 666 and CBE is planning to increase its branches in the coming year. By the end of October 2009, the number of bank branches providing forex services reached 311(NBE 2009).

¹⁷ Kiyota (2007)

¹⁸ NBE (2009)

Table 8.3: Assets, loans, and deposits of banks (2000-2008)

		2000	2001	2002	2003	2004	2005	2006	2007	2008
Assets	<i>Total</i>	23,959.0	26,493.0	28,338.0	32,110.0	38,125.0	47,254.0	54,089.0	67,571.5	2,004.2
	<i>Government Banks</i>	20,802.0	22,457.0	23,104.0	25,142.0	29,032.0	35,001.0	37,646.0	45,345.0	52,808.1
	<i>Private Banks</i>	3,157.0	4,036.0	5,234.0	6,968.0	9,093.0	12,253.0	16,443.0	22,226.5	29,196.0
	<i>share gov't.</i>	86.8	84.8	81.5	78.3	76.1	74.1	69.6	67.1	64.4
Deposits	<i>Total</i>	18,423.0	21,050.0	23,212.0	25,816.0	30,402.0	36,214.0	42,243.0	51,246.0	1,366.0
	<i>Government Banks</i>	16,218.0	17,976.0	19,133.0	20,377.0	23,215.0	26,423.0	29,259.0	34,009.0	39,122.0
	<i>Private Banks</i>	2,205.0	3,074.0	4,079.0	5,439.0	7,187.0	9,791.0	12,984.0	17,237.0	22,244.0
	<i>share gov't</i>	88.0	85.4	82.4	78.9	76.4	73.0	69.3	66.4	63.8
Loans	<i>Total</i>	11,528.0	12,024.0	10,963.0	10,776.0	12,142.0	15,433.0	19,495.0	23,494.0	33,488.0
	<i>Government Banks</i>	9,665.0	9,450.0	8,007.0	6,702.0	6,933.0	8,280.0	8,699.0	9,512.0	17,480.0
	<i>Private Banks</i>	1,863.0	2,574.0	2,956.0	4,074.0	5,209.0	7,153.0	10,796.0	13,982.0	16,008.0
	<i>share gov't</i>	83.8	78.6	73.0	62.2	57.1	53.7	44.6	40.5	52.2

Source: National Bank of Ethiopia

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The Commercial Bank of Ethiopia claimed the largest share of disbursed loans, 44% in 2008/9. The nearest competitor was Awash International Bank accounting for 11% share of total lending market. This reflects the near monopoly position status of CBE. Nevertheless, the financial sector has witnessed a number of new private sector entrants which will serve to enhance the level of competitiveness and product innovation. Although the share of CBE has gradually declined, it is still the largest bank in the financial sector, representing over 63.8% of commercial banking assets. As of 2008, total assets of public banks in Ethiopia were 37.6 billion Birr, while the private banks had Birr 16.4 billion of asset, which shows the continued predominance of the public sector.

The state-owned banks play a key role both in the supply side as direct participants in intermediation as well as in the demand side as a borrower. These banks provide financial services to support economic growth and deepen financial inclusiveness to the priority sectors of the government. The government banks were involved in financing 200,000 condominium houses, flower farms, the Ethiopian Telecommunication Corporation, Ethiopia Power and Electricity Corporation, 2000 dam trucks, import inorganic fertilizer through cooperatives and Agricultural Input Supply Company, etc and provided loan capital to deposit taking MFIs. CBE has been the largest source of input loan on the basis of a 100% regional government credit guarantee scheme. In 2009/10, CBE provided Birr 2.73 billion loan to purchase agricultural inputs for five regions. The highest input loan was extended to Amhara followed by Oromiya, SNNP, Tigray and Benishangul Gumuz. The credit from CBE has been channelled to individual farmers through cooperatives, local government offices, and few micro-finance institutions. The state-owned banks in Ethiopia were instrumental in creating a stable and sustainable interest rate and exchange rate which support the development

program of the government under the framework of developmental state. On the other hand, World Bank studies such as Scott (2007) indicated that the direct participation of government banks resulted in lower levels of financial development, less credit to the private sector, wider intermediation spreads, greater credit concentration, slower economic growth and recurrent fiscal drains. In some countries, the involvement of government banks discourages the private banks from entering into areas where government-run banks are present. Government support, subsidies and poor repayment among state-owned banks increases the cost of entering the market for private banks, distorts market prices and encourages the lenient enforcement of loan repayment. Currently, since there is huge demand for loans in Ethiopia, the possibility of crowding out the private banks is remote. Moreover, the performance of CBE has improved significantly in the last five years. However, although there is a room for efficiency in both private and public banks, they are being profitable, operating under protected market.

Concentration and competition in the banking sector

The market concentration among the top three players is very high. CBE is still the largest bank in the financial sector, representing over 44 percent of outstanding loans. Together with Development Bank of Ethiopia (DBE), contributing 12 percent of all outstanding loans, they provide more than half of the credit volume in Ethiopia.¹⁹ In 2007, all public banks were holding 67% of all total bank assets. Compared to Ghana (21%), Morocco (27%) and Zambia (21%) the share of public banks is exceptionally high.²⁰ The strong role of government institutions, together with the high concentration, lead to relatively low levels of competition in the sector. This is reflected in the very

¹⁹ NBE (2008)

²⁰ NBE (2008), database IFS (IMF)

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flat average lending rates and low deposit rates that are strongly influenced by movements of CBE.

Table 8.4: Concentration Index and Hirschman Hirfindahl Concentration Index

		2000	2001	2002	2003	2004	2005	2006	2007	2008	Average
Deposits	Concentration Index (4)	94.5	93.9	92.9	91.5	90.4	87.7	86.9	85.0	83.3	89.6
	HH Concentration Index	0.73	0.69	0.64	0.60	0.56	0.51	0.47	0.43	0.40	0.6
Loans	Concentration Index (4)	92.1	88.2	86.2	81.6	79.8	78.2	73.9	71.8	76.8	81.0
	HH Concentration Index	0.61	0.54	0.47	0.35	0.31	0.28	0.21	0.19	0.28	0.4
Assets	Concentration Index (4)	93.6	92.1	91.3	90.1	89.2	86.5	85.4	83.9	82.1	88.2
	HH Concentration Index	0.69	0.66	0.62	0.58	0.55	0.51	0.46	0.43	0.40	0.5

Source: Own Computation

Table 8.4 shows concentration indices of the banking system. It can be seen from the results that the banking system is highly concentrated with more than 88 percent of the assets owned by the largest 4 Banks, the largest player being CBE. The same is true with deposits (89 percent) and loans (81 percent). However, the concentration is gradually lowering from an index of 94 in 2000 to an index of 83 in 2008 in the case of deposits. Similarly, concentration index for loans and assets came down respectively from 92 percent and 93.6 percent

in 2000 to 76 percent and 82 percent in 2008. This shows that the private banks in Ethiopia are expanding with rapidly increasing share in the market.

Although there are no barriers to enter in commercial banking, particularly for Ethiopians²¹, the new private banks entering the market have very limited capacity (usually sub-optimal) to serve the relatively huge demand for financial services. The private banks instead of selling shares to expand their activities and outreach, they tend to focus on giving higher dividend to shareholders. However, it should be noted that the dominance of the government banks has direct or indirect influence on the competition and performance of the sector. The small size of the banking sector in Ethiopia, which is sub-optimal size, has limited competition and efficiency of the sector. In spite of the increase in the number of private banks, the lending and saving interest rates of banks are within a similar range. This is partly aggravated by the dominance of CBE in lending and saving mobilization and the pace setter in the financial sector. As a result, CBE's interest rates influence the pricing of the private banks.

Relative to SSA benchmark countries, entry barriers to domestic players, especially minimum capital requirements, are low in Ethiopia, which has further contributed to the growth of the private banking sector. However, Ethiopia has one of the strictest banking regulatory frameworks in Africa that prohibits foreign bank entry and limited competition.

²¹ *The commercial bank proclamation prohibits foreigners or foreign banks from entering the banking business in Ethiopia.*

Sectoral and geographical distribution of bank loans

Financial services coverage of formal banks in Ethiopia stands at approximately 134,670 people per branch which is far below international and African standards (Ghana 54,000, Uganda 130,000, and Namibia 11,136). Bank branches are concentrated in urban areas. More than 52 % of all bank branches in Ethiopia are located in the eight major towns where only 6.6 % of the population live; Addis Ababa alone accounts for 37.6 % of all bank branches (Wolday Amha 2010). According to NBE's credit bureau, the number of outstanding loans accounts in the formal banks amounted to 61,395 loans (March 2007), which is very low by any standard.

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Table 8.5: Disbursement of bank loans by sector

Sectors	2004/05		2005/06		2006/07		2007/08		2008/09	
<i>Total disbursement</i>	9,433.0	100%	12,401.9	100%	15,559.0	100%	27,254.5	100%	25,477.0	100%
<i>Agriculture</i>	1,560	17%	2,189	18%	2,621	17%	5,372	20%	3,038	12%
<i>Industry</i>	1,080	11%	1,302	10%	1,525	10%	2,739	10%	2,668	10%
<i>Domestic trade</i>	1,908	20%	2,458	20%	2,986	19%	5,012	18%	5,265	21%
<i>International trade</i>	2,939	31%	3,542	29%	4,377	28%	9,210	34%	8,166	32%
<i>Export</i>	1,241	13%	1,658	13%	2,234	14%	3,116	11%	2,859	11%
<i>Import</i>	1,697	18%	1,884	15%	2,143	14%	6,094	22%	5,307	21%
<i>Hotels and Tourism</i>	49	1%	92	1%	165	1%	244	1%	275	1%
<i>Transport and Communication</i>	372	4%	1,007	8%	1,432	9%	1,338	5%	903	4%
<i>Housing and Construction</i>	627	7%	1,167	9%	1,675	11%	2,017	7%	4,040	16%
<i>Mines, Power and Water Reso.</i>	-	0%	-	0%	13	0.1%	59	0%	-	0%
<i>Others</i>	815	9%	503	4%	585	4%	998	4%	771	3%
<i>Personal</i>	84	1%	141	1%	180	1%	266	1%	242	1%
<i>Interbank Lending</i>	-	0%	-	0%	-	0%	-	0%	110	0%

Source: National Bank of Ethiopia (NBE), 2010

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In 2008/9, the highest proportion of bank loans were disbursed to the import and export trade (32%) followed by domestic trade (21%). About 16% of the bank loans were channelled to the construction sector. Although the priority sectors of the government are agriculture, manufacturing and export, bank loans provided to industry only accounted 10%. Although the agricultural sector currently contributes 44-54% of GDP and employs over 70% of Ethiopia's population, it only accounts for merely 12% of total disbursed loans. Many would concede that credit is focused towards large scale commercial farmers, thereby excluding the millions of rural smallholder farmers who have limited access to financial intermediation and are unable to meet strict collateral requirements maintained by banks. The bank loan disbursed to transport and communication and hotel and tourism accounted for 4% and 1% respectively (Table 8.5).

Given the small size of the banking sector and collateralized lending, all banks (private and government-owned banks) in Ethiopia are hardly involved in delivering financial services to smallholder farmers and micro and small enterprise operators. The bankers consider the management of small loans to smallholder farmers and micro and small enterprise operators as costly. On the other hand, commercial banks have provided very limited credit to commercial farmers. Bankers believe that lending to farmers and micro and small enterprise operators are not commercially viable and does not generate substantial profit. Inadequate collateral, insufficient legal status, high transaction costs, and inability of the smallholder farmers and micro and small enterprise operators to cope with the complexities of dealing with formal banking procedures are among the reasons why banks in Ethiopia are not interested in serving these sectors. Furthermore, banks believe that lending to farmers and micro and small enterprise operators has high risk and are unprofitable due to lack of information on enterprises' financial condition, no

business plan, weakness in management, limited market linkages, weak governance and inadequate information technology. Even the government-owned commercial banks (CBE and DBE) moved away from funding smallholder farmers and micro and small enterprise operators. Banks in Ethiopia in general are unable to manage lending to farmers and micro and small enterprise operators due to inappropriate lending technologies, operation system and lack of appropriate instruments for managing risks. Moreover, lack of staffs who understand the characteristics of the smallholder farmers and micro and small enterprise operators is another factor for the reluctance of the banking sector to lend to the excluded population.

There are three options to involve banks in providing credit and other financial services to smallholder farmers and micro and small enterprise operators: (i) establish dedicated banks to serve smallholder farmers and micro, small and medium enterprise; (ii) enforce a regulatory framework which requires all banks to extend a specific percentage of their loans to finance the agricultural sector and micro and small enterprise operators; and (iii) provide incentives to all banks to deliver credit and other financial services to commercial and smallholder farmers, agribusiness operators and micro and small enterprise operators. This could involve linking banks with MFIs, financial cooperatives and others which deliver financial services to the agricultural sector. However, this will require a clear financial sector development strategy that guides banks to lend the excluded population and sectors.

Interest rate spread

In 1998, the NBE liberalized lending rates, while only maintaining a floor on deposit rates. In December 2010, NBE has put the minimum saving rate of 5% for banks and MFIs. In spite of the increase in the number of private banks, the lending and saving interest rates of banks are within a similar range.

According to the survey report of NBE (2009), by the end of October 2009, the average rates of interest for lending and saving deposit were about 9% and 4% respectively, while private banks had lending interest rates of 12.25% and 4.5%. The average time deposits of public banks and private banks were 4% and 5.17% respectively. The average demand deposits of banks stood at 0.25%. Dashen, United and Wegagen banks pay interest on demand deposits. The interest spread – defined as difference between ex-ante lending and ex-ante deposit interest rates – currently varies between 5 and 8%. However, as a result of the increase in floor saving interest rate from 4% to 5% in December 2010, the lending interest rate is expected to increase by at least 1%. Although the average lending and deposit rates have increased proportionately, by a little bit above 1%, the interest spread remained the same over the past years. The similar range of lending and saving interest rates in the banking sector and the pricing of private banks in Ethiopia are mainly influenced by the dominance of CBE in lending and saving mobilization.

Because of the high inflation, banks in Ethiopia operate under a negative interest rate scenario. However, in spite of the inflation and the relatively higher saving rates provided by private banks, the saving rate of CBE has increased significantly. Moreover, although the interest rates are the key instruments of the monetary policy of the government to promote objectives such as increased savings mobilization, inflation control, exchange stability and maintenance of sustainable overall economic growth, they proved to be ineffective in the Ethiopian context. As a result, the government used direct interventions by specifying the priority sectors and the volume of loans to be financed by bank loans.

8.1.4. Product offering

Commercial banks mainly provide saving deposits, loans, money transfer, letter of credit, and foreign exchange related services. Since the financial products of all banks are very similar, they lack diversity and innovation.

Deposit products

The saving products of commercial banks mainly include: (a) demand deposit; (b) saving deposit; and (c) time deposit. There are people (particularly from the Muslim community) who are not interested in receiving interest on deposits. These deposits are classified as special demand deposits. The major deposits are mobilized from private companies and individuals followed by government/public enterprises and cooperatives and associations. There has not been any improvement in the saving products in the last 60 years either in public or private banks. The demand deposits or the current accounts are not usually paid interest rate. However, some private banks which have liquidity challenges pay interest on demand deposit. Although the interest rate on saving deposits are usually 5%, as of December 2010, there are private banks which pay more than the minimum for individuals and institutions which save more than 500,000 Birr. Higher interest rates on deposits are introduced by private banks whenever they have higher demand for loans. Although banks are expected to pay higher interest rate for time deposits, many of the banks, particularly government-owned banks, tend to provide similar rate for both saving deposits and time deposits. Coupon and term bond are usually paid 5% before December 2010.

Despite the negative interest rate scenario due to inflation, the volume of savings of banks has increased significantly in the last three years. On the other hand, one of the strategies of the newly implemented 5-year development and transformation plan of the government is to enhance domestic savings in the country. The share of domestic saving to GDP in 2010

was 5.5%. This is expected to increase to 17.4% by the end of 2015. The banks are expected to play a key role in mobilizing huge deposits to meet the 5-year plan. With the objective of encouraging savings, the NBE has issued Directive No. NBE/INT/11/2010 on 1st of December 2010 to raise the minimum interest rates on saving and time deposits from 4% to 5%.

Loan products

Apart from loan provided to the government, the private sector gets limited types of loans mostly concentrating on financing of working capital rather than providing long term capital investment loans. In addition, consumer loans provided by banks are very limited, if not non-existent. Although the interest rates on loans vary with the type of activities, the minimum lending interest rate of banks was about 9.5% (after December 2010). Pre-shipment lending rate is 7.5%. The loans provided by banks are highly collateralized and therefore almost inaccessible to the working class population. Car loans, housing loans (with the exception of condominium loans by CBE and housing loans for CBB) and other consumer related loans don't exist in most of the banks unless there is adequate collateral that covers the risk.

The available survey in 2006 indicates that 97% of loans of banks in Ethiopia required property collateral (probably the highest in the world) compared with other sub-Saharan Africa (85%); e.g., 79% for Nigeria, 90% for Uganda, 95% for Tanzania and Zambia and 96% for Angola. The average collateral required as a percent of the loan value is much higher for Ethiopia (175%) compared to African countries (130%); e.g., 122% for Kenya, 123% for Tanzania, 135% for Nigeria, 128% for Egypt, and 100% for Angola. The above information is sufficient to conclude that the Ethiopian banks determine credit worthiness on the basis of high property collateral.

Table 8.6: Collateral requirements of commercial banks in Africa, 2008

Country	Percentage of loans requiring collateral	Average collateral requirement a percentage of loan value
<i>Ethiopia (2006 survey)</i>	97	175
<i>Ethiopia (2002 survey)</i>	71	130
<i>Sub-Saharan Africa</i>	85	
<i>Africa</i>		135
<i>Nigeria</i>	79	135
<i>Uganda</i>	90	
<i>Tanzania</i>	95	123
<i>Zambia</i>	95	
<i>Angola</i>	96	100
<i>Kenya</i>		122
<i>Egypt</i>		128

Source: WB ICA 2009

Foreign exchange products

Banks provide service to foreign related transactions. There are two major parts here; trade related foreign exchange transactions and transfers related. Banks have established forex bureaus that handle the exchange of currencies coming from transfers and service exports. Facilitating outgoing foreign exchange payments is also part of the services provided by forex bureaus. On the trade side, banks facilitate transactions by opening L/Cs and facilitating transfers when the merchandise changes ownership.

Money transfer

Banks are also involved in local and international money transfer services. Given the scanty information on remittance, more than one million Ethiopians

are expected to reside abroad, mainly North America, Middle East and Europe. Given the potential, the actual volume of remittance from abroad, through formal and informal channels, is low. However, the remittance of private individuals from abroad has increased from 101.2 million USD in 2000/01 to 790.3 million USD in 2009/2010. The remittance from NGOs has also increase from 258.7 million USD to 860.5 million USD in the same years. Although other studies indicate a higher figure than NBEs' estimates, the informal money transfer by private individuals has increased from about 66 million USD in 2000/01 to 960.3 million USD in 2009/10. There is need to develop diverse transfer products and reduce the regulatory and legal hurdles to increase the volume of remittance and channel the informal transfers into the formal one. There is hardly any data from NBE on the volume of local money transfer.

8.1.5. Performance

To assess the financial performance of the banking sector in Ethiopia, there is a need to conduct a standard CAMEL analysis, taking capital adequacy, asset quality, management efficiency, earnings and liquidity into account. In sum, while these indicators mostly show "positive" values, they are also reflective of a financial system that does not properly perform financial intermediation services.

Capital Adequacy Ratio (CAR)

Capital adequacy is measured by the ratio of capital to assets. The CAR of Ethiopian government-owned banks is 18%, while it is 19% for private banks²². Relative to SSA benchmarks (12 percent), this indicates well capitalized institutions. This is, however, reflective of a low asset and especially low lending base.²³

Asset quality

One of the indicators for asset quality is the ratio of non-performing loans to total loans which in turn is indicative for the quality of credit decisions made by bankers. In 2009 Ethiopian NPL ratio was 4 percent for public banks, 3 percent for private banks, 5% for MFIs and 2% for SACCOs, which is encouraging compared to an SSA average of close to 7%.²⁴ However, back in 2002, the overall NPL ratio in Ethiopia was above 60 percent and in 2005 still around 28 percent, primarily due to loan defaults in the public-owned banks. While these NPLs have been cleaned up currently, it is at least not clear if the fundamentals behind these issues have been addressed. In fact, the lack of proper risk-management skills has contributed a lot to the NPL status of both public and private banks.

Management efficiency

Management efficiency is usually measured in terms of assets or operating revenues per employee or cost-income ratios. The asset- and operating revenue indicators show significant improvement potential relative to benchmarks. Lower values reflect the inefficiency of the banking system with a

²² Data for about capitalization of banks in Africa collected from various sources, incl. AEMFI, WDI, central bank reports, analyst reports, annual reports, banking associations

²³ Compare also Abede (1991).

²⁴ Data about asset quality of banks and other financial institutions collected from various sources, incl. AEMFI, WDI, central bank reports, analyst reports, annual reports, banking associations.

low degree of competition.²⁵ Also the operating revenue per employee is with USD 37,000 for CBE and 30,000 for private banks relatively low compared to benchmark countries (93,000). Cost-income ratios are in turn more favorable in Ethiopia than in benchmark countries compared to regional benchmarks.²⁶ However, deeper analysis on the bank-level indicates that this is mostly due to low salary levels, especially in public banks and low levels of technical sophistication of banks that nevertheless enjoy low levels of competition.²⁷

Return to Equity (ROE)

The earnings of Ethiopian banking system is very positive for financial institutions with return-on-equity (ROE) around 32 and 23 percent for public and private banks respectively relative to an SSA benchmark of 20 percent. Again, this is likely reflective of the protected and low-levels of competition in the sector.²⁸ The financial performance of banks is relatively strong with average Returns on Equity reaching 31% in 2009 compared to 27% for Sub-Saharan Africa, indicating that banks are building solid income from their core activities and suggest a profitable opportunity to expand equity. Returns on Assets were modest at 2.5% suggesting room to optimize profitability. Returns in the banking sector have been consistently strong which is characteristic of a static sector with low levels of competition. There is a large variation among banks in profitability with larger banks having higher ROE. The largest bank has 40 % ROE whereas the bank with smaller scale has ROE of 19%.

Return to Assets (ROA)

²⁵ The total assets per employee were in 2008 for CBE USD 0.6mn and for private banks USD 0.3mn (SSA benchmark countries are here slightly above USD 1mn), data collected from various sources, incl. AEMFI, WDI, central bank reports, analyst reports, annual reports, banking associations.

²⁶ In 2008 23% for CBE and 32% for private banks, compared to 56% of benchmarks

²⁷ Amha (2010), Interviews with market experts

²⁸ Data about liquidity situation of banks in several African countries collected from various sources, incl. AEMFI, WDI, central bank reports, analyst reports, annual reports, banking associations.

The return on assets (ROA) of Ethiopia's banking system has been consistently high over the past years, reaching 3.2% in 2009, which is higher than the average for Sub-Saharan Africa. Given the low overhead costs, the profitability is strikingly high due to high demand for loan and other financial services and very weak and protected market and low competition. High profit margins in the non-lending business (non-interest) drive the high profitability of the banking system. Although private sector lending has increased significantly, the large profit margins on non-interest income (the most important profit driver of Ethiopian banks) has reduced the incentive of banks to become more competitive in the credit business. On the other hand, as uncertainty over the supply of foreign exchange has a negative impact on banks as well as local businesses, this may also push some banks to seek other avenues for generating revenue in the future, increasing competition among banks.

Capitalization of banks

Banks are well capitalized with capital to asset ratios hovering around 19%. Loan to deposit ratios and loan to asset ratios were modest at 0.4 and 0.5 respectively. Many would speculate that the banking industry does not experience shortage of capital but is highly under-lent.²⁹ Recent studies attribute overly conservative lending policy of commercial banks in developing Africa not to the absence of viable projects per se but rather to the high transaction costs and lack of mechanisms by which risks and viability can be adequately assessed, and new ventures selected, monitored and repayment enforced.³⁰ The latter supposition is clearly illustrated in Ethiopia's financial

²⁹Abede, A. (1991). *A Critical Evaluation of Sources of Funds for Bank Lending in Rural Africa*. Paper submitted to the Fifth Technical Consultation on the Scheme for Agricultural Credit Development (SACRED), FAO, Rome, AGS: ACD/91/1 (a), (April).

³⁰Nissanke, Machiko. (1991). *Domestic Resource Mobilization for African Development and Diversification – Liberalization Experience and Structural Impediments to Savings Mobilization and Financial Intermediation*. International Development Centre: Oxford University.

sector typified by inadequate risk management processes, narrow monitoring and evaluation, conservative lending practices, and an inadequate legal enforcement system to protect lenders against default.

Although very small sector, the overall asset quality of banks in Ethiopia is high as a result of weak competition, high demand for loans, and as significant reduction of CBE's NPL from more than 40% before five years to 1.7% in 2010, which is far better than private banks in Ethiopia. Cost-income ratios are relatively soft compared to regional benchmarks due to low labor costs and inadequate technical infrastructure. Other management efficiency ratios matrices indicate low efficiencies within the banking system which could be improved with enhanced technical capacity building (i.e., support studies, training, development of community-based organizations and institutions, and monitoring and evaluation) and the implementation and utilization of innovative technology.

8.1.6. Liquidity

The banking system has been plagued by excessive liquidity problems which continue to pose a challenge to the effectiveness of monetary policy instruments. A high degree of liquidity is observed in the banking sector, especially in the state-owned bank (CBE), driven by low lending volumes and conservative use of funds.³¹ Excess liquidity has been prevalent since the late 1990's due to diverse monetary policies. Excess reserves in most periods between 1999 and 2004 were driven by weak lending skills and highly conservative use of funds. In the period between 2004 through 2005 the sector

³¹ *Loan to deposit ratio of public banks (mainly CBE) was in 2008 with 35% extremely low (SSA bank average 68%), data collected from various sources, incl. AEMFI, WDI, central bank reports, analyst reports, annual reports, banking associations.*

witnessed a decrease in excess reserves, mostly due to increased lending to the government of Ethiopia in the “boom” phase of the economy. Gradual decreases in excess reserves were experienced between 2006 through 2008; the market saw a scaling back of excessive reserves due to mechanical decreases of excessive reserves in order to curb credit growth and inflation. However, beginning in 2008 excess liquidity began to show gains due to forced lending limitations and high reserve requirements underlying the need to curb inflation. The effect led banks to aggressively mobilize savings to fill the credit gap. Subsequently commercial banks spawned a spike in savings via incremental boosts in the average interest rate offerings to depository clients. Ironically, this occurred during a relatively high inflationary period in thereby reducing the purchasing power of depositors’ savings.

Table 8.7: Reserve and liquidity requirement of banks in Ethiopia, as of October 31, 2010

Reserve and liquidity position	October 2008	October 2009
Net deposit	66,907.62	82,582.36
Reserve requirement	10,036.14	12,387.35
Actual reserve	15,839.22	21,315.21
Excess reserve	5,803.08	8,927.86
Actual reserve ratio	23.67	25.81
Net current deposit	63,900.67	79,085.60
Liquidity requirement	15,975.17	19,771.40
Liquid assets	25,622.79	34,347.79
Excess liquidity	9,647.63	14,576.39
Actual liquidity ratio	40.10	43.43

Source: NBE (2009) Bank industry: Risk management survey report. Addis Ababa

Excess liquidity is in fact one of the most striking and consistent features of the Ethiopian banking system that has prevailed even through "boom" phases of the economy and "mechanical" increase of reserve requirements in 2007/2008. Most recently, third quarter of 2008/2009, domestic liquidity as measured by broad money supply reached Birr 80.6 billion, 22.6% higher than same period last year. Table 8.7 indicates that net deposits, actual reserve, excess reserve, liquid assets, and excess liquidity have increased significantly in October 2009 compared to 2008 figures. This is due to direct monetary instruments (increasing the reserve requirement of banks and credit caps introduced by NBE) to contain inflationary pressures. The coordinated tight monetary policy measures taken since 2007/2008 and through March 2009 have borne some fruit as it was possible to subdue annual Consumer Price Index (CPI) to 23.7% in March 2009 from 64% in July 2008.³² Nevertheless, the persistent rise in the excess liquidity of the banking system has continued to pose a challenge to the effectiveness of monetary policy instruments. According to the NBE, this hinders the development of a money market in Ethiopia. Loans for large investments need to be available to private investors with attractive incentive packages such as long grace periods, subsidized loans, matching funds and loan guarantee schemes. Excess liquidity, especially in a credit-constrained economy like Ethiopia, is highly reflective of financial institutions not being properly incentivized and capable to perform financial intermediation services. Given the significant demand for loan in the economy, it is still believed that excess liquidity is a very short-term problem, which could be depleted when NBE removes the credit caps for banks.

³²National Research & Monetary Policy Directorate, National Bank of Ethiopia. (2009). Quarterly Bulletin: Third Quarter 2008/2009. National Bank of Ethiopia: Addis Ababa.

8.1.7. Infrastructure, technology and institutional capacity of banks

The inhabitants per square kilometer in Ethiopia, 81 persons, is lower than in Nigeria (166 persons), Malawi (158 persons), and Ghana (103 persons) (WDI, UN, World Bank 2008). Moreover, about 83% of the population in Ethiopia resides in rural areas. Only 12% of the road network in Ethiopia is paved and road density remains one of the lowest in Africa (30km road/km² land, Africa average 50 km). About 70% of the population in Ethiopia have no access to all-weather roads as they live more than 20 km away. Bringing 90% of the population in Ethiopia within 20km of an all-weather road would cost 4 billion USD (equivalent to 75% of annual GDP) (WDI, UN, World Bank 2008). According to the information from ETC and WEF (2010), the mobile penetration is also very low compared with other African countries. Subscription per 100 population is 7.1 percent in Ethiopia compared to 49.2% in Kenya, 40.2% for Tanzania, 35.8% in Uganda 100.1% in South Africa. Users of internet per 100 population is 0.4% for Ethiopia, 8.7% for Kenya, 1.3% for Tanzania, 7.8% for Uganda and 8.6% for South Africa. The landlines telephone penetration in Ethiopia, 1.1 per 100 population, is relatively better compared to Kenya (0.7), Uganda (0.5) and Tanzania (0.3). The above evidence indicates that poor communication and physical infrastructure in Ethiopia increase transaction costs and limits access to financial services. The relatively dispersed population living in remote areas and the long distances between the lenders and homestead of smallholders increases administrative and transaction costs on finance providers (in searching, screening, monitoring, and enforcement). There is a need to develop appropriate finance providers which use light, flexible structures in order to reduce fixed costs linked to delivering professional quality financial services to remote farmers served with poor infrastructure. Small-scale permanent outlets equipped with low-cost high-tech information technologies and mobile offices can offer fast and

quality financial services to large number of the excluded population at reduced cost.

Technology enables inclusive finance providers to deliver a wider range of products and tailor them to individual needs. The use of back-office and front-office technologies such as hand-held point of sale services, smart cards, biometrics and mobile telephones can accelerate the growth and depth of outreach and performance of inclusive finance providers in the next five years. The use of debit, credit, and smart cards promises to significantly reduce the transaction costs of delivering financial services for rural clients and improves saving mobilization of finance providers. It brings banking and rural finance services to new clients and remote districts which were previously beyond the practical reach of traditional finance channels. Access to payment systems offered by financial institutions allows rural producers and agribusiness operators to participate in modern, efficient community trading systems that offer better prices. The present dearth of formal financial institutions and underdeveloped infrastructure in Ethiopia makes the use of debt and credit transfer payment instruments difficult. In the absence of checks and electronic payments (debit, credit card, GIROs, and wire transfers) in rural Ethiopia, cash is the most used payment instrument. Although the situation is expected to expand with time, adopting the new system could still be difficult given the high level of illiteracy and unreliable electric and telecommunication services in the rural areas. Difficulties in estimating the cash flows of farmers and non-existence of credit bureaus also contribute to the expansion of the electronic cards in Ethiopia.

Although Ethiopia has limited experiences with technology-based financial products or approaches, a positive development has been noted in the last two years. Banks have been aggressive in addressing back-office and front-office

technologies. The majority of commercial banks in Ethiopia (eight out of fifteen) have already implemented centralized internal systems by implementing a core banking system at the head office level and are in the process of connecting the branches to the centralized system. The branches are connected to their head office and can use the central database and are able to update the database if needed. CBE was the first bank to introduce electronic payment system by installing seven ATM (installation of 50 ATMs in the pipeline), followed by Dashen bank (55 ATMs) and Zemen Bank, with a multiple channel IT-based services and a single branch and also offers ATM services. The eight banks have invested more than 37 million USD to install core banking software and promote front office technologies. On the other hand, electronic data exchange is not used for clearing and settlement of inter-bank payments. The clearing of checks is fully manual and paper-based, including the link between the AACO and the Bankmaster system, the large value payment system of the NBE. Moreover, the NBE Bankmaster system is fully paper-based. Participants (commercial banks and government agencies) have to send in payment orders via letter of instruction. Information on settled incoming and outgoing payments and balances in the account at the end of the day is sent by NBE on the following morning to the participants also on paper. The above challenges reveal that there is a dire need for the establishment of well-functioning national credit bureau and national payment system which also serves the deposit-taking micro-finance institutions and cooperatives providing financial services to the excluded population.

8.1.8. Issues

After the removal of the entry barriers in the sector, the participation of the private sector in establishing banks increased significantly and increased

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competition in the sector. As of June 2010, 13 private banks have been established since 1996. Although this is very encouraging, in terms of improving outreach (increase in branch networks) and increasing the number of private banks, the sector has very limited capacity to meet the growing demand for financial services. Moreover, despite the decline in the share of the public owned banks, they still dominate the financial sector. The size of loans and saving of banks has increased significantly; lending is entirely based on collateralized lending. The financial sector is still closed to foreign investment and lacks both depth and breadth in the services it provides and the types of clients it serves. The banking sector in Ethiopia is characterized by limited competition and concentration in Addis Ababa and other few large urban centers. Although the speed is very low, the effort to further liberalize the financial sector is still on the reform agenda of the government.

The NBE has made several steps towards financial sector liberalization that contributed to the growth of privately-driven domestic banking sector. On the money and banking front, some of the policy measures taken by the government had a significant impact while some have fallen short of the initial expectation. The major proclamations in this domain are the monetary and Banking Proclamation, No. 83/1994, and the licensing and Supervision of Banking Proclamation, No. 84/1994. The major impact of proclamation No. 83/1994 has put an end to the incipient mono-bank system that was consolidated under the command type economy of the Derg regime. As a result of the current government's action, a better financial system is now on the rise.

In the Ethiopian context, the actual effect and impact of government banks seems to be different. The NPLs, profitability, return to equity and asset of state-owned banks are comparable to international standards and

benchmarks. There are cases where some of the government-owned banks excel the private banks in some efficiency indicators. Currently, because of the huge demand for loans and other financial services in Ethiopia, the crowding out of the private banks seems to be remote. However, both the government and private banks in Ethiopia have moved away from providing rural and agricultural lending and lending to micro, small and medium enterprises in an attempt to mitigate the risks. Although the government-owned banks claim to have development and social objectives, by serving the excluded, the reality is different. They have failed to adhere to their dual mission (financial and developmental objectives). We believe that a cost-benefit framework for discussing the role of the government-owned banks would be the right tool for both determining the appropriate overall direction, as well as the right path for achieving this in Ethiopia.

Currently, Ethiopia has a small banking system, with a low but increasing level of financial intermediation. The number of private banks has increased significantly. Credit to the private sector has increased steadily growing as a result of the two digit economic growth rate in the last five years. Financial institutions in Ethiopia, particularly commercial banks, are certainly constrained by high transactions costs, low population density, and the lack of mechanisms by which risks and viability can be adequately assessed, and new ventures selected, monitored and repayment enforced.³³ The bank concentration ratio is higher than the average for Sub-Saharan Africa (77%). Foreign ownership and participation hardly exists in the banking sector. Ethiopia's banking system is relatively profitable. Since there is huge demand for loans, the profit base does not provide banks with an incentive to go down

³³Nissanke, Machiko. (1991). *Domestic Resource Mobilization for African Development and Diversification – Liberalization Experience and Structural Impediments to Savings Mobilization and Financial Intermediation*. International Development Centre: Oxford University.

market in the deposit and loan segments to reach out to smallholder farmers and micro, small and medium enterprises. Despite the substantial growth and improvement in the banking sector, Ethiopia still faces several challenges. Indeed, credit is often rationed in favor of larger and more established businesses even under the most advanced of financial systems because of the informational asymmetry inherent in lending transactions. At the same time, informational asymmetry and other potential sources of credit rationing are more severe or prevalent in countries like Ethiopia, where many aspects of the financial system are clearly underdeveloped. This should create space for potential allocative efficiency gains and within firm productivity growth through financial sector reforms aimed at addressing the informational disadvantages particularly of small businesses in credit markets.³⁴

The financial sector in Ethiopia³⁵ has a crucial role to play in mobilizing savings for productive investment, and by facilitating capital inflows and remittance from abroad. It can increase technological progress, productivity and improve resource use by reducing transaction costs, facilitating inward investment, and making capital available in better technologies. The development of finance influences private sector development and has direct impact on income and asset of households by enabling the people to save in a secure place and draw accumulated savings and/or borrow to invest in income generating activities and access other financial services. However, the financial sector has been constrained by a number of factors. The key issues in the development of the financial sector in Ethiopia include the following points.

³⁴World Bank. (2009). *Towards the Competitive Frontier: Strategies for Improving Ethiopia's Investment Climate*.

Report No. 48472-ET. World Bank: Washington, DC.

³⁵ Financial sector is all the wholesale, retail, formal and informal institutions in an economy offering financial services to customers, business and other financial institutions. In its broadest definition, it includes everything from banks, stock exchanges, and insurers, to credit unions, microfinance institutions and informal finance providers.

Financial access to smallholder farmers and MSE operators

Providing loans and other financial services to farmers and agribusiness operators, small and medium enterprises, without property collateral, requires an in-depth understanding of the sectors and its inherent risks. A better knowledge of the activities of these sectors will safeguard the banks from granting loans for activities that are too risky or granting loans beyond borrowers' repayment capacity, thereby helping them avoid over indebtedness. To this end, there is a need to build the capacity of finance providers by deploying a specialized staff and department dedicated to serve these sectors, when the business volume justifies it. Moreover, loan officers specializing in agricultural and micro, small and medium enterprises will be more inclined to offer judicious advice, properly assess farmer's needs, develop a viable business plan and a sound business relationship with borrowers. There is also a need to build the capacity of finance providers to provide quality financial services to farmers, small and medium enterprises and increase their outreach, efficiency and sustainability. Moreover, the mindset and understanding of the staff of finance providers such as banks should be changed through sensitization and tailored training, so that the staff considers delivering financial services to farmers and MSE operators as their national responsibility. Once the finance providers decide to serve the excluded, they will require revisiting their business plans, developing tailored financial products, training and retraining the staff in agricultural lending. All will require the guidance and strategy of the government, particularly the NBE.

Increasing bank credit to the private sector

Ethiopia had been a low inflation country in Sub-Saharan Africa for a long time. However price started to increase gradually and reached about 25.3 %

and 35% for general inflation and food inflation in June 2008 respectively. This was aggravated by high reserve requirement of NBE and global financial crisis which affected macro-economic stability. As a result, the high inflation created sizable challenge to economic growth and the welfare of the society, particularly the poor. On top of the administrative measures implemented to reduce the price of grain (by taking legal measure against individuals hoarding grain and distributing wheat to urban dwellers using EGE), the government introduced various monetary and fiscal measures to reduce inflation. These include: (i) elimination of fuel subsidies; (ii) tightening fiscal policies by reducing government borrowing from the banking system; (iii) reducing public enterprise domestic borrowing; (iv) curtaining money growth; (v) greater exchange rate flexibility; (vi) careful prioritization of public expenditure; (vii) temporary exemption from VAT on food and food-related items; (viii) auctions of Treasury Bills (held every two weeks) as a tool to control liquidity. In addition to these, NBE issued directives which increased the reserve requirement of banks and introduced total credit limits of banks by identifying the priority sectors (agriculture, manufacturing and export). Other sectors would receive foreign exchange and loan access after serving the priority sector.

The significant reduction of bank credit has a negative impact on the development of the private sector and economic growth in the country. There is a need to balance reducing inflationary pressure and fostering sustainable economic growth. Moreover, while annual inflation has increased significantly (with annual average inflation reaching 45.2% in March 2009), bank lending rates only increased from 7% in 2004/5 to 9% by public banks and 11.5% by private banks, as of January 2009. The average time deposit rate was 4% for public banks and 5.69% for private banks (before December 1, 2010). Although the negative interest rate was expected to significantly reduce saving

mobilization of banks, the effect was very minimal. Despite the high inflation, the saving deposits of CBE continued to increase significantly. On the other hand, the high inflation resulted in an increase in the average loan size. This might suggest that interest rate is secondary in affecting savings and investment in a less monetized economy such as that of Ethiopia.

Promoting competition and creating a plain level field for private banks

Competition in banking or any other industry can be affected by a host of factors. One of the major ones is the structure of the market and the conduct of firms in the market. Other factors include, institutional setup, earnings in the market, policy and legal framework. The level of competition is said to be higher in markets where there are small number of big and equal sized firms. In this case the race to excel one another is fiercer. In cases where there is one very big firm and the others are small the competition is very limited as the small ones tend to follow the actions of the big firm. Given the huge demand for loan, there is still a relatively lower competition among the smaller banks. In the Ethiopian banking system, there is very high concentration. As CBE takes up more than half of the assets of the system its actions determine what happens in the market. Most of the people in the private banks are former employees of CBE and this is likely to make the private banks followers of CBE. However, recently, private banks have started to be more innovative in introducing new services which enhances competition among the private banks. Earning is also another factor that affects competition. There are arguments that in markets where the earning level is high firms are less motivated to compete against each other or to innovatively differentiate themselves. Again as discussed above the returns to equity ratio of most commercial banks in the country is very high even by Sub-Saharan Africa level. This may give less incentive to banks to take measures to compete. The prohibition of entry of foreign banks in the sector has a negative impact on

competition. The policy of the government tends to favor public banks. For example, public banks have an advantage over private banks in accessing loans from foreign banks. Moreover, unlike public banks, private banks are denied access to credit facilities made available by the Chinese government.

Preparation to increase ‘systemic fitness’ before allowing foreign banks to enter into the market

The government outlined the justification for not inviting foreign banks into the country as follows (i) the NBE does not have the capacity to monitor and control the sophisticated foreign banks. Therefore, prior to inviting foreign banks into the country, the government seeks to strengthen the monitoring and supervision capacity of the NBE; (ii) the government is responsible for managing the macro-economy to provide stable macro-economic environment for domestic and foreign investors. Instead of allowing foreign currencies to be bought and sold at bureau de exchange, the government is channeling foreign exchange through local banks. Given the current Ethiopian context, it would be very difficult to implement this prudent macro-economic management policy if foreign banks are allowed to operate in Ethiopia; and (iii) the government believes that domestic banks should play a leading role in mobilizing financial resources for investment. If experienced and strong foreign banks are allowed to operate in Ethiopia, they are bound to take this role away from local banks, which is detrimental to the development process (FDRE 2002). As a result, removing the entry barriers for foreign banks has remained a point of friction between the Ethiopia government and the IMF³⁶. There are obvious risks of

³⁶ Prof. Stiglitz (formerly Vice President and Chief Economist of the World Bank) once commented that the IMF wants Ethiopia to do almost overnight what the United States and Western Europe did not do before 1970s, when their markets, and the necessary device of regulation, were infinitely more developed than Ethiopia. He argued that Ethiopia had “excellent reasons” for resisting the IMF’s demand to open the banking system. His advice was based on what happened in Kenya, which had given into IMF pressure to ‘liberalize’ its financial market, convinced that the competition between banks was going to decrease interest rates. According to Prof. Stiglitz, the results had been catastrophic. This liberalization was followed

allowing foreign banks in Ethiopia which include: (i) foreign banks ‘skimming’ most attractive market segments and leaving the local banks with unprofitable consumers (potentially causing massive exits); (ii) local regulators with challenges to cope with foreign players, causing potential systemic instability; (iii) exposure to risks in foreign banks home countries as well as potential short-term engagement mind set; and (iv) failures of new entrants due to inability to cope with local market conditions. However, there are clear opportunities of foreign bank entry in Ethiopia including the potential for the transfer of new skills, technologies, products, systems, management, etc; increase in competition that can benefit customers; increase in funding; better overall economic diversification and potential strengthening of regulatory framework by customizing imported regulations. Since allowing foreign banks is eminent, there is a need to develop a preparation plan to increase “systemic fitness” before foreign banks enter the market in the long run.

Financial sector technological infrastructure

Finance providers fail to expand their rural network mainly due to poor physical infrastructure. Improving roads, warehouse infrastructure, electricity, telecom, absence of national ID, and security infrastructure is associated with reducing the transactions costs of doing business (lower interest rates and fees) for finance providers. Thus, intervention of government and development partners in improving the physical infrastructure will have a positive impact on the expansion of inclusive finance in Ethiopia. The present dearth of formal financial institutions and underdeveloped infrastructure in Ethiopia makes the use of debt and credit transfer payment instruments difficult. In the absence of checks and electronic payments (debit, credit card, GIROs, and wire transfers)

by fast growth of indigenous banks, during a time when the banking legislation and the surveillance of banks were inadequate, leading to predictable results: fourteen bankruptcies in 1993 and 1994; and increase in interest rates (Prof. Stiglitz’s comment during his visit to Ethiopia).

in rural Ethiopia, cash is the most used payment instrument. However, the situation is expected to expand with time.

Currently, the NBE is making significant efforts to promote ICT in the financial system. A feasibility study was conducted a national payment system for banks, which has not fully covered the connection of MFIs and financial cooperatives to the payment system. The recommendations of the study with respect to centralization and the architectural design of national payment system entail the following core elements:

- (a) Adoption of the legal framework and the upgrading of the infrastructure for telecommunication and other utility services to ensure an environment that is conducive for national payment system*
- (b) The development of virtual private networks (VPN) for communication purposes in the banking industry, the sending in of payment orders for inter-bank and intra-bank clearing and settlement and the exchange of data between clearing and settlement systems and the participants in these systems.*
- (c) The implementation of a Real Time Settlement System (RTGS) for large value and time critical payment*
- (d) The introduction of a broad range of new payment instruments and the working out of a strategy to develop the market for retail payments and the development of a plan to enlarge the access to banking and payment services in Ethiopia*
- (e) The improvement of the management of software for payment processing of commercial banks that supports straight through processing, the implementation or upgrading of core banking systems and the connections of the branches to the head offices*
- (f) The modernization of the clearing and settlement system for cheques by:
(i) introducing standardized cheques with MICR lines; (ii) electronic cheque*

presentation; and; (iii) involvement of the facilities for clearing of cheques issues outside Addis Ababa either by introducing cheque imaging or a system of regional cheque clearings

- (g) The implementation of a central switch for card payments in order to ensure interoperability of the networks of ATM's and POS terminal of individual banks*
- (h) The implementation of an efficient inter-bank clearing and settlement infrastructure for retail payments other than cheques*
- (i) A feasibility study for settlement arrangements for cross border transactions*
- (j) The implementation of a Central Securities Depository (CSD) for central registration of securities in book-entry form and implementation of a safe and sound clearing and settlement infrastructure for securities settlement*
- (k) The implementation of an overnight framework*

Payment system

Access to payment systems offered by financial institutions allows financially excluded population in urban and rural areas to participate in modern, efficient community trading systems that offer better prices. The payment system in the country remains cash dominated in Ethiopia. Other modern instruments of payment are not widely used in Ethiopia. Cash, cheques and letter of Credit (L/C) are the major instruments. With regard to electronic payments, some institutions have issued certain electronic forms of payments such as SWIFT and Western Union in banks used to settle foreign exchange transfers. Total fuel station has a fuel card used for payment. Dashen Bank introduced a credit card which is not used widely, but only used in some hotels and shops. A number of reasons are cited for the low level of development of electronic and internet-based payment system. The low connectivity in lines, the low level of development of high speed internet, and the lack of institutional and legal

framework for establishing better payment instruments. Cognizant of these the National Bank of Ethiopia has been working on modernizing the payments systems in the country.

Regulation

The various policies and the regulatory framework designed to guide and monitor the activities of finance providers have direct impacts on outreach and viability. Ensuring the safety of clients and building healthy finance providers for the development of the financial sector require prudential regulation and supervision compatible with the objective condition of Ethiopia. In fact, finance providers such as banks provide financial services (including loans, savings and insurance products) to numerous individuals and companies repeatedly. The need for quick repayment, extending individual loans without collateral, the use of innovative lending products, mobilizing savings from millions of excluded population and highly decentralized system require efficient regulatory and supervision system and ensure good governance. To this end, the National Bank of Ethiopia (NBE) has been heavily involved in regulating banks³⁷. In spite of the success in prudential regulation by NBE, there is a need for improving regulations which include: Putting in place deposit insurance system: Although there have not been an incidence of bankruptcies of banks or MFIs which mobilize public savings in Ethiopia, there is a need to put in place deposit insurance system to guarantee the safety of depositors. The deposit insurances will have an impact on increasing deposit mobilization of finance providers and lowers the risk of 'unfounded' bank and MFI runs. There is also a need to provide an enabling policy and regulatory environment to reduce entry barriers such as attracting foreign banks and social investors and

³⁷ Multipurpose and financial cooperatives are regulated by the Federal Cooperative Agency.

promote competition. Removing the credit limits for banks will improve financial access to the private sector and increase economic growth.

Although there are different approaches to encourage finance providers to provide financial services to the financially excluded population, such as through incentives, one way of involving the commercial banks is through regulation. For example, the NBE may direct the commercial banks (say 10%) of their loans to the financially excluded and priority sectors such as small enterprises and smallholder commercial farmers. To meet the NBE requirement, commercial banks can open a separate window to serve the priority sectors or activities; they could outsource these activities for MFIs for fees or establish their own MFI.

Risk management skills of finance providers

While specific issues vary by type of institution, risk management stands out as a key issue in the banking sector. Commercial banks in Ethiopia instead of focusing on risk-base or cash flow lending, all practice collateral-based lending. The commercial banks lack the skills to properly assess the risks of agricultural investments. A recent survey of NBE with regard to risk-management skills of Ethiopian banks substantiates this issue (see box below).³⁸

³⁸ NBE Risk Management Survey Report 2009

Box 8.1: Overview of results of NBE risk management survey report, December 2009

Board responsibility: *In 87% of banks a significant part of the board members didn't have risk management training; in 60 % of banks board of directors are not provided with relevant and up-to-date economic, business, and market data for informed decision-making.*

Structure and resources: *Specific budget allocated to risk management function in 75% of banks is either relatively insignificant (less 0.5% of total budget) or unknown; in 73% of banks, only part or none of the staffs were trained in risk management.*

Strategy and Policy: *74 % of banks have not yet documented risk management strategy and program; 60 % of banks do not define risk limits.*

Auditors: *77 % of external auditors and 60 % of internal auditors of banks do not independently review effectiveness of banks' risk management functions.*

Risk identification: *Risk management function of 93% of banks does not capture risks related to procurement and HR; 87% of banks do not conduct workshop to identify risks in each activity/product and don't exercise stress testing as a risk management tool; 93% of banks do not have continuity/disaster recovery/contingency plan in place for other risks like market or reputational risks (NBE 2009).*

Product development

All banks in Ethiopia provide similar financial products to clients. There have been limited innovations in the products, which is partly the result of low completion in the sector. Banks should shift from the traditional supply-driven products to demand-driven and innovative products. To this end, banks need to increase their scope of searching for new markets and deepen penetration by broadening the range of financial services offered to existing and potential clients. Using a product development process that is client-centered allows

meeting both financial and development objectives of banks. Focusing on what is of value to client influences the financial performance, outreach, product design, increase in client satisfaction and retention of banks. Moreover, attempts should be made by banks to develop financial products that match the financial needs of the excluded population.

Value chain finance

Value chain finance can be described as all innovative financial products and services that flow to or through any point in a value chain in order to increase returns on investment and growth and competitiveness of that value chain (Terrafina 2009). Well functioning commodity value chain ensures that each link can adequately and efficiently access to credit either: i) directly from a financial institution; ii) indirectly from another link. Unless the commodity value chain actors are provided with sustainable financial services, ensuring growth through the commodity value chain approach will be very difficult. On the other hand, value chain finance works best, where the value chain is functioning well, that is, where there is strong end-market demand, as well as transparency, trust and strong and repeated inter-firm transactions (Dali Mwangore et al 2009).

The value chain finance providers include formal banks, MFIs, cooperatives and informal sources which target one or more of the key leverage points within the chain. The finance providers are expected to design tailor-made financial products to suit different needs of the commodity value chain actors, as opposed to conventional financing approach such as group lending methodology which has been applied to all clients across different environments. Finance providers will benefit from financing the commodity value chains in the form of interest rates payable from clients. On top of accessing loans, the value chain actors also benefit from the saving, insurance,

payment system and money transfer services provided through sustainable finance providers which at the same time improve their credit worthiness. Saving mobilization is one of the tools of finance providers to generate loan capital which can assist them to on-lend to commodity value chain actors. The value chain finance approach is very useful in identifying the key leverage points (such as input production and supply; production; processing and marketing) and prioritizing constraints of the value chain actors. Providing financial services to commodity value chain actors, by identifying the priority value chains, has not been considered by the Ethiopian banks. We believe that identifying only the priority sectors is not enough and there is a need to start implementing value chain financing.

Credit reference bureau

The NBE claims that it has a credit bureau where the list of all clients of the banks is made available. However, the information of the credit bureau is not detailed lacking the credit history of each client. Banks are also hesitant to obtain customer authorization at the time they process loan applications and share loan and repayment details through the credit bureau. As a result, the credit bureau is unable to fulfill its function of assisting lenders in assessing risks and price credit appropriately. The establishment of robust CRB will improve the quality of credit delivery and reduce loan default rates. The bureau will also be a useful tool in increasing outreach and efficiency of banks and other finance providers such as MFIs. Establishing CRB requires conducting a detailed study to assess the institutional and legal challenges, management and governance, and identifying the institution where it should be housed.

Realizing the weaknesses of the existing credit bureau, the NBE has proposed establishing a functional credit reference bureau and developing the legal

framework and necessary directives which clearly state the rights and responsibilities of various parties. Although establishing the credit bureau under NBE will prevent misuse of customer information, such as violation individual privacy of by credit bureau employees, the stakeholders themselves could be more efficient, if such deficiencies are rectified through a stable and well-functioning legal framework. Moreover, the banks can obtain customer consent for sharing information as part of loan applications, share such information with credit bureaus, and affirmatively seek such information from credit bureau for new loan applicants. The NBE could make conditional upon the credit bureau submitting to its supervision, so as to watch for consumer interest. There is a need to support the current initiative of establishing CRB by banks and extend its services to all inclusive finance providers.

Designing detailed financial sector development strategy

There is a need to articulate a strategy, looking both to the near-term and the future. To the best of our knowledge, the government has no financial sector development strategy that has been made public. Choice of a strategy and sequencing of its elements should be based on prior detailed analysis of the financial landscape that prevails in the country, and proper forecasting of the macro-economic growth both in the short-run and long-term.

As it is known, the government has prepared several sector strategies and development policies over the last fifteen years. What is missing is the financial sector development strategy that supports the rest of policies and strategies. The implication of the absence of a coherent financial sector policy should be clear particularly to the policy makers. Such a strategy could have served as a framework and policy guideline to those operating banks in the industry when deciding on various issues of national importance. A clear example is the absence of a clear guideline at the national level with regard to

branch opening by individual banks. This issue is generally left to individual banks, which generally prefer to concentrate in Addis Ababa and major regional towns, to the neglect of the vast majority of the people who are in dire need of the financial service to bring a change in their livelihood.

8.2. Insurance sector

The livelihoods of human beings are contained by diverse controllable and uncontrollable risks ranging from death of individuals to asset loss of companies. The main purpose of insurance companies is, therefore, transferring these risks from unfortunate individuals or businesses towards policy holders. In addition, insurers use the premiums paid on policies to invest in assets such as bonds, stocks, mortgages and other loans to pay out claims on the policies.

This section reviews the historical evolution, structure, role, performance, entry barriers, competition, types of products and the human capital developments of the insurance industry over the past decade. Comparison is also made with selected sub-Saharan African countries to examine the relative position of the state of the Ethiopian insurance industry.

8.2.1. Historical developments

Insurance appears simultaneously with the existence of human beings. In ancient form of insurance, members of communities helped each other when they faced natural or unnatural catastrophic events that could lead to a large financial loss. In modern money economy, insurance is part of the financial intermediation services. Ancient insurance service was practiced by Chinese

and Babylonian traders as long ago as the 3rd and 2nd millennia BC. The first life insurance company in the United States was established in 1759 and is still in existence (Mishkin, 2004).

In Ethiopia, insurance is dated back to ancient years when people contributed money/labor to assist other members whenever they faced financial difficulties or needed assistance. 'Idir' and 'Eqqub' are among the organizations that have played significant role in traditional insurance service in Ethiopia.

The first modern insurance company in Ethiopia can be traced back to 1905 with the establishment of Bank of Abyssinia. The bank was acting as agent for foreign insurance companies to underwrite fire and marine policies. According to Hailu, 2007, in 1923, the first Austrian agent of La Baloise Fire Insurance Company came to Ethiopia and paid the first loss on warehouse and shop in 1929. Prior to 1950, only foreign insurance companies had been operating in Ethiopia. In 1951, the first domestic insurance company- Imperial Insurance Company of Ethiopia-was established. Thus, during the 1950s and 1960s, 33 foreign and 1 domestic insurance companies were giving insurance services. The rise in the number of domestic insurance companies and the expansion of foreign insurance agents motivated the government to issue the first insurance proclamation to regulate the insurance business in the country.

In 1970, the first insurance regulation, Proclamation No. 281/1970 was issued. This proclamation prohibited foreign companies to undertake insurance business in Ethiopia either directly or through agents. Article 56 of the proclamation raised the minimum paid up capital for all insurances types. Following the 1974 revolution which followed the path of the command economy, all domestic insurance companies were nationalized through

Proclamation No. 26/1975. The Ethiopian Insurance Corporation (EIC) established in 1976 by the then government of Ethiopia monopolized the insurance business by taking over the assets and liabilities of private domestic insurance companies (Hailu, 2007).

As part of the change in the economic policy of the country, the insurance industry has been re-liberalized again by proclamation No.86/1994. This proclamation stopped the monopoly of the EIC and permitted the establishment of private domestic insurance firms.

8.2.2. Structure of the insurance industry

By the end of June 30, 2010, the Ethiopian insurance industry was composed of 13 insurance companies (12 private and 1 public), 37 insurance brokers, 47 loss assessors, 2 surveyors, 812 sales agents, 1 insurance association, and 1 insurance society. Eight of the existing private insurers were established during the first three years of liberalization (September 1994- January 1997). In the last ten years only five private insurers joined the industry with total branch networks of 47. Thus the insurance industry was not growing in the last five years in line with the population and economic growth.

Currently, the minimum required capital to establish an insurance company is Birr 3 million for general insurance, Birr 4 million for long-term insurance and Birr 7 million for composite insurance. The minimum required capital in Ethiopia is lower than South Africa, Egypt, Kenya and Tanzania. South Africa and Egypt required capital of more than USD 1.5 million to establish insurance business. Ethiopia's minimum required capital is higher than only Uganda and Zambia (African Insurance Organization, 2008).

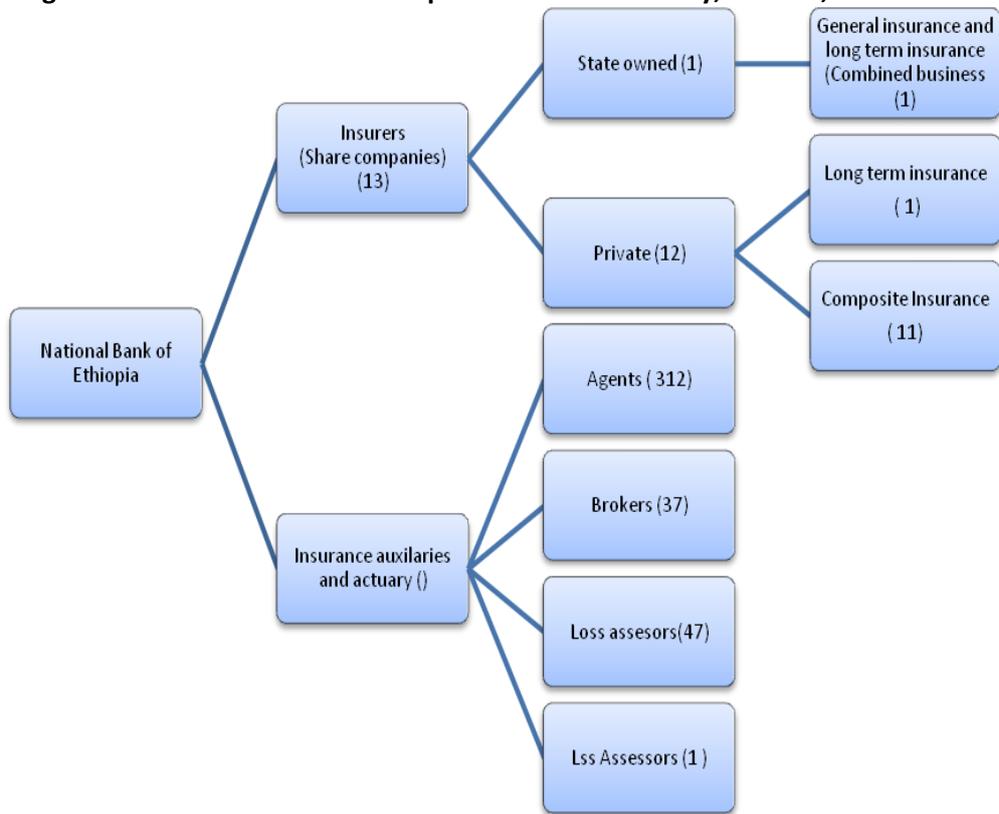
Table 8.8: Insurance companies in Ethiopia at the end of October 2010

No.	Name of company	Year of establishment	Branches as at October 31, 2010	Share of branch network (in %)
1	<i>Ethiopian Insurance Corporation</i>	1975	41	19
2	<i>National Insurance Company of Ethiopia S.C.</i>	1994	16	8
3	<i>Awash Insurance Company S.C.</i>	1994	26	12
4	<i>United Insurance Company S.C.</i>	1994	23	11
5	<i>Africa Insurance Company S.C.</i>	1994	13	6
6	<i>Nile Insurance Company S.C.</i>	1995	20	9
7	<i>Nyala Insurance Company S.C.</i>	1995	16	8
8	<i>Global Insurance Company S.C.</i>	1997	10	5
9	<i>Nib Insurance Company S.C.</i>	2002	20	9
10	<i>Lion Insurance Company S.C.</i>	2007	11	5
11	<i>E-Life Insurance Company S.C.</i>	2008	0	0
12	<i>Oromiya Insurance Company S.C.</i>	2009	15	7
13	<i>Abay Insurance Company S.C.</i>	2010	1	0.5
Total			212	100

National Bank of Ethiopia

At the end of June 30, 2010, the total capital of the industry (both life and non-life) reached Birr 806 million. The insurance industry sells general (non-life) insurance business since its inception. The general (non-life) insurance business constituted more than 95% of total industry's capital on average during the last ten years. The share of long-term (life insurance) has taken only the marginal share of 5% of the industry's capital in the last ten years. This dominance of the general insurance business is an indication that an insurance product of the companies is not diversified.

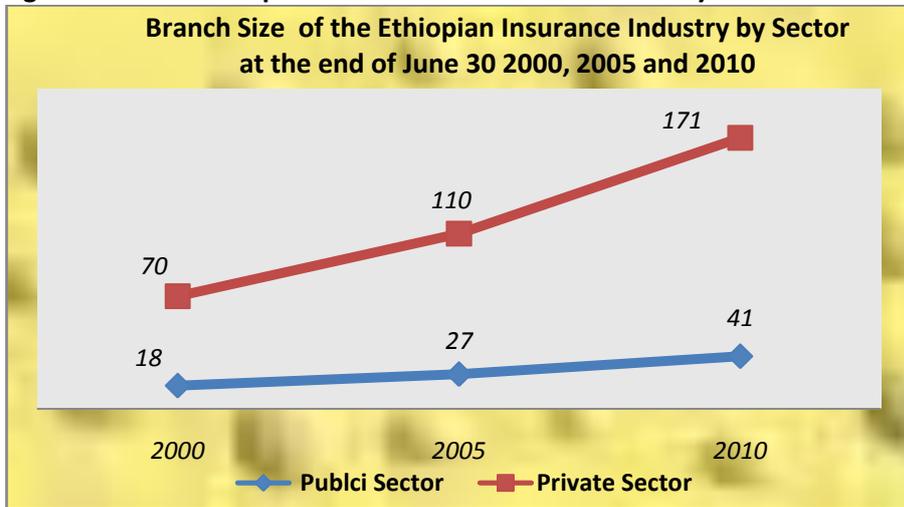
Figure 8.4: Structure of the Ethiopian insurance industry, June 30, 2010



In terms of ownership, the number of branches of the Ethiopian Insurance Corporation (EIC) increased from 16 in 1994 to 41 in 2010. Although 5 new private insurers with 47 branch networks joined the industry in the last 10 years, the share of EIC has remained constant at about 19%. The share of total capital of EIC, however, dropped by 10 percentage points during 2005-2010 indicating that the newly opened insurers have high capital to branch ratio. Since the rural economy has low insurance coverage, most of the branches are

found in the urban centers. By June 30, 2010, 50% of the total branches were located in Addis Ababa.

Figure 8.5: Ownership structure of the insurance industry



Source: National Bank of Ethiopia

8.2.3. The role of insurance in economic development

Unlike banks and capital markets there is no ample evidence on the causality between insurance and economic growth in developing countries. In developed economies, insurance companies together with mutual and pension funds are the biggest institutional investors in stock, bond and real estate sectors. And their possible impact on economic growth has been scrutinized (Peter, 2006).

The major role of insurance companies is financial compensation of unexpected misfortunes which could come from geographical (earthquake and volcano), meteorological, hydrological and climatological events.

According to Hass 2006, the role of the financial sector is to channel resources from savers to investment projects. Thus, the financial sector helps to: (i) improve resource allocation by improving the screening of fund seekers and the monitoring of the recipients of funds (ii) mobilize savings, (iii) lower costs of capital through economies of scale and specialization and (iv) provide risk management and liquidity. In developed economies, insurance companies play some of the above functions of the financial intermediaries and thus should have a major role in the economic growth. In developing countries like Ethiopia, insurance companies give only marginal role of transferring risks from unfortunate individuals or business towards policy holders because there are no flourished capital markets that the insurance firms invest their portfolios. In most of developing countries, insurance companies invest in treasury bills and government bonds which have very low interest rates.

In developed economies, insurance companies smooth the economic cycle and reduce the impact of crisis situation by reducing uncertainty and volatility. The indemnification of insurance companies enhances trade, transportation and capital lending. By giving product liability, insurance firms which are engaging in development of new products spur economic growth in the long run via these new products. Risk transfer function of the insurance services is not, however, without possible negative outcome to the economy in that the policy holder may change his behavior due to insurance coverage by dispensing him from taking precautionary actions against the occurrence of the secured event and the extent of the resulting damage (Marijana et al, 2009).

In the modern economy, insurance companies especially life insurance companies' augment additional competition to the financial markets that helps customers to access diversified portfolio of investments (Peter .H, 2006). Thus, developed insurance business encourages business to take risks not only on present production processes but also motivates individuals to invest on technological innovations which have higher impacts on long-term economic growth.

8.2.4. Performance of the insurance industry

At the global level, the demand for insurance service slowed down in recent years. Low insurance rate due to high competition in the industry and low interest rate due to the global credit crunch in 2008-2009 are the major factors. The global demand measured by premium volume has dropped in 2008 and 2009 by about 3 and 1%, respectively (see Table 8.9).

America and Europe took the lion's share of global demand. In 2009, the combined share of the two continents exceeded 70%. Similarly, insurance penetration and insurance density in America and Europe surpassed other economic blocks by far (see Table 8.9).

The share of Africa in the world market was only 1.2%. In fact, if South Africa which has relatively developed insurance market is excluded, Africa's share will be marginal. Insurance penetration (gross premium to gross domestic product ratio) is also negligible in Africa being only 3.3% in 2009 compared to 7% in America and 7.6% in Europe. The insurance density measured by gross premium per population was also USD 0.05 million in Africa which is 30 and 38 times lower than America and Europe, respectively. Foreign dependence on reinsurance business, fragmented market, low disposable income, weak

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supervision, low level of technological infrastructure, inadequate human capital and inefficient financial market, are the major problems of insurance market in Africa (African Insurance Organization's 2008 Annual Review)

Table 8.9: Insurance demand by region in 2009

Region	Premium volume (in billions of USD)			Real growth			Share of world market (in %)		premiums as a % of GDP		premiums per capita (in mn of USD)	
	2009	2008	2007	2009	2008	2007	2009	2007	2009	2007	2009	2007
America	1,349	1,450	1,417.50	-6.1	-2.5	2.7	33.2	6.9	7.5	1.5	1.6	
Europe	1,611	1,704	1,330.10	1.8	-9.9	2.1	39.6	7.6	8.7	1.9	4	
Asia	989	935	840.6	2.8	6.4	4.5	24.3	6.8	6.2	0.2	0.2	
Africa	49	53	68.8	-11	1.9	3.9	1.2	3.3	6.6	0.05	2.1	
World	4,066	4,220	4,060.90	-1.1	-3.6	3.3	100	7	7.5	0.6	0.6	

Source: Swiss Re, Economic Research & Consulting, sigma No. 2/2010.

Ethiopia is the second populous country and has one of the fast growing economies in Africa. However, the insurance industry is one of the least developed measured by insurance density and penetration. Although the number of insurance companies, sales agents and insurance brokers showed slight increase in recent years, it did not return to the level where it had been 3-4 decades back. According to African Insurance Organization's 2008 Annual Review, Ethiopia and Uganda are the only countries in sub-Saharan Africa without reinsurer companies. As a result, huge amount of foreign exchange has been flowing out to reinsurance companies.

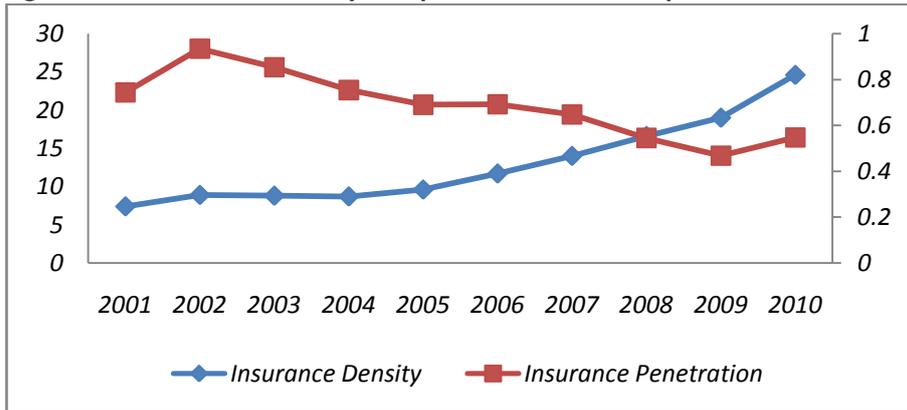
Table 8.10: Insurance development in selected Sub-Saharan countries

Country	Population (in millions)	Per capita GNP (in \$US)	Number of companies		Brokers
			Insurers	Reinsurers	
Ethiopia	74.8	100	12	-	36
Ghana	2.4	290	22	2	3
Kenya	34.7	980	44	2	201
Sudan	41.2	330	14	1	N/A
Uganda	28.2	280	19	-	24
Tanzania	38	300	17	1	60
South Africa	44.3	11,639	172	12	Na

Source: African Insurance organization Annual Review 2008

As the following figures indicate insurance density has showed an increasing trend from low level of Birr 7.4 in 2001 to more than Birr 24 in 2010. However, since the price level has also increased significantly during these years, the real insurance density may not increase as nominally looks so.

Figure 8.6: Insurance density and penetration in Ethiopia



Source: National Bank of Ethiopia and own computation

Similarly, insurance penetration as measured by gross written premium as percent of GDP depicted declining trend over the last ten years. The global credit crunch which had visible impact on the global insurance demand in the last two years has also affected the insurance business in Ethiopia. The gross written premium has recorded the lowest figure in 2009 due mainly to the global crisis. Other factors that affected the insurance business in Ethiopia are: the structure of the economy which is dominated by rain-fed agriculture, absence of differentiated products, unethical competition, backward technology, restrictive proclamations, and absence of compulsory insurance, non-existence of re-insurance companies, lack of capital market and low and negative interest rate (ADB, 2009).

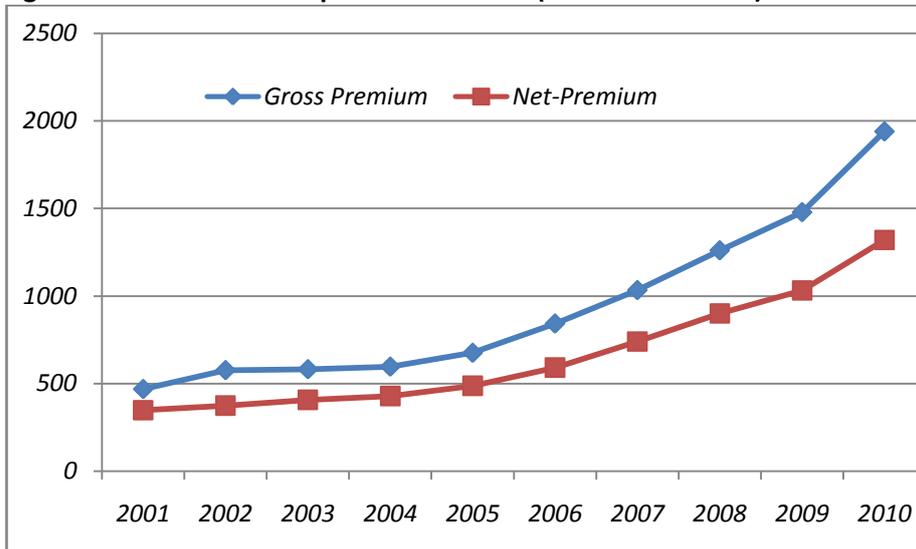
The total gross written premium of the insurance industry exhibited an increasing trend in the last ten years to reach Birr 1.9 billion at the end of June 30, 2010. Of this sum, about 43% was generated from Ethiopian Insurance Corporation which is the only public insurance company.

Further, insurance is attributed to modern sectors in Ethiopia. Agriculture which contributed more than 46% of GDP in the last five years and employed more than 85% of the labor force has a weak linkage with insurance business. The introduction of weather insurance and crop insurance in recent years may improve the diminishing trend of insurance penetration.

There is a widening gap between gross premium and net premium in Ethiopian insurance industry and has been widening in the recent years. This is because all private insurance companies in Ethiopia have outward reinsurance business arrangements to foreign reinsurance companies of Europe, Asia and African origin. The only exception is that the EIC transacts inward reinsurance business on a reciprocal basis with some African countries. The premium cession rate

which is the ratio of premium ceded to the gross written premium exceeds 40% indicating that much of the gross written premiums are ceded to foreign reinsurers companies (Hailu, 2007).

Figure 8.7: Gross and net premium income (in millions of Birr)



Source: National Bank of Ethiopia and own computation

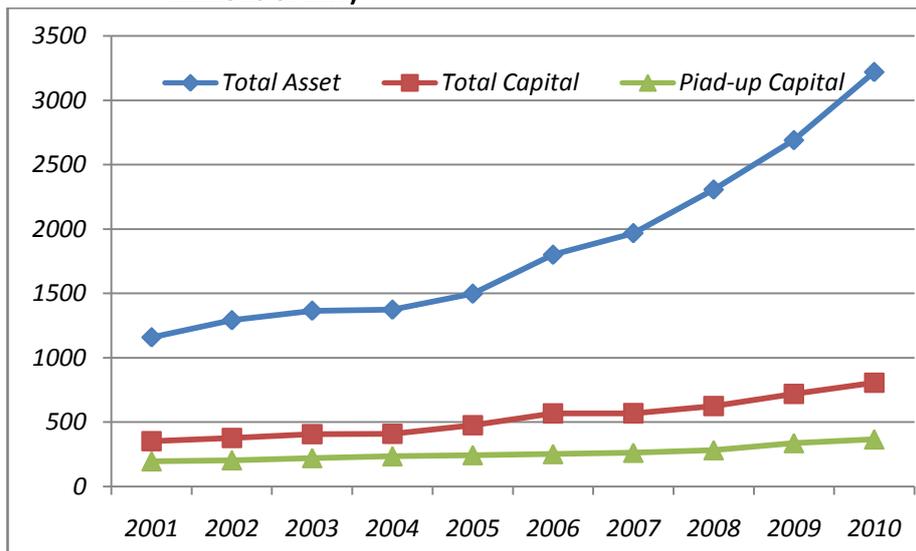
The major financial indicators of the insurance industry have an overall increasing trend during 2001-2010. EIC has lost its dominance in gross premium, net premium, total asset, total capital and profit in the range of 4-13 percentage points in the last ten years.

The total asset of the insurance industry increased from Birr 1.2 billion in 2001 to 3.2 billion in 2010. On average, the total asset grew by 12% in the last ten years. The highest decrease in the share of EIC was observed on its asset which dropped from 53% in 201 to 40% in 2010.

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The total capital and the paid-up capital of the Ethiopian insurance industry as at June 30, 2010 rose to Birr 806 and 366 million, respectively. The public insurer, EIC accounted for 35 and 16% of the total capital and the paid up-capital of the industry, respectively.

Figure 8.8: The financial position of the Ethiopian insurance industry (in millions of Birr)

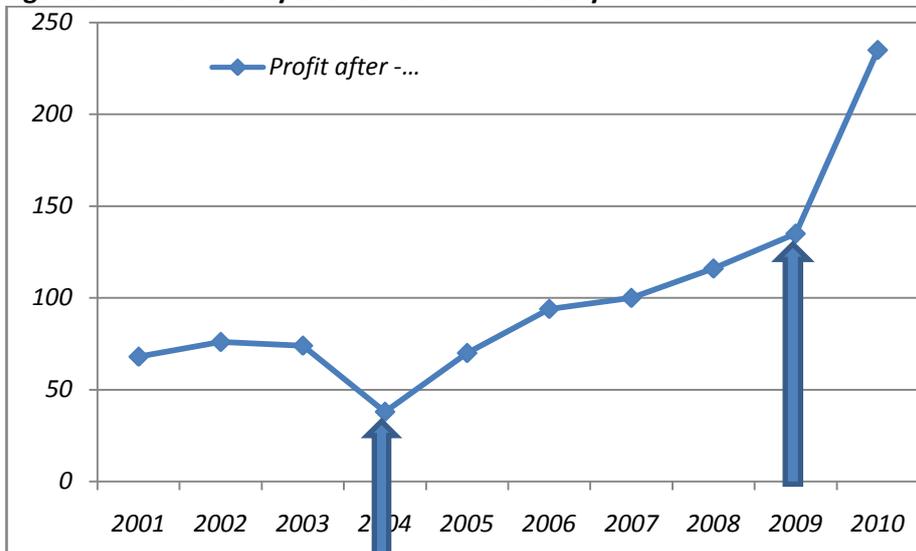


Source: National Bank of Ethiopia

The total profit after tax of the non-life insurance business at industry level reached Birr 235 million at the end of June 30, 2010. The profitability of the industry went down during 2001-2004 by 13%. The average profit of the industry stood at Birr 64 million per annum. From 2005 -2010 the profitability of the industry increased by about 40% and the average profit of the industry rose to Birr 125 million per annum per insurance company. The profit tax of

the insurance business is 30% of net profit which is equivalent to most of African countries.

Figure 8.9: Profitability of the insurance industry



Source: National Bank of Ethiopia and own computation

The vertical lines in 2004 and 2009 show the profitability of the industry shrunk in these years. The 2004 low profit could be associated with the sluggish economic growth in the domestic economy prior and during that year. The profitability of the insurance industry dropped in 2009 perhaps due to the global crises and the tight credit policies in the domestic economy. The erratic trends of insurance profitability coupled with high and stable return on investment in banking and real estate might have also discouraged new entrants into the insurance industry.

8.2.5. Entry barriers in the insurance industry in Ethiopia

There are different gauges that are used to see whether there are entry barriers to insurance industry. The major ones cited in literature are: legal barriers, economies of scale, product differentiation, high capital requirement, switching cost of customers, access to distribution channels, cost advantage of existing companies, patent right, experience and know-how.

In Ethiopia, there are no legal barriers for local investors to invest in the insurance sector except like other financial sectors; insurance business is not allowed to foreign investors. When we look at the date of establishments of insurance companies, more than half of them were established during the first three years of liberalization (1994-1997). In the last 15 years, only 5 private insurers joined the industry.

Since 1994, as stated in the proclamation No. 86/1994, the minimum capital requirement to establish a general, long-term and composite insurance businesses stood at Birr 3 million, Birr 4 million and Birr 7 million, respectively. According to African Insurance Organization's Report, Ethiopia's minimum capital requirement is one of the least in the region. However, the number of insurance companies in Ethiopia was much lower than that of Uganda, Kenya and Tanzania which had 44, 19 and 17 insurance companies, respectively in 2008. Unlike the case in Ethiopia, foreign participation is also allowed in most of African countries including Uganda and Tanzania with 100% or joint venture basis.

The public insurer (EIC) has dominated the insurance industry in Ethiopia although its share has been decreasing in recent years. This coupled with the

preference of the public enterprises and government organizations to EIC could be mentioned an entry barrier for private insurers.

Product differentiation cannot be a cause for entry barrier in Ethiopia for there are no differentiated products that allow one company to have competitive advantage over other rivals since similar products are sold in the market. The exception in this regard is the introduction of innovative products such as floriculture, travel, condominium and crop insurance by some companies that could create product differentiation in the future.

The mini-survey conducted by EEA on the perception of insurance companies showed that the major entry barriers to Ethiopian insurance industry are: lack of product differentiation, volatile profitability of the industry, unfair market competition, preference of public enterprises and government organizations to the public insurance, economies of scale by bigger insurers, minimum return for investment in the industry and shortage of insurance professionals.

8.2.6. Competition in the insurance industry

Since the beginning of insurance business in Ethiopia, competition and monopoly have been observed interchangeably. In the pre-command economy, there was competition among private insurers. During 1975-1994, state-owned insurer monopolized the industry by Proclamation Number 68/1975. Since 1994, in line with other market liberalization policies, domestic private insurers were allowed to invest in the industry and competition began between public and private insurers and among each other.

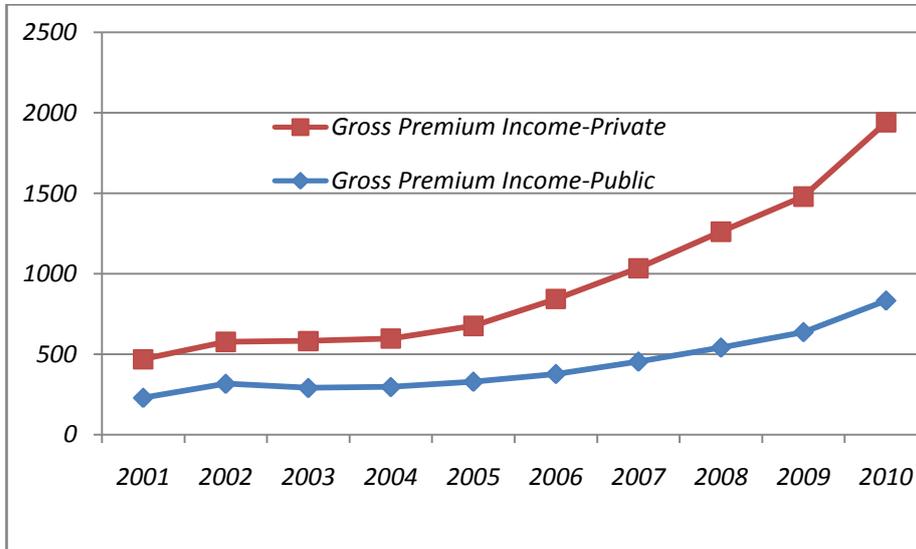
The number of insurance companies has been increasing although slowly. However, since the type and number of products are limited, they compete for

the same customers and products. Similar market share of private insurers is also another source of competition because they compete to take the market leadership among themselves.

The increasing number of insurance brokers and sales agents is also another indication of competition in the industry. The study conducted by Hailu (2007) indicates that as at 30 June 2005, the number of sales agents and insurance brokers was 904 and 25, respectively. This number at the end of June 30, 2008 increased to 1398 and 41 respectively. This trend shows that the competition in the Ethiopian insurance market has increased because the number of players competing for the same market has increased more than it used to be some years back.

There is stiff competition in all classes of insurance business except in aviation and marine which are predominantly monopolized by EIC. The public insurer had been the sole provider of life-insurance taking almost 95% of the business in 2001. However, its share has continuously declined to reach 50% at the end of June 30, 2010. Private insurers took the prime share and maintained an average of 58% in the last five years. The establishment of E-life insurance company which specializes in life insurance could be another addition to reduce the role of EIC in life insurance business in the recent years.

Figure 8.10: Share of insurance companies by ownership for life and non-life insurance business



Source: National Bank of Ethiopia and own computation

The mini-survey of EEA sows price cutting and bias of the government and public enterprises to the public insurer (EIC) are the two major causes of unfair competition in the insurance sector in Ethiopia. To examine the level of competition, there are two commonly cited methods namely: (i) K- company concentration ratio³⁹ and (ii) Hirfindahl- Hirschman Index (HHI)⁴⁰. Our computation shows there is an overall high concentration in the insurance industry in Ethiopia compared to both Kenya and Tanzania. In 2008, the first 4 companies took more than 70% of the insurance market in Ethiopia compared to 38% in Kenya showing market dominance in motor insurance market in Ethiopia.

³⁹ This indicator adds the market share of the first 'k' largest companies in the market

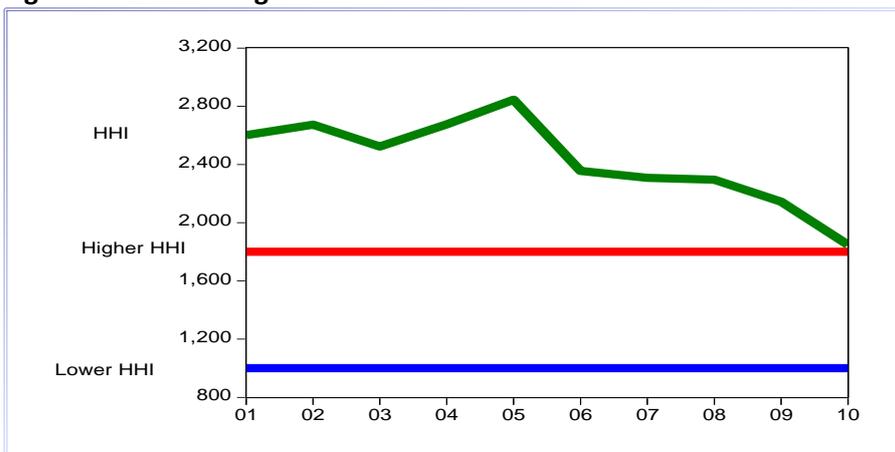
⁴⁰ $HHI = \sum MS_i^2$ where : MS= the market share of company i , n = the number of companies in the market
 $HHI > 1800$ high concentration, $1000 < HHI < 1800$, moderate concentration and $HHI < 1000$ low concentration

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According to the k- company method, in 2001, the largest four companies comprised 84% of the gross premium in general insurance business in Ethiopia. This trend dropped to 77% in 2005 and 69% in 2010. This shows that the level of concentration of the insurance market has been continuously dropping over time.

Similarly, the HH index computed for fiscal years 2001-2010 shows that there has been market concentration in the general insurance business in Ethiopia. The market concentration for general insurance business has persistently decreased to mark the highest threshold in 2010

Figure 8.11: HHI for general insurance business



Source: Own computation

8.2.7. Financial products

General insurance is the dominant business in Ethiopian insurance industry. According to African Economic Review, about 75% of the insurance premium was collected from non- life insurance services. The following are the main

types of insurance services currently available in the Ethiopian insurance companies. Motor insurance took the lion's share of general insurance sold by almost all insurance companies followed by engineering, aviation, and marine.

Table 8.11: Insurance product in Ethiopia

I. General Insurance	I. Life Insurance
<i>Fire& Allied perils/lightning/fire and general accidents</i>	<i>Endowment Policy</i>
<i>Motor vehicle policy (private and commercial)</i>	<i>Ordinary Endowment (without profit)</i>
<i>Auto Damage (collusion)</i>	<i>Ordinary endowment (with profit)</i>
<i>Third party</i>	<i>Group Endowment Assurance (without profit)</i>
<i>Comprehensive</i>	<i>Group Endowment Assurance (with profit)</i>
<i>Money Policy (in safe and in transit)</i>	<i>Anticipated endowment (with profit)</i>
<i>All Risks Policy</i>	<i>Education endowment policy (with profit)</i>
<i>Marine policy</i>	<i>Marriage endowment policy</i>
<i>Hull</i>	<i>Endowment Annuity</i>
<i>Cargo and transit</i>	<i>Whole life Policy</i>
<i>Individual personal accident insurance</i>	<i>Whole life policy (without profit)</i>
<i>Group personal accident</i>	<i>Whole life policy (with profit)</i>
<i>General liability</i>	<i>Term life Policy</i>
<i>Aviation insurance</i>	<i>Individual Term life Assurance (level term)</i>
<i>Business interruption insurance (consequential loss)</i>	<i>Group Term Life Assurance (Level Term)</i>
<i>Workmen compensation</i>	<i>Group Yearly Renewable Term (GYRT)</i>
<i>Burglary house breaking insurance</i>	<i>Regular term Life Assurance</i>
<i>Fidelity and guarantee insurance</i>	<i>Modified large Group Term</i>
<i>Plate and glass insurance</i>	<i>Mortgage Protection Assurance</i>

Table 8.11: continued

<i>Engineering insurance</i>	<i>Other Life Related Policies</i>
<i>Contractors' All Risk (CAR)</i>	<i>Idir Insurance</i>
<i>Machinery breaking</i>	<i>Eqqub insurance</i>
<i>Contractor's plant and machinery insurance</i>	<i>Addendum to main life policies</i>
<i>Erection all risk (EAR)</i>	<i>Supplementary accident insurance (SAI)</i>
<i>Machinery loss and profit</i>	<i>Waiver of premium (WP)</i>
<i>Boiler insurance /boiler & pressure vessel</i>	<i>Accidental death benefit (ADB)</i>
<i>Electronic equipment insurance</i>	<i>Accidental Death and Dismemberment</i>
<i>Computers All Risk</i>	<i>Comprehensive Accidental Indemnity</i>
<i>Householder's comprehensive (domestic package)</i>	<i>Catastrophic accidental Insurance</i>
<i>Bond</i>	
<i>Legal expense</i>	
<i>Professional indemnity/professional liability</i>	
<i>Public liability</i>	
<i>Travel coupon</i>	
<i>Inland carrier's liability</i>	
<i>Goods –in-transit</i>	
<i>Livestock insurance</i>	
<i>Product liability</i>	
<i>Private employment agency</i>	
<i>Condominium insurance</i>	
<i>Green house/ Floriculture insurance</i>	
<i>Weather insurance</i>	

Source: Survey Result

8.2.8. Insurance regulation and supervision

The sustainability and stability of insurance business is a function of strong regulation and supervision. Insurance regulation is important because an insurance company generally collects the price of insurance cover before

insurance policy matures and claims are paid. In addition, insurance companies invest a huge amount of insurance funds that demands to be managed properly. Lack of proper regulation and supervision of the financial system became one of the major sources of the crises as witnessed in the last two great crises, the 1930s and 2008-09. Thus, to ensure fair price of insurance, protect insurance company solvency, prevent unfair practice by insurance companies and follow the availability of insurance coverage, regulation and supervision is a vital tool.

Insurance regulation and supervision focuses on: authorization and monitoring of the operation. Authorization includes activities prior to issuance of license. The supervisory body checks the proper legal form of the business organization, article and memorandum of association, types of insurance business (general, long term, or composite insurance), minimum paid-up-capital, feasibility study, operating plan and others. The monitoring and supervision, on the other hand, includes examining and verification of business documents, collecting and evaluating financial and non-financial data, reviewing re-insurance arrangements and taking intervention methods in case of downward trend of insurer's strength and irregularities observed in the activities of an insurance company.

In Ethiopia, although domestic and foreign insurance companies had been undertaking insurance business since the inception of insurance business in 1905, the first insurance proclamation was issued in 1970. The proclamation No. 86/1994 which replaced the earlier proclamation bestowed the supervision power to the National Bank of Ethiopia. Its functions in relation to insurance include: (a) licensing, supervising, and regulating insurance companies, (b) promoting and encouraging the dissemination of insurance services throughout the country and (c) making short and long-term

refinancing facilities available to insurance companies. The National Bank set up the Insurance Supervision Department with the following main duties and objectives: (i) licensing insurance companies and insurance auxiliaries, (ii) conducting continual on-site and off-site supervision and monitoring, (iii) taking intervention measures based on the findings of supervision and monitoring (iv), ensuring the existence of sound and stable insurance industry and (v) protection of the interest of policy holders.

Field visits and regular reports are the major tools to supervise and monitor the insurance companies. The three parameters set in the directive to conduct the supervision are: (i) solvency), (ii) trade debtor provision and (iii) investment of insurance funds. The supervisory body intervenes when insurance companies deviate from the provisions of the insurance proclamation, directives and when irregularities are observed.

There are problems in the insurance supervision that preclude the effective implementation of duties and responsibilities of the regulator body such as (i) low emphasis by government relative to the banking sector, (ii) lack of skilled personnel and (iii) lack of bench marks.

Currently, the supervisory body follows the compliance-based supervision approach⁴¹. This method has, however, limitations in that it has already been replaced by risk-based supervision approach⁴² in most countries. Thus, moving towards risk-based supervision is important because the global environment demands to be compliant with international standards. Sooner or later

⁴¹ *Some minimum requirements are set and the supervisory body periodically checks whether or not each insurance company compliance with the minimum requirement*

⁴² *This approach requires the supervisor to monitor risks and to work with institutional management and board of directors to reduce risk when prudent levels are being surpassed*

Ethiopia will be member of WTO which demands a standard way of doing business.

8.2.9. Human resource development in the insurance industry

Human resource development is an indisputable factor for the successful conduct of insurance business. Insurance industry demands a specialized knowledge like any other financial sector. In Ethiopia, a large percentage of human resource in the industry has qualifications of diploma and below. By the end of June 30, 2010, the industry has only one licensed insurance actuary, one loss assessor and one insurance surveyor. Thus, all insurance companies depended on foreigners to actuarial valuation of long-term insurance business.

At the end of December 2009, the 12 insurance companies employed about 3,005 persons with managerial, professional, clerical and non-clerical positions. The private insurance companies employed about 1,759 persons or 62% of the labor forces in the sector. There is slight difference in the number of employees among the private insurers. Nile, Awash and Nyala took the leading role in terms of number of persons employed. The new entrants Lion, E-life and Oromiya jointly accounted for 6% of the labor force in the sector. The Clerical staffs constituted the substantial share of the labor force in the insurance sector, accounting for 31%, followed by professional (29%), managerial (19%) and non-clerical taking the balance.

The Ethiopian Institute of Banking and Insurance which was established in 1975 has been playing a significant role in the human resource development of the insurance industry. The institute has been giving three years evening program to the banking and insurance sectors with diploma qualification in either banking or insurance specialization.

Insurance business demands a specialized knowledge in risk assessment, risk management, actuarial science, loss assessment and rating. However, such specialized trainings are not given in any of the higher institutes in Ethiopia. Insurance companies are trying to fill this gap through in-house training and foreign correspondence learning (Hailu, 2007).

Table 8.12: Total number of employees of insurance companies by category (as at Dec. 31, 2009)

Category	Africa	E-Life	Lion	Nice	Nyala	United	Awash	EIC	Nib	Nile	Global	Oromiya	Total
Managerial	25	3	19	28	46	33	41	120	20	32	19	20	406
Professional	59	0	24	32	114	45	73	178	88	106	26	30	775
Clerical	66	4	29	46	15	65	101	555	59	70	32	3	1181
Non-Clerical	46	0	24	28	35	33	52	393	50	82	23	13	779
<i>Total</i>	196	7	96	134	210	176	267	1246	217	290	100	66	3005

Source: NBE

8.2.10. SWOT analysis

The following table shows the Strength, Weakness, Opportunities and Treats of the insurance industry in Ethiopia. The analysis is based on mini- survey on how insurance companies perceive the major strengths and challenges of the industry.

Table 8.13: SWOT analysis

STRENGTHS	WEAKNESSES
<ul style="list-style-type: none"> • Fairly stable financial position of the industry • Diversification (sister companies like banks). • Fairly large number of brokers 	<ul style="list-style-type: none"> • Limited products/services • Un-ethical and unhealthy competition- due to high premium rate • Backward technology • Poor supervision • limited compulsory insurances • Absence of local reinsurer • Stagnant industrial sector • Absence of local insurance training institute and lack of skilled man power • High insurance illiteracy rate
OPPORTUNITIES	THREATS
<ul style="list-style-type: none"> • Huge untapped market in rural areas • Diversification into other industries other than banks, like real estate • Booming modern sector(services and Industry) • The increasing investment opportunity via the blooming share market 	<ul style="list-style-type: none"> • Increased competition based on accession to the WTO • Low level of ICT • Absence of Capital Markets • Unwillingness of government and public enterprises to buy policy from the private insurers

Source: EEA Mini Survey

8.2.11. Issues

The insurance industry in Ethiopia remains small and little known. In 2007, about 0.1% of Ethiopia's population had access to insurance services. Insurance premiums (both for life and general insurance) accounted for about 0.2% of GDP, which is very low compared with other African countries. Insurance products tend to be very much limited in range and tend to target a very limited segment of the country's population. The most common product offered is motor vehicle insurance. The insurance products in Ethiopia are largely elitist: they address the needs of those who have large assets or salaried individuals with large disposable incomes. There are very limited formal insurance products that would allow low-income households or individuals to mitigate the risk of crop failure, livestock risks, and better cope with health hazards, etc. Moreover there is a limited capacity in designing, administering, and distributing insurance products that are appropriate for low-income households.

Although affordability is a key issue, there is a need to ensure greater understanding of what insurance products are and their benefits especially among those who are rural-based and with little education. Not only these individuals have a higher risk profile, but there are also serious challenges related to reaching out to these clients. There is a need to develop innovative products and approaches to provide insurance services in a cost-effective and sustainable way. With time, competition between insurance providers will increase, which results in significant improvement in the quality and range of products, speed of payout, transparency and affordability.

The availability of formal insurance can protect farmers against unexpected output losses and other damage and can reduce credit risk such as crop and

insurance. However, although there has been a relative success in building sustainable finance providers in Ethiopia, such as the deposit taking Micro-finance Institutions (MFIs), private banks and insurance companies, and financial cooperatives in a short span of time, they failed to provide tailored micro-insurance services and interventions which address the insurance needs of producers and agribusinesses operating in rural areas and low-income people in urban areas. There have been some attempts by insurance companies (such as Nyala Insurance Company which introduced weather-index insurance for smallholder farmers) and MFIs (piloted crop insurance with the support Oxfam US) to provide micro-insurance services to the financially excluded population. However, the outreach and diversity of insurance products are very limited (Wolday Amha 2010b). Despite the fact that most crop insurance schemes funded publicly have generally not worked for smallholder farmer, catered only to large commercial farmers, there is a need to develop new schemes, single-peril (drought, windstorm, hail, etc) to avoid moral hazard and adverse selection problems and keep premiums affordable for smallholder farmers. In addition, other risk reducing instruments which help to manage price and production, such as forwards, futures, options, and swaps, need to be cautiously promoted. This will require establishing commodity exchange markets and putting the right institutions, legal system and infrastructure in place.

Expanding and improving the quality of micro-insurance services requires a clear legal and regulatory framework. The Licensing and Supervision of Insurance Business Proclamation No. 86 of 1994 governs all insurance activities in Ethiopia. Insurance sector players in Ethiopia fall under the regulation and supervision of the National Bank of Ethiopia (NBE). According to the proclamation, only a share company fulfilling the minimum capital requirement is allowed to write insurance. There is no separate definition of

micro-insurance in Ethiopia and accordingly the regulatory framework and proclamation do not make any concessions to micro-insurance, although it does not restrict the insurance companies from expanding micro-insurance. On the other hand, the new micro-finance proclamation No. 626 of 2009 allows deposit taking MFIs registered under NBE to get involved in the delivery of micro-insurance services to the excluded. However, cooperatives are not allowed to directly issue insurance policy to their members. In general, the current framework may not be considered a stumbling block to expand micro-insurance services in Ethiopia.

8.3. Deposit-taking micro-finance institutions (MFIs)

The NGOs in Ethiopia have been delivering relief and development services such as emergency food, health, education, and water since the 70s. In terms of the delivery of financial services to the poor, NGOs were directly funding micro-credit activities as part and parcel of their income generating programs/projects. As the delivery of micro-finance activities grew, the question of operational and financial sustainability has been raised. Initially the NGOs in the country had positive impact in developing flexible methodologies that fit the needs of beneficiaries and tested various innovative ideas and lending methodologies in their programs. However, the NGO micro-credit programs had several problems such as mixing the social and financial objectives and failed to follow sound, financial principles, norms, and ethics which encourage financially irresponsible behavior. The major shortcomings of the micro-credit schemes of NGOs in Ethiopia included: (a) orientation of the micro-credit initiatives or activities geared towards a project concept, not in establishing sustainable institutions that deliver diversified financial services to the financially excluded; (b) proliferation of heavily subsidized programs of NGOs, with low lending interest rates (which didn't cover even the operational

costs), created a problem in building sustainable financial institutions; (c) very high default rates; (d) limited knowledge and commitment of NGO staff to ensure financial discipline; and (e) saving products were forgotten in the delivery of financial services to the poor which failed to promote saving culture (Wolday Amha 2007). Moreover, the Development Bank of Ethiopia (DBE), government programs/projects and cooperatives were also facing similar challenges before the issuance of the micro-finance law in 1996. NGOs, AIDB, government projects and cooperatives were not in reality financial intermediaries, but rather tools of distributing donor or government funds to a target population in order to increase production and productivity. As a result of the above challenges, the government decided to introduce national standards and adopted an appropriate regulatory framework to improve their performance of finance providers.

Given the problems of NGOs, DBE, government projects and the collapse of the service cooperatives in Ethiopia by the end of the 90s, it was time for the policy makers, NGOs, practitioners involved in development activities to revisit and redesign new strategies of delivering financial services to the financially excluded through sustainable financial institutions. This required redefinition and reorientation of the mission, vision and objectives of the lending institutions that used to provide only micro-credit services. The most important change of direction was building a sustainable financial service delivery system followed by mobilizing savings, charging reasonable interest rates on loans sufficient to cover operational costs, applying strict financial discipline through strict loan recovery procedures and loan follow-up, developing proper lending methodologies, reducing transaction costs and increasing outreach. The experiences of some sustainable micro-finance institutions in Asia, Latin America, and Africa were also useful in guiding the changes in the delivery of financial services to the excluded population in

Ethiopia. To this end, the government of Ethiopia introduced a micro-finance law (Proclamation No. 40/96) to regulate and support the development of sustainable deposit-taking micro-finance institutions. This initiative brought the activities of the MFIs under Ethiopia's monetary and financial policy framework. Proclamation No. 40/1996 also clearly indicated the requirements of licensing micro-finance institutions by empowering the National Bank of Ethiopia (NBE) to take charge of the regulation and supervision, and support the development of the micro-finance sector.

8.3.1. Regulation and governance

In order to clearly separate charity and finance, the government of Ethiopia introduced a regulatory environment that has a direct impact on building sustainable MFIs and reaches millions of financially excluded population. Moreover, since the MFIs in Ethiopia are all depository micro-finance institutions (collect deposits from both the public and clients); the government through NBE needed to oversee the financial soundness of the MFIs and introduced prudential regulation in 1996.

Ensuring the safety of depositors and building healthy institutions for the development of the financial sector appear to require micro-finance regulation and supervision framework compatible with the objective condition of Ethiopia. Actually, MFIs, have specific risk profiles different from those of conventional banks. This comes from the fact that they are providing financial services to the financially excluded population with numerous repeated loans and they are attempting to provide their services physically to clients. In addition they are targeting quick repayment, using group lending methodology, highly decentralized system and with high operating cost per loan or deposit amount and management orientation towards poverty

reduction (not always profit). The high-risk profiles of MFIs will then increase the importance of prudential regulation and strict supervision in the sector.

Until 2009, Proclamation No. 40/1996 was the major law used to regulate and supervise MFIs. The NBE is empowered to license, supervise and regulate the delivery of financial services to the excluded population through MFIs. The 20 directives of the NBE serve as the basis for prudential regulation influencing good governance of MFIs and prudent lending. The law allows MFIs to mobilize public savings. With the exception of banks, cooperatives and MFIs, the proclamation prohibits other institutions from delivering financial services in the country (Wolday Amha, 2008b). Proclamation No. 40/1996 was replaced by a relatively stronger Proclamation No. 626/2009 that focuses on institutionalized financial discipline, prudent lending and transparency of MFIs. We believe that the prudential regulation of MFIs in Ethiopia is relatively enabling. The main reasons include:

- (a) Prudential regulation of MFIs in Ethiopia has significantly reduced market distortions or the potential disruption of the overall stability of the financial system.*
- (b) The regulatory framework has promoted entry into the micro-finance industry. The required minimum paid-up capital payment for an MFI in Ethiopia is low and affordable. This has enabled the formation of new committed MFIs and increased the number of MFIs (from 11 MFIs in 1999 to 30 MFIs in 2010) and the volume of financial services to the poor.*
- (c) The prudential regulation has promoted saving mobilization efforts of MFIs. MFIs have proved that the poor in Ethiopia can save.*
- (d) Prudential regulation has also improved the performance of MFIs. It has encouraged MFIs to meet minimum performance standards and increased their commitment to operational and financial sustainability. As a result,*

the MFIs have demonstrated impressive repayment performance and introduced financial risk management tools.

- (e) The Rural Financial Intermediation Program (RUFIP) which was established by the Ethiopian government (with a huge soft loan from IFAD and ADB) to provide loan capital and capacity building to MFIs and Rural Saving and Credit Cooperatives (RUSACCOs) has also significantly contributed to the implementation of prudential regulation in the micro-finance industry.*
- (f) The prudential regulation, particularly the requirement of annual external audit and the on-site and off-site supervision of NBE have improved transparency of MFIs. This has also helped MFIs to build trust and confidence to mobilize public deposits and access donor and bank credit line.*
- (g) The regulation provides a clear tax incentive to MFIs which don't distribute dividend to shareholders*

The new proclamation allows MFIs to provide insurance products to their clients. The NBE is currently involved in revising the directives to match with the new proclamation and support the dynamic development of the micro-finance sector. NBE has been involving the MFI practitioners before issuing the proclamations and directives through consultative workshops. Despite the positive developments in the micro-finance sector there are issues which need the attention of NBE. Since some of the MFIs are large (even larger than some of the private banks), it will be appropriate to revisit the one-size-fit-all type of regulatory system for deposit-taking MFIs. Some of the MFIs have conducted various studies to transform themselves to micro-finance banks or rural banks and provide all types banking and microfinance services to remote Woredas. However, under the current framework, those MFIs which are ready for transformation are expected to fit to the banking act. This is an area which needs the attention of NBE. Although the regulatory environment is relatively

conducive to support the growth of sustainable MFIs, there are regulatory challenges that need to be addressed: These include:

- (a) The prudential regulation in Ethiopia has been very restrictive (over regulation limiting the scope of services of MFIs). Although there are some improvements in terms of removing the 5,000 birr loan ceiling and loan term (maximum of five years) for MFIs which mobilized more than 1,000,000 Birr of savings, the loan ceiling still applies to smaller MFIs. Unfortunately, many of the smaller MFIs are located in Addis Ababa where the credit needs of clients exceed more than 5,000 Birr (581 USD). Moreover, as per the directives of the NBE in May 2002, the loan term has been increased from one to two years, however, the smaller MFIs (which are not re-registered) are prohibited from extending the loan term up to five years. This directive clearly prohibits housing microfinance that requires a loan term of 5-30 years. The limits need to also take inflation into consideration since it reduces the real expenditures of the borrowers.*
- (b) Policy makers, experts in the government sector, NGOs, donors, researchers, and the public have limited knowledge of the regulation in the micro-finance industry.*
- (d) Absence of a well-functioning and efficient legal system to enforce contracts affects the implementation of prudential regulation and the performance of MFIs. Prolonged delays in obtaining legal redress from courts encourage unscrupulous loanees to default with impunity. Clear property right law and a directive to implement the foreclosure law for MFIs are critical to avail collateral support and asset-based lending. Although there are some efforts to improve the efficiency of the legal system through the introduction of Business Process Reengineering (BPR) in Ethiopia, the court system is still very weak in enforcing contracts and facilitating microfinance activities.*

- (e) MFIs in Ethiopia do not provide flexible and responsive financial services to clients partly because of the regulatory framework. The regulation places unnecessary restraints on innovations and the development of loan products. Moreover, the law prohibits the participation of international NGOs as shareholders in the MFIs that denies MFIs huge inflow of foreign capital.*
- (f) Sound financial sector policy/strategy remains an important pre-condition for designing micro-finance strategy and development of sustainable financial institutions that deliver inclusive financial services to the excluded population.*
- (g) The poor infrastructure in Ethiopia also affects the efficiency of regulating the micro-finance industry.*

Compared with commercial banks, MFIs in Ethiopia face unique operational risks such as ownership and governance risk, the risk of political interference, donor and NGO interference, management orientation of MFIs towards poverty reduction (not always financial sustainability), weak MIS and internal control increasing management risk, absence of property collateral increasing portfolio risk and a lack of adequate professional experience which makes prudential regulation and supervision challenging. Moreover, there is limited theoretical and practical experience with prudential regulation of the micro-finance industry, which can provide guidance to regulators in Ethiopia. The above problems coupled with limited capacity of the NBE have made the enforcement of prudential regulation in the MFIs very difficult. However, the prudential regulation, which was drafted and implemented with limited debate and participation of stakeholders in 1996, has promoted on the other side the growth of sustainable MFIs in Ethiopia. The new initiative of NBE to introduce risk-based supervision requires a significant capacity building of

MFIs. There is also a need to regularly review the prudential norms and regulatory framework fit the dynamic growth of MFIs.

The regulatory structure in the MFIs in Ethiopia must provide incentives for growth in terms of increasing outreach and sustainability of MFIs and encourage flexibility and innovation. Moreover, because of small transactions in the MFIs, the regulation and supervision framework should focus on systems and processes. Attempt should also be made by MFIs to critically assess all types of risks in order to refine their risk management architecture.

Governance is one of the main problems of MFIs in Ethiopia. Since the board members of MFIs are not investing their own capital, they are not real investors in the sense of risking capital and earning dividends. That is, there is very limited private capital investment in the MFIs. This implies that, MFIs are currently unattractive investment opportunities to private equity investors. The nominal shareholders may not have sufficient interest and commitment to control and guide the management of MFIs. Yet again, they may not be willing to provide the required capital quickly whenever the MFIs are in crisis. Thus, the board members of MFIs will not observe seriously the management and performance of MFIs compared with business investors.

The board of government supported MFIs focus on meeting the development objectives of regional governments, giving limited attention to the sustainability or financial objectives of the MFIs. Thus, MFIs require restructuring and training their board members. Regular assessment and evaluation of the board is also important for effective governance. Although many of the MFIs in Ethiopia are established as private share companies, dividends are not distributed to shareholders, i.e., the entire resources (dividends) are to be utilized for the benefit of the target groups and scale up

the activities of the finance providers, i.e., the poor (Itana Ayana, et al, 2003 and Bienen D. et al, 2009). As a result, the structure of ownership and governance of MFIs makes the task of regulators much difficult and complex.

8.3.2. Financial products of MFIs

Improving the financial products or developing new products create additional value, if they reduce households and enterprises' transaction costs of accessing financial services and increasing revenue and profitability. Taking a loan is profitable for a client if the costs are reasonably less than the expected additional income, from using the loan. There are both direct and indirect costs incurred by a client: the direct cost is the amount paid to the MFI in the form of fee and interest and the indirect costs include opportunity cost of forgone work, cost involved in doing the paper work or when obtaining a guarantor and the risk that is tied with the probability of failure to fulfill his obligation for various reasons. Innovations which reduce the total lending costs for a client, increases the demand for loans and expand the frontier of finance. MFIs, like the clients, incur financial costs, transaction costs (or operation costs and risk costs). This is materialized by improving the institution's competitiveness by identifying the needs of clients, improving the quality of its services and/or reducing prices of the financial products. However, improving the existing product and new product development can be costly and risky as well. Although loan and saving products are the dominant financial products provided by the MFIs in Ethiopia, they have also started the provision of micro-insurance, leasing, money transfer and managing the administration of pension fund on behalf of the Social Security Authority and collecting taxes and other payments from the public on behalf of the government.

Loan products

Loans have been extended to smallholder farmers and micro and small business operators through MFIs. The group lending methodology widely used by Ethiopian MFIs is a major breakthrough in reducing administrative costs and default of borrowers and addressing the challenges of collateralized lending. The entry-level group solidarity loans constitute often the first step towards the use of proper banking services to financially excluded population. The solidarity group loans of MFIs enabled farmers and Micro and Small Enterprise (MSE) operators to build up a credit history that will eventually make them eligible for individual loans.

However, this methodology has also its own limits. For example farmers, who need higher loan size for agricultural investments, failed to access loan from the MFIs without collateral. Similar to banks, deposit taking MFIs in Ethiopia have attempted to provide loans to farmers on the basis of property of collateral, and cosigning a loan by a third party or a group. However, many of the farmers do not have the property collateral or a cosigner to secure a loan. Thus, there is a dire need to address this issue by using innovative approaches such as the warehouse receipt system, equipment leasing, etc.

Typical collateral of smallholder farmers in Ethiopia is land or agricultural output or farming equipment. The prohibition of using land as collateral, by law, as well as storage costs and limited durability of agricultural output make collateral difficult to use or unusable. As a result, smallholder farmers in Ethiopia have little acceptable collateral which is aggravated by unclear property rights and absence of a registry system for movable assets. Even when relatively rich farmers have assets that can be used as collateral, they are often not acceptable to finance providers because of the high cost and long delays in using judicial enforcement mechanisms.

MFIs in Ethiopia provide a variety of loan products which can be broadly categorized into agricultural loans, micro-business loans, micro and small enterprise loans (micro-bank loans), employee loans, package loans (food security loans), and housing loans (Wolday Amha 2008). Many of the loans are group loans followed by individual loans and cooperative loans. Recently MFIs have started introducing individual lending methodology to MSE operators that needs larger loans (above 5,000 Birr). Although the frequency of repayment for business loans is usually on monthly basis, the agricultural loans in many of the MFIs are end-term loans which are paid at the end of the loan period. However, interest is paid mostly on monthly and in some cases on weekly basis.

Out of the 27 MFIs, only 13 MFIs provided individual loans. Almost all MFIs provided agricultural and MSE loans. 18 MFIs provided asset/housing loans to their clients. Nineteen MFIs delivered loans for consumption loans (Wolday Amha 2008). Unlike MFIs in the rest of Africa which tended to avoid financing agricultural activities, MFIs in Ethiopia have aggressively attempted to deliver financial services to the agricultural sector. About 66% of the loans of MFIs were used to finance the agricultural activities. This is followed by activities related to trade (19%). Moreover, the loans categorized under trade activities were predominantly agricultural trade activities (Wolday Amha 2008). According to the study of Assefa Admassie et al., (2005) livestock purchase was the dominant activity followed by agricultural production and expansion of existing business in that order. More than 81% of the clients reported to have spent their last MFI loans for productive purposes (livestock purchase (45%), agricultural production (20%), and start new business/expand and existing one (16%) (Wolday Amha 2008). The clients of Oromiya Credit and Saving Share Company (OCSSCO) (50.7 %), Amhara Credit and Saving Institution (ACSI) (46.7%) and Dedebit Credit and Saving Institution (DECSI)

(43.7%) indicated that the purpose of loans was to purchase livestock. On the other hand, all the clients of Sidama MFI reported expanding business (93.5 %) and starting new business (6.5 %) as the main purposes of loans. Although the average loan size of MFIs is about 170 USD, the loans for the agricultural sector varied between 6 USD and 1,100 USD. The loan size of MFIs varied from six months to five years.

Some MFIs have package (or food security loans) that are aimed to help farmers achieve food security at household level. The package contains about nine agricultural activities (poultry, dairy cow, goat/sheep rearing, fattening of goat/sheep, fattening of cattle, traditional bee farming, modern bee farming, irrigation and modern inputs). Eligible farmers have to choose more than one component which help to ensure food security as per the business plan of the households. The loans could be in cash or in-kind (where borrowers take credit coupons from the MFI which they show to the Bureau of Agriculture and receive the items in the chosen package) and are given on individual basis where the regional governments provide full guarantee in case of any default (for loans not exceeding 5,000 Birr) or asset collateral (for loans exceeding 5,000 Birr). In the case of DECSI, beneficiaries are selected by the Regional Food Security Office or Bureau of Agriculture. These clients are given training relevant to their respective packages. The package loans have better terms and conditions of credit for clients compared to the regular loans of DECSI, including no group formation requirement, lower interest rates, larger loans, longer maturity period and a grace period (for in-kind loans only) (Borchgrevink et al 2005).

The loan size of MSE activities has increased significantly in the last three years. Clients, who access individual loans, are required to provide physical property as collateral. Although the average loan size of MFIs is 2200 Birr the

loans for the agricultural sector varied between 96 Birr and 17000 Birr. The loan period of MFIs varied from six months to five years. Some MFIs provide loans for purchasing equipment to members of the youth organized mainly in construction cooperatives. The MFIs own the title to the equipment until total costs are completely repaid with interest. The interest rates varied from 10 to 15% (flat). The loan size also varied from 5,000 Birr to 300,000 Birr (Wolday Amha 2008). The leasing products have given new opportunities for the youth and others who do not have the capital or the collateral to invest.

The lending interest rates of MFIs are again relatively lower than the interest rates in other Sub-Saharan countries. The lending interest rate of MFIs varies between 9 percent declining rate to 24 percent flat rate. However, the financial reports of some branches and sub-branches of MFIs reveal that they are operationally sustainable. These branches and sub-branches even question why they should subsidize unprofitable branches and sub-branches of an MFI. The MFIs focus on poverty reduction and targeting the rural poor do have high costs of operation that reduces their profit margin. This issue has emerged as one of the challenges of the MFIs in Ethiopia. However, there is a need to balance the financial and social objectives of MFIs.

Saving

The traditional approach assumed that the saving potential in rural areas was so low that it was not worthwhile to mobilize savings or to offer savings facilities in rural areas. The vicious circle could only be broken by channeling external funds into rural areas to help raise the low investment rate (Zeller et al 1997). Contrary to the conventional assumption, the Ethiopian MFIs have proved that the rural poor can save if they are provided with affordable, flexible and quality saving product. Some farmers even preferred saving products than loans, if they were to choose either or. Thus, in addition to loan

products, smallholder farmers and micro and small enterprise operators in Ethiopia require saving and insurance products and efficient payment system. Delivering saving products would assist both the finance providers and clients to be more efficiently transfer risk and allow farmers to better manage liquidity and accessing credit.

All MFIs provide compulsory saving products to promote saving culture and serve them as cash collateral for the group loans. Voluntary savings are for both clients and non-clients. The voluntary savings of Ethiopian MFIs include: pass book saving, time deposit, regular saving, joint account, minor account, institutional saving and demand deposit

Savings allow wealth to be kept in a form that preserves its value and is liquid and readily accessible (DIFD 2004). Savings are important to poor households to maintain precautionary balances against shocks, build up cash collateral and serve as a track record to allow them easier access to credit. The results of a study by Assefa Admassie et al, 2005 indicated that more than 96% of the respondents do not have saving accounts with banks. However, farmers in Ethiopia have a saving culture, particularly in kind (in the form of seed for the next cropping season, livestock, etc) and cash savings at home. For the very poor households who cannot access credit for formal financial providers, it may be better to make use of one's personal savings account as a source of funds, instead of taking unnecessary debt and pay interest that the profitability of the activity would hardly cover. However, the micro-credit programs of government and donors masked the virtues related to saving deposits of the poor. The recent expansion of financial cooperatives and deposit-taking MFIs in Ethiopia has changed the whole picture of mobilizing savings in Ethiopia.

There are basically two types of saving products, namely voluntary and compulsory saving (forced saving), provided by the MFIs. The type of compulsory savings varies from MFI to MFI. The minimum compulsory saving of ACSI is 5% for installment loan and 3% for end loan. DECSI has a compulsory saving product in which clients are required to save at least 5% of the loan, as cash collateral, for rural loans and 10% in the case of urban borrowers and government employees. The compulsory saving of Wisdom MFI is 10 – 15% depending on the type of loan. MFIs pay 3 – 4% interest on compulsory savings. Although compulsory savings have the advantage of inculcating saving culture in the society, it is intended by MFIs for loan security, particularly for group loans.

Voluntary saving can be withdrawn whenever the saver wants. The voluntary savings are designed to clients, non-clients, government institutions, non-government institutions and associations. ACSI has four types of voluntary savings, namely pass book saving, time deposit, joint account and minor's account. MFIs pay 3 – 6% interest rate on voluntary savings. Eshet and Wosassa pay higher interest rate (6%) for voluntary loans (Wolday Amha 2008). Clients, who have voluntary saving account, reported that voluntary savings are useful financial products which they deposit and withdraw whenever they want, the location of the sub-braches/branches are very close to their homestead; the interest rate is good; and the MFI offers them a safe way of holding savings (Borchgrevink. et al 2005). The experience of Ethiopian MFIs (which are located close to clients) reveals that poor households can save money voluntarily to meet various forms of expenditure. The average saving of clients ranges from Birr 1,000 to more than Birr 2,000 (Assefa Admassie et al 2005).

According to the study of Assefa Admassie et al (2005), about 80% of the respondents believe that compulsory saving is important. However, about 40% of the DECSI clients are not very informed on the importance of compulsory savings. More than 65% indicated that compulsory saving helped them to repay loan. Another 11% pointed out that they can use the savings for future consumption. About 11% perceived forced savings as mechanism of capital accumulation and asset building. Some of the clients were not satisfied with the compulsory savings. Some even preferred to save in-kind. About 93% of the sample clients felt that it does not make any sense to save unless they are able to use their savings before repaying their loans or whenever the need arises. More than five percent of them do not like compulsory savings because it is not based on personal interest while very few cited the low interest rate paid (3-4%) on compulsory savings as a deterrent. About 80% reported that they did not have information regarding the bank interest rates on saving deposits.

The voluntary savings are similar to the normal savings deposits within the formal banks. Only one quarter of the sample clients have voluntary savings with the MFIs (Assefa Admassie, et al., 2005). This implies that much remains to be done to convince households to use the MFIs for maintaining their voluntary savings. About 34% of the respondents do not know the interest rate on their savings. About 75% reported the inability to save as the main reason for not having voluntary saving. Cumbersome procedures to withdraw savings, the fear of clients that savings with MFIs could be used to settle group debt, and a lack of encouragement by MFIs may be additional reasons affecting the mobilization of voluntary savings.

MFIs have proved that the poor can save, if they are provided with demand driven saving products. Although mobilizing savings is difficult, MFIs have

mobilized about Birr 1.9 billion, which covers about 38% of the loans from deposits. Despite the saving mobilization efforts of MFIs, they have, currently, a serious problem of loan capital to on lend to clients. This has been aggravated by the lack of donors and banks to provide loan capital to MFIs. The challenge of accessing loan capital and the focus of the government to develop the saving culture of financially excluded population has forced MFIs to transform from credit-led approach to saving-led.

Micro-insurance products

Micro-insurance covers an extremely broad range of services such as life insurance, health insurance, crop insurance, livestock insurance, asset insurance, etc which could be provided through a variety of actors with various statuses. Since the deposit-taking MFIs in Ethiopia provide loan and saving services to more than 2.4 million poor clients and have branch networks in almost all Woredas in Oromiya, Amhara, SNNP, and Tigray regions, they hold a unique position in delivering micro-insurance. Moreover, as per the new proclamation (No. 626 of 2009), they can act as direct insurers. MFIs can use the credit, saving and payment transactions as premium collection opportunities. Premium can also be deducted from the saving of clients over the year, if the client gives consent for the same. However, if they do not possess the technical skills and capacity to offer insurance services, MFIs can serve as agents of insurance companies. Micro-insurance products delivered through a MFIs can also protect their clients efficiently in case of major risks and encourage them to invest in riskier yet more lucrative activities.

The dominant micro-insurance product in the Ethiopian MFIs is credit-life insurance. The provision of credit life or loan insurance is driven by MFIs' desire to mitigate the risks they face that are associated with the possibility of death among their target clients and difficulties in recovering loans from the

estates of deceased or their families. Many of the MFIs have started providing credit-life insurance for group loans where the policy holder is the individual client. Instead of the group liability, MFIs are using the insurance fund to manage default risk. The credit-life insurance is used to protect the risk of MFIs, where a client/family of a client usually gets the advantage of writing-off his/her outstanding loan balance in the event of the borrower's death. Some MFIs such as Agar MFI has started providing credit-life insurance for individual loans. However, some practitioners indicated that since MFIs are currently providing individual loans on the basis of property collateral, there is no need for credit-life insurance. These MFIs require the clients to ensure their property collateral before taking loans. On the other hand, some MFIs have also started providing livestock insurance, property insurance for housing loan and insurance for cash-in-transit.

OCSSCO has two types of credit-life insurance: (a) in the event of death, if the client pays 1% of the loan as a premium, the loan balance of the deceased is settled from the insurance fund; (b) if the client pays 1.5% of the loan as a premium, in addition to the settling of the loan balance, an amount equivalent to the loan balance is provided to the family of the deceased. DECSI has piloted parametric or index-based insurance covering the loss of crop yield due to a random variable that can be easily observed and tightly linked to the yield of the insured crop (rainfall, temperature, etc). Moreover, DECSI is in the process of finalizing the development of manuals, selection of staff to be trained in micro-insurance, particularly health insurance for the poor.

Addis Credit and Saving Institution (AdCSI) is currently involved in delivering loans, savings, money transfer, payment system and micro-insurance activities. All clients are required to have an insurance policy for the loans in exchange for a premium expressed in terms of percentage of the total loan. All

loans of AdCSI delivered to clients are covered with credit-life insurance which are classified as life, property and business credit-life insurance. With the exception of housing loan (with a premium of 2% of the total loan), AdCSI charges 1% of the loan amount as a premium (Wolday Amha 2010b).

Money transfer

The money transfer product of MFIs includes local payments and transfer services between family members and others from one area to another. Although there are limited empirical studies on money transfer in rural and urban areas in Ethiopia, informal money transfer is more prevalent as opposed to the formal systems. DECSI and ACSI are the only MFIs that have designed and implemented local money transfer systems. They are in the process of expanding this product to link with international money transfer companies.

Payment system

MFIs in Ethiopia are currently involved in payment and collecting taxes from the public on behalf of tax authorities and other government institutions. ACSI, DECSI and OCCSCO deliver the monthly pension of civil servants and military pensioners in Amhara, Tigray and Oromiya regions respectively. MFIs charge 2.5 Birr as service fee per pensioner. This product has been useful to both the MFIs and the pensioners. DECSI, OCCSCO, Omo, ACSI, AdCSI and Deri MFI are involved in collecting fees for using TV services from the public on behalf of Ethiopian TV and Radio Broadcasting Agency. AdCSI is collecting taxes on behalf of the tax authority of the Addis Ababa city administration.

As indicated the above, deposit taking MFIs in Ethiopia are delivering supply driven financial products under a non-competitive environment. In addition to this, there is a huge unmet demand and shortage of loan capital. The above problems have made them give less attention to product development.

However, some of the critical conditions which discouraged product development are changing quite rapidly and, MFIs need to develop client-centered financial products.

MFIs in Ethiopia need to increase their scope and operation by searching for new markets and deepen their penetration by broadening the range of financial services offered to households which will help in broadening the reach of financial markets. Since the poor, in both rural and urban areas, are lucrative customers worth follow up of their needs, the MFIs should shift from the traditional supply- to demand -driven financial products which involve market research and new product development. Using a product development process that is client-centered allows meeting both the financial and social goals of an MFI. For example, women and the Moslem community need tailored financial products that match their needs. This will have a direct influence on outreach, operational and financial sustainability and increase client satisfaction and retention. Designing product terms tied to client cash flow also improves the repayment capacity and allows the MFIs to sustain their operation.

8.3.3. Performance of the deposit taking MFIs

The performances of MFIs in Ethiopia are measured against indicators which define how well the institutions perform, how well they are managed, and how well they are being institutionalized as autonomous institutions. The selected and agreed indicators measure the depth, scale, and growth of outreach; profitability, operational and financial sustainability; productivity and efficiency; and liquidity and risk. However, there are also institutional indicators which measure the extent to which MFIs create the basis by which they will sustain themselves institutionally, which include the level autonomy

from direct government or NGO oversight, governance and ownership structure, the strength of their financial and administrative management systems and business planning, etc.

Growth and outreach indicators

Outreach is measured in terms of the number of active clients (with outstanding loan), loan size, number of saving clients, volume of savings, percentage of loans to clientele below poverty line, percentage of female clients, range of financial and non-financial services offered to clients, the level of transaction costs and the extent of client satisfaction with respect to financial services. In the last decade, the MFIs in Ethiopia have shown a remarkable progress in terms of outreach and performance. However, it should be noted that the 30 MFIs currently operating in Ethiopia meet only less than 20% of the demand for financial services. This indicates that there is a significant unmet demand for micro-finance services in the country.

Currently, some of the MFIs are at their startup stage, where their clients are less than five thousand and require support to build their capacity so that they can increase their client base. There are also emerging MFIs with clients between 5,000 and 20,000, where their emphasis is on consolidating their activities to improve the quality of portfolio, performance and increase outreach. There are also MFIs that deliver financial services to 20,000 to 50,000 clients. These are MFIs that are growing: with the right support, they could become mature and sustainable MFIs. Mature sustainable MFIs, in the Ethiopian context, would typically have more than 50,000 clients. Five of the MFIs in Ethiopia are in this category.

Although the development of deposit taking MFIs in Ethiopia started very recently (1997), the industry showed a remarkable growth in terms of

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outreach. Since the issuance of the micro-finance law (1996), 30 MFIs (with more than 1000 branches and sub-branches have been registered by NBE to deliver financial services to the financially excluded population. The number of active clients increased from 755,073 in 2003 to 2.33 million by the end of 2009. The active loan portfolio also increased from Birr 594 million to about Birr 5.1 billion (388 million USD⁴³) (Table 8.14). This growth suggests that the market has immense penetration opportunities. The average loan size of MFIs increased from Birr 787 in 2003 to Birr 2192 in 2009. The percentage of women client also increased from 30% to 54% (Table 8.14).

⁴³ 1 USD = 12.89 Birr (December 2009)

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Table 8.14: Outreach of Ethiopian MFIs, 2003-2009

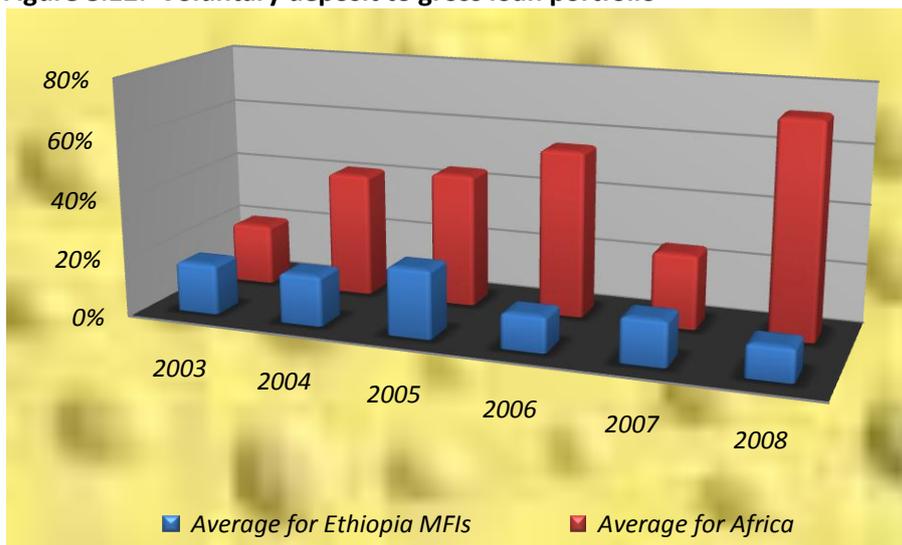
Year	No. of Active Client	Women Borrowers (%)	Outstanding loan	Compulsory Saving	Voluntary Saving	Total Saving
2003	755,073.00	30.00	593,978,863.00	98,776,157.00	200,811,598.00	299,587,755.00
2004	1,005,432.00	47.00	996,078,250.00	150,436,843.00	260,797,976.00	411,234,819.00
2005	1,277,939.00	45.00	1,622,107,210.00	218,867,864.00	364,796,235.00	583,664,099.00
2006	1,568,572.00	57.00	2,190,158,748.00	332,891,955.00	466,464,369.00	799,356,324.00
2007	1,780,363.00	43.00	3,189,521,117.00	449,929,538.00	722,950,231.00	1,172,879,769.00
2008	2,229,984.00	54.00	4,770,087,410.00	754,207,415.00	1,030,953,374.00	1,785,160,789.00
2009	2,328,349.00	54.00	5,104,584,416.00	839,962,876.00	1,315,023,263.00	2,154,986,139.00

Source: Various performance reports of AEMFI, 2010

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The total saving increased from Birr 299,587,755 in 2003 to Birr 2.15 billion in 2009. The average saving per client also increased from Birr 397 to Birr 926. The voluntary saving also showed significant increase, from Birr 201 million in 2003 to Birr 1.3 billion in 2009. In 2009, MFIs covered about 42% of their loan capital from savings. As a result, MFIs in Ethiopia have proved that poor people can save, if they are given the right product and environment.

Figure 8.12: Voluntary deposit to gross loan portfolio



Financial performance and profitability

The financial performance measures the ability of MFIs to generate sufficient financial revenue from their loan portfolio and other revenue related to financial services to cover their financial expenses, loan loss provisioning and operation expenses. If an MFI's financial revenue exceeds expenses, the institution is able to cover its costs through financial operations. Of the 22 MFIs analyzed by AEMFI's performance report, only six institutions did not achieve operational self-

sufficiency (David Peck 2010). Although financial self-sufficiency is similar to operational self-sufficiency; it includes inflation, loan loss provisioning and cost of fund adjustments. The Ethiopian MFIs were unable to attain financial self-sufficiency in 2008 - a reversal of the prior year achievement in which 30% of the institutions analyzed were financially self-sufficient. One of the main reasons for low ratio of financial self-sufficiency of Ethiopian MFIs was the presence of very high inflation rate which stood at an annual rate average of 44,4% in 2008 (versus 17.2% in December 2007).

Table 8.15: Overall financial performance

Year	Return on assets		Return on equity		Operational self sufficiency		Financial self sufficiency	
	Average for Ethiopia MFIs	Average for Africa	Average for Ethiopia MFIs	Average for Africa	Average for Ethiopia MFIs	Average for Africa	Average for Ethiopia MFIs	Average for Africa
2003	-5%	-2%	-8%	-6%	104%	111%	77%	94%
2004	-3%	-3%	-8%	4%	128%	117%	89%	101%
2005	-2%	-7%	-6%	-6%	123%	107%	92%	89%
2006	-4%	-7%	-5%	15%	131%	104%	87%	89%
2007	-6%	-1%	-11%	-3.02%	127%	106%	81%	95%
2008	1%	-3%	5%	NA	119%	115%	52%	100%

Source: Various performance reports of AEMFI, 2010

The operation self-sufficiency of Ethiopian MFIs has not shown any significant change in the last six years (Table 8.15). The average operational self-sufficiency of MFIs varied between 104% and 131%. However, the operational self-sufficiency ratio of Ethiopian MFIs has been relatively much higher than the average for African MFIs. On the other hand, the financial self-sufficiency of Ethiopian MFIs has shown a declining trend as a result of the high inflation in 2007 and 2008. As a result, the average financial self-sufficiency of

Ethiopian MFIs is lower in 2007 and 2008 compared to African average. Given the relatively young age of Ethiopian MFIs and focusing on social objectives, they are doing well in terms of financial performance (David Peck 2010). The Return on Equity (ROE) and Return on Assets (ROA) are commonly used indicators to measure the ability of MFIs to continue operations in the future. Table 8.15 indicates that, in 2008, the ROE and ROA of the MFIs in Ethiopia were 5% and 1% respectively. This is quite encouraging compared to negative figures in the previous years and the average ROE and ROA of MFIs in Africa.

Efficiency and productivity

Efficiency and productivity indicators examine the extent to which institutions deliver full financial services in the most cost effective manner while maximizing their services using a nominal amount of resources. The indicators measure the best usage of resources at least cost. The commonly used efficiency indicators include ratios such as operating expense to loan portfolio; personal expense to loan portfolio; cost per borrower and cost per loan. For many MFIs, staff is a large operational item. The number of field staff working directly with clients and their proportion to the total number of clients indicates how productively the human resource is being used. The key productivity indicators include borrower per staff; loans per staff; borrower per loan officer; and volume of loans per loan officer.

The MFIs in Ethiopia reduced their operating expense ratio from 20% in 2003 to 12% in 2008, while the average ratio for MFIs in Africa increased from 36% in 2003 to 42% in 2008 (Table 8.16). According to an IMF report (2005), the most efficient micro-finance institutions have operational expenses in the order of 15% to 20% of their loans, compared to less than 5% for banks in developing countries. This indicates that the operational expense ratios of Ethiopian MFIs are categorized within the range of more efficient MFIs. In

2008, the personnel and administrative expenses accounted 7% and 6% of the total asset respectively. DECSI, ACSI and Omo MFIs maintained the lowest personnel expense ratio at 2% and upheld an average administrative expense ratio of 1% - weighted against the gross loan portfolio (David Peck 2010). Table 8.16 also indicates that the personnel expense ratio of Ethiopia's MFIs has declined from 11% in 2003 to 7% in 2008, while the average ratio for MFIs in Africa increased from 15% in 2007 to 19% in 2008.

Table 8.16: Efficiency and productivity

Year	Operating expense ratio		Personnel expense		Cost per borrower		Borrowers per loan officer	
	Average for Ethiopia MFIs	Average for Africa	Average for Ethiopia MFIs	Average for Africa	Average for Ethiopia MFIs	Average for Africa	Average for Ethiopia MFIs	Average for Africa
2003	20%	36%	11%	15%	129	499	383	253
2004	16%	36%	9%	19%	113	842	479	368
2005	13%	42%	7%	21%	110	1221	434	319
2006	15%	42%	8%	21%	139	1386	390	270
2007	14%	32%	8%	14%	152	114	541	241
2008	12%	42%	7%	19%	206	187.1	395	367

Source: Various performance reports of AEMFI, 2010

The borrower per loan officer ratio is used to measure the productivity of the loan officers of an MFI, which is partly affected by population density, ease of access to clients and type of product and lending methodology. In 2008, the average ratio of borrowers per loan officer of Ethiopian MFIs was 395 which was higher than the average for MFIs in Africa (367). In 2008, the average cost per borrower ratio (operating expenses/number of active clients) of Ethiopian MFIs was Birr 206, representing 13% of the average outstanding loan balance.

However, the cost per borrower of OCSSCO, ACSI, Sidama, DECSI, and Omo MFIs was about 5% of the groups average outstanding loan balance. Contrary to the previous ratios, while the cost per borrower for Ethiopian MFIs increased from 129 in 2003 to 206 in 2008, the ratio for African MFIs declined from 499 in 2003 to 187 in 2008 (Table 8.16).

Risk and liquidity

Operational performance indicators measure portfolio quality and service delivery coverage of MFIs. The key portfolio quality indicators include: portfolio at risk, repayment rate, and loan loss rate. Loan portfolio is by far the largest asset managed by MFIs. If loan is not managed well, bad debts shall be the institution's largest expense leading to bankruptcy. Good portfolio management is what generally distinguishes solid and sustainable financial institutions from those suffering from serious problems. Bad portfolio quality erodes the MFI's efficiency in a variety of ways such as diverting attention to loan recovery; cost escalation with additional loan recovery effort; income diminishing as a result of missed interest payments; good clients losing access to credit service due to shortage of lending fund; and loss of confidence enticing withdrawal of savings that will aggravate the liquidity problem. The ultimate result of the above shortcomings will be the eminent bankruptcy of MFIs.

Portfolio at risk (PAR) of MFIs measures the amount and percentage of loans in the portfolio whose payments are in arrears, thereby subjecting the loans to the risk of non-reimbursement. A review of Ethiopia's PAR age analysis, which classifies loans in terms of the length of time they are overdue, indicates that PAR>30 and PAR>90 days at 7.6% and 5.4% (David Peck 2010), is very close to the average PAR>30 day of African MFIs (Table 8.17). The loan loss ratio of Ethiopian MFIs has also declined significantly in the six years indicated in Table

8.17. The above results indicate that the Ethiopian MFIs have consistently demonstrated strong asset quality despite the sector's inherent risk factors of the institutions, the global financial crisis, food crisis and high inflation pressure (Devid Peck 2010).

Table 8.17: Risk & liquidity

Year	PAR >30 days		Loan loss ratio		Non earning liquid assets		Risk coverage	
	Average for Ethiopia MFIs	Average for Africa	Average for Ethiopia MFIs	Average for Africa	Average for Ethiopia MFIs	Average for Africa	Average for Ethiopia MFIs	Average for Africa
2003	6%	5%	5%	8%	28%	14%	160%	64%
2004	6%	5%	7%	3%	27%	16%	43%	120%
2005	4%	8%	6%	4%	21%	16%	67%	70%
2006	5%	9%	5%	5%	18%	15%	98%	92%
2007	4%	5%	5%	2%	19%	13%	104%	59%
2008	8%	7%	2%	3%	16%	19%	87%	197%

Source: Various performance reports of AEMFI, 2010

Concentration and competition

Out of the 30 MFIs in Ethiopia, the five MFIs (16.7%), namely, ACSI, DECSI, OCSSCO, Omo and AdCSI, account for 83% of the active clients, 90% of the loan outstanding, 92% of the total savings, and 91% of the total asset. About 97% of the voluntary savings were mobilized through the five big MFIs. These indicate the dominance of the industry by few MFIs which have an impact on low level of competition in the micro-finance sector. With the exception of Afar and Somali regions, the MFIs operate in all the regions, including Harer and Dire Dawa. However, the penetration of micro-finance activities are much higher in Tigray than in other regions, including Addis Ababa.

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Although competition in the microfinance sector is relatively very limited in Ethiopia, MFIs operating in Oromia, particularly those working in Addis Ababa and semi-urban areas around the city, are competing for clients . As a result of the competition for the same clients, the MFIs operating in Oromia region are reporting high rate of multiple borrowing (multiple loans from multiple finance providers) among their clients. In order to minimize the problems, nine MFIs agreed and signed a code of conduct in 2010 which helps them to identify such clients, share client information and enable them make a better decision in selecting clients and assessing debt. MFIs in Ethiopia are also competing with cooperatives, particularly in implementing the credit component of government and donor programs such as the food security program. On the other hand, unlike in Kenya where about 50 banks and 20 non-bank financial institutions are down-scaling their financial delivery system and competing with MFIs, the Ethiopian MFIs hardly compete with the 16 banks.

Table 8.18: MFIs outreach as of June 2010

No.	Name	No of active borrowers	Loans outstanding	Total saving	Total asset	Total liabilities	Total capital
1	ACSI	677,331	1,765,373,941	1,052,115,000	2,533,221,000	1,828,768,000	704,453,000
2	ADCSI	128,480	416,188,000	108,583,000	530,138,000	184,886,000	345,252,000
3	Aggar	4,377	14,533,342	7,986,553	17,296,386	12,926,190	4,370,196
4	AVFS	14,981	10,673,647	271,330	18,078,583	6,954,532	11,124,051
5	Benishangul	28,874	51,762,087	20,734,134	68,423,657	48,829,270	19,594,387
6	Bussa	37,952	50,059,920	9,682,271	61,236,854	31,293,241	29,943,613
7	DECSI	410,993	1,511,845,614	627,389,574	2,137,258,700	1,634,866,159	502,392,541
8	Dire	6,797	18,865,017	6,630,663	39,820,699	17,883,907	21,936,792
9	Degaf	1,213	1,444,410	598,270	1,712,890	791,820	921,070
10	Eshet	24,836	33,102,983	6,125,960	46,501,596	34,455,680	12,045,916
11	Gasha	6,991	14,736,312	5,298,377	20,732,067	15,952,049	4,780,018
12	Ghion	233	286,268	311,112	492,236	319,805	172,431
13	Harbu	16,782	13,712,794	6,325,069	18,766,462	10,825,337	7,941,125
14	Letta	811	3,528,210	1,217,550	4,114,490	1,138,420	2,976,070
15	Meket	3,226	2,592,624	309,846	3,406,289	947,918	2,458,371

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Table 8.18 continued

16	<i>Meklit</i>	14,224	23,029,053	24,749,112	19,152,812	16,316,428	2,836,384
17	<i>Metemam</i>	14,098	11,340,170	2,716,400	16,268,100	3,427,900	12,840,200
18	<i>Ocssco</i>	363,469	833,606,737	217,163,629	1,219,370,430	930,051,278	289,319,153
19	<i>Omo</i>	283,902	537,370,948	195,685,296	622,880,282	441,651,578	181,228,704
20	<i>PEACE</i>	18,174	42,440,247	12,212,369	52,958,216	33,333,408	19,624,808
21	<i>SFPI</i>	31,157	43,061,855	18,820,000	61,176,613	33,851,272	27,325,341
22	<i>Shasheme</i>	3,158	9,972,781	1,960,221	13,391,097	6,991,965	6,399,131
23	<i>Sidama</i>	47,810	28,334,552	11,250,963	36,267,057	24,665,404	11,601,654
24	<i>Wasasa</i>	42,817	83,408,094	24,073,797	95,149,189	65,524,533	29,624,656
25	<i>Wisdom</i>	47,685	89,768,394	22,391,846	120,619,585	63,823,586	56,795,999
26	<i>Harrar</i>	3,100	6,151,000	2,545,100	17,451,300	7,474,600	9,976,700
27	<i>Lefayeda</i>	270	458,589	164,519	863,534	235,636	627,898
28	<i>Dynamic</i>	280	1,431,168	1,214,594	2,198,709	1,275,617	923,093
29	<i>Gambella</i>	880	1,173,831	134,008	1,537,441	367,909	1,169,532
30	<i>Tesfa</i>	106	116,650	6,520	706,400	227,960	478,440
	Total	2,235,007	5,620,369,237	2,388,667,083	7,781,190,675	5,460,057,401	2,321,133,274

Source: AEMFI 2010, Addis Ababa

8.3.4. Issues

A lack of access to financial services – the absence of convenient credit and savings instruments – is a major constraint limiting the accumulation of assets by the financially excluded population and the development of indigenous enterprises. Thus, improving access to financial services, including micro-insurance and payment system, have been viewed as one of the anti-poverty tool of the development programs. It fosters employment, and helps increase income. Improving financial access to the financially excluded also facilitates economic growth by easing liquidity constraints in production, by providing capital to start up new production or adopt new technologies and by helping producers assume production risk. As a result, the intervention through the MFIs will have a significant effect in reducing poverty at macro and micro levels. However, micro-finance is not a panacea for poverty and related development challenges. Micro-finance alone cannot improve roads, housing, water supply, education, and health services. However, it can play an important role in making the above development interventions be realized. It also empowers the excluded population and provides them the confidence, self-esteem and financial means to increase income and access to social services.

In spite of the lack of property collateral of micro and small enterprise operators and high and covariant risks of the agricultural sector, MFIs in Ethiopia have developed financial products which have the potential of creating employment for the youth in urban areas and increasing agricultural production and improving the household food security of the rural poor.. The establishment of regional MFIs has also contributed to equitable distribution of micro-finance activities in the country. Moreover, the expansion of outreach and the high repayment rate of MFIs (more than 95%) is partly explained by

the support of grassroots level government institutions and the use of group lending methodology. The MFIs have mobilized a significant amount of saving from poor households. Savings mobilization in Ethiopia is becoming an integral part of a viable micro-credit delivery system, such that the link between savings and credit promotes the delivery financial services to the excluded population. The experience of MFIs in Ethiopia reveals that the poor are indeed bankable. However, there are gaps such as developing financial products and procedures that fit to diverse needs of micro and small enterprises and agricultural activities; introducing prudent risk management techniques to increase outreach and sustainability; adopting new technologies; and building the institutional capacity of MFIs to provide skills in lending to the financially excluded.

The prospect for delivery of effective financial services through sustainable deposit taking MFIs to the financially excluded population in Ethiopia is bright, particularly when the macro and meso level supports from various stakeholders are put on the ground and when MFIs are allowed to do what finance is supposed to do. Although there is an enabling policy and regulatory framework to promote the activities of MFIs in Ethiopia, there are critical issues that need to be addressed at macro level which include: introducing a national I.D, establishing a national registry system for moveable assets, supporting financial literacy and consumer protection campaign and taking measures to reduce the effect of inflation in the delivery of financial services to the financially excluded population. Moreover, there is a dire need to address the critical challenges at meso level which include developing the technology platform of the micro-finance industry to address the back-end (MIS) and front-end technology, the formation of credit reference bureau, opening specialized training institutes, certification of trainers and other technical service providers, establishing a wholesale refinancing facility to meet the

huge demand for loan fund by finance providers and promoting a national micro-finance rating firms (See the details in Wolday Amha 2010c). The critical issues in expanding the activities of deposit taking MFIs in Ethiopia are presented as follows:

Competition, limited entry and growth of MFIs

MFIs in Ethiopia were established with the support of NGOs and regional governments. The regional supported MFIs have shown a significant increase in outreach in a short span of time. However, given the decline of donor and NGO support for MFIs, the growth of smaller MFIs and entry of new players into the sector seems to be remote in the near future. On the other hand, the existing 30 MFIs are serving only 2.3 million active clients, which is far lower compared to the demand for loan in the country(although the total demand has not been quantified with studies). There is a dire need to increase their capacity and increase the outreach of these MFIs and encourage new entry into the micro-finance sector. There is a need to promote competition between MFIs, banks and financial cooperatives. There is also a need to increase the competition among MFIs themselves by attracting the establishment of new MFIs through the provision of incentives and building their financial and managerial capacity.

Access to loan capital for MFIs

As indicated earlier, compared with the supply side, there is a huge demand for loans in Ethiopia (although not quantified). In the short-run, since the MFIs cannot mobilize the required savings to on-lend to clients, there is a need to introduce different strategies to improve access to loan capital to MFIs. However, this should not discourage saving mobilization and distort financial markets. On top of government and donor support to address the need for

loan capital, there is a need to design different interventions to address the problems. These include:

Transformation of the credit-led MFIs into saving-led institutions

The MFIs need to transform themselves to provide all the loans from savings. This will require institutional restructuring; provide training of staff; building internal control system and MIS; use of front office technologies to mobilize savings; build trust and image of finance providers; develop client-centered and innovative saving products; gain the support of policy makers (at all levels) to mobilize savings; etc. The specific interventions to develop tailored saving products and mobilize savings include: (a) improve the macro-economic management to provide high positive real rates on saving and encourage saving mobilization; (b) effective supervision of deposit taking finance providers and introduce explicit deposit insurance; (c) radical change in the strategy, transforming the deposit taking MFIs from credit-led to saving-led; (d) well developed system supported with back-office and front-office technology; (e) develop demand driven saving products; (f) provide financial education to develop saving culture; (g) build the image of MFIs; (h) expand branch networks and saving outlets; (i) promote flexible hours of operations of finance providers to suit the existing and prospective clients; (j) establish mobile banking to reach remote areas; and (k) capture some of the flow of remittances as savings

Establishing an autonomous apex for wholesale lending and building the capacity of MFIs

Supporting the establishment of an apex organization could serve as an appropriate channel in enhancing access to loan capital and credit guarantee mechanisms to MFIs through government, donors and the other development partners. The apex can also serve as an independent institution to build the

capacity of stakeholders at macro and micro level. Eligibility to access loan capital, credit guarantee fund, and capacity building support from the apex will require adherence to the minimum agreed performance criteria, reporting, and achievement of an acceptable rating. The criteria set by the apex should be based on international best practices. This will assist in building confidence and increase levels of government and donor funding through the apex. However, implementing the standardized criteria and verifying the reports will require a data base and regular performance reporting system (industry performance and benchmarks). Currently, Rural Financial Intermediation Program (RUFIP) is providing limited institutional capacity building and loan funds to MFIs and Rural Saving and Credit Cooperatives (RUSACCOs) and technical service providers which meet certain criteria. RUFIP could be transformed to serve as an autonomous apex body by expanding its current activities. This will require a comprehensive study which reviews best practices, proposing the right type of governance, institutional setup and systems and managing the entire transformation process.

Promoting linkages between commercial banks and micro-finance providers

The ability of MFIs in Ethiopia to expand operations over the coming five years also depends on their access to commercial loans (domestic loans and other sources of capital). However, MFIs must demonstrate their credit worthiness to banks. Although the strategy recognizes the importance of the provision of wholesale funds for inclusive finance providers to expand their outreach, linking inclusive finance providers with banks helps the bankers to channel part of their liquidity to the micro-finance sector. Banks also benefit by outsourcing some of the more difficult micro-lending components of their programs to micro-finance providers whilst leading to greater coverage of the target groups. To this end, banks in Ethiopia should have the regulatory space (i.e., capacity to lend to institutions with non-collateralized portfolios without

being penalized) to refinance micro-finance providers and individuals without property collateral and third party guarantees.

Optimal use of back-office and front-office technology platforms

The use of ICT reduces the cost of delivering financial services to clients and brings micro-finance services to new clients and remote districts which were previously beyond the practical reach of traditional micro-finance channels. With the improvement in the telecommunication services and infrastructure in the remote rural areas, MFIs in Ethiopia are undertaking several experimenting with technology-based financial products or approaches. The NBE, the Ethiopian Telecommunication Corporation, MFIs and other stakeholders need to develop comprehensive strategy and roadmap to optimally use back-office and front-office technology platforms. These shall involve:

- (a) Developing the infrastructure to take advantage of technological advances*
- (b) Implement efficient organization of the payment systems through inter-technology interoperability*
- (c) Promoting branchless banking (delivering financial services by mobile phones and point-of-sales terminals) to substantially reduce transportation and transaction costs*
- (d) Promote affordable card-based payment instruments (smart, debt and credit cards)*
- (e) Develop the right regulatory framework to promote technology-based financial products*

Developing new products and improving the existing financial services

Developing quality financial products that respond to the needs of clients and potential clients (particularly for the excluded) by giving due focus to loan, savings, insurance and payment systems and remittance products are key in the capacity building interventions packages for MFIs. There is a need to build the capacity of MFIs to design and deliver financial products to the excluded. MFIs should use innovative approaches such as the value chain financing and warehouse receipt systems to provide financial services to smallholder farmers and those engaged in productive activities in rural and urban areas. The support on product development should focus on four products:

- (a) **Loan products:** these products include financial services for diverse activities in both rural and urban areas. The loan products will address the working and investment capital needed by clients. The loan products should match with the financial needs of smallholder farmers, micro and small enterprise operators, youth, women and disadvantaged groups such as those living with HIV/AIDs. The market for loans includes agricultural and micro-enterprise activities focusing on productive activities, housing loans, consumption loans, etc.*
- (b) **Saving products:** these products help in developing the saving culture of clients and allow MFIs to generate internal resources for on-lending and be involved in real financial intermediation. Savings products should be accessible in terms of proximity, be attractive in terms of prices, safe and secure, simple in features and convenient (good customer service).*
- (c) **Micro-insurance:** the financially excluded population are able to utilize the financial services, such as loans, when basic household risks are mitigated. In Ethiopia, where more than 85% live on agriculture, production and market risks are very high. There is a need to develop appropriate micro-insurance products such as crop insurance, livestock insurance, deposit insurance, credit life insurance, asset insurance, etc, to protect both the clients and the finance providers. A lot of financial education will be*

necessary to motivate the excluded population to purchase insurance products.

Since the new micro-finance law (626/2009) allows MFIs to provide micro-insurance services, there is a need to develop demand driven and tailored micro-insurance products to the financially excluded population. There were some attempts by DECSI and Nyala Insurance Company (with the support of Oxfam US) to pilot weather-index insurance for smallholder farmers and provide micro-insurance services to the financially excluded population. However, the outreach and diversity of insurance products are very limited (Wolday Amha 2010b). Despite the fact that most crop insurance schemes funded publicly have generally not worked for smallholder farmers, catered only to large commercial farmers, there is a need to develop new schemes in Ethiopia, single-peril (drought, windstorm, hail, etc) to avoid moral hazard and adverse selection problems and keep premiums affordable for smallholder farmers. In addition, other risk reducing instruments which help to manage price and production, such as forwards, futures, options, and swaps, need to be cautiously promoted. This will require developing micro-insurance market and putting the right institutions, legal system and infrastructure in place.

- (d) Payment systems and remittances:** *The aim of this product is to reduce the physical handling and labor costs associated with an ever expanding volume of paper money, cheques, deposit slips, and the like, as well as to provide increased convenience and service to the public. Some of the more advanced payments mechanisms have been due to technological advances including ATM machines, cash cards, debit cards, point-of sale terminals, mobile phones and home banking over the internet. The other technology-related innovations include direct deposit and direct bill payment schemes.*

There is a need to promote innovative remittance products and use them to expand productive activities.

There is a need to provide incentives to those MFIs involved in piloting new innovations to address the financially excluded population. One of the interventions is the creation of an innovation fund to promote new products, systems and approaches which is aimed at including the excluded. MFIs can access this fund on a competitive basis.

High production and marketing risks

Production and marketing risks, providing financial services to smallholder farmers is perceived by finance providers as less sound and risky as discussed above. Because of covariate risks tied with agricultural production and marketing, and absence of formal insurance mechanisms to mitigate them, finance providers have shown less interest and are cautious in financing agriculture. Moreover, finance providers in Ethiopia have very limited capacity to manage and mitigate risks which are very useful in introducing risk-based lending and safeguard agricultural loan portfolios against systemic risks.

Building managerial and institutional capacity of MFIs

Managerial and institutional capacity building include the provision of training and education to staff (including the board of directors) of MFIs and developing systems and procedures and effective governance in the institutions. This also includes enhancing mobility, improving the management information system (MIS), supporting acquisition of appropriate equipment, etc. The capacity building support at micro level should be institution specific. The institutional and managerial capacity building support to government-owned finance providers should focus on the transformation processes which make them autonomous and financially sustainable. Moreover, special

emphasis should be given to MFIs reaching more excluded people and in the development of special services and products for the excluded population.

Creating enabling policies/strategies and legal system and regulatory space

The success of the national strategy for inclusive finance in Ethiopia is largely dependent on aligning it with the wider financial sector development policy and macro and sectoral policies/strategies of the government. There is a dire need to improve the legal and court system to enforce contracts. Raising the limits and power of the Kebele level social courts to entertain or handle court cases up to 10,000 Birr is one way of addressing the challenges of MFIs. There is also a need to design appropriate law and directives to expand leasing products of MFIs. Designing a legal framework and registry to use moveable and non-movable properties as collateral will assist MFIs to deliver loans using individual lending methodology. Moreover, once the issue of title deeds for land is address, it will be much easier to use it as collateral. There is also a need to develop a separate regulatory framework to transform large deposit-taking MFIs into rural/micro-finance/community banks. This will require revising the existing one-size-fits- all type regulatory frame-work by tiered approach.

Financial literacy and client protection

Large communities in Ethiopia have little interaction with formal financial institutions, which affects the credit and saving culture. This will require financial education/ literacy, which involves a series of capacity building activities focused on increasing the knowledge of the financially excluded population on financial concepts, skills and attitudes and to translate this knowledge into behaviors that result in good financial outcomes both for the finance providers and users of inclusive financial services. Financial literacy has a primary objective of providing knowledge and skills to manage financial

resources effectively. There is a dire need to educate Ethiopians on how to develop saving and insurance culture, manage loans and other financial resources, manage cash flow, manage relations with lenders etc by involving regulators (NBE), FCA, AEMFI, the finance providers themselves, Ministry of Education, the media, etc.

Alignment of the activities of MFIs with other development programs

The provision of technical training and Business Development Services through complementary programs is a critical intervention in building the capacity of the clients. Although MFIs are expected to specialize in delivering financial services to clients, there is a need to align and integrate their activities with other development strategies/programs focusing on building the capacity of clients in urban and rural areas. For priority sectors of the government, such as the development of micro and small enterprises, the facilitators (the federal and regional micro and small enterprise development agencies) and MFIs need to jointly plan, implement and monitor the activities. On top of involving in the provision of training (technical and BDS), market linkages, working places and extension services, the facilitators should be accountable in collecting the loans.

Experience in Ethiopia and the rest of the world demonstrates that the emergence of viable MFIs with a large clientele depends on three fundamental conditions. First, the policy and regulatory environment must be sufficiently flexible to accommodate MFIs, financial cooperatives and a range of banks and non-bank institutions to encourage and enable them to implement cost-recovery interest rates and innovative programs for risk management. Thus, we need developing the policy, legal and regulatory frameworks that are essential to the development of innovative financial institutions and instruments. A critical element is a regulatory framework that is conducive to

the evolution of new ways of doing business, including interest rates sufficient to cover costs and innovations in risk management. Second, institution building must be based on achievement of high level of performance if MFIs are to be sustainable and if banks are to view rural households and micro and small enterprises as desirable clients. International best practice shows that lending to rural households and micro and small enterprise operators is feasible if financial institutions implement practices that allow them to widen their scale and outreach, lower their costs and risks, and provide suitable products. There is a need to build the capacity of MFIs to achieve acceptable standards of performance. Third, MFIs should be able to innovate and develop financial services and products appropriate to rural households and micro and small enterprise operators.

8.3.5. Research agenda

Financial access survey and estimating the demand for financial services

From the supply side, the banks, MFIs and SACCOs in Ethiopia provide loans to 61,395 clients; 2.4 million clients and 400,000 members respectively. This indicates that about 2.9 million people access loan from formal finance providers. Moreover, about 14% of adults in Ethiopia access financial services from formal and semi-formal finance providers. Given the 80 million population, this is very low by any standard. However, although the MFIs and SACCOs are reporting that they need huge loan capital to meet the request of smallholder farmers in the last three years, there are no detailed empirical evidences to show which potential clients and activities require loans and other financial services at any given time. Conducting a study to estimate the effective demand for loans and other financial services should be given priority. There is a possibility of conducting the financial access survey and the demand study under a single research project. The financial access survey is

expected as a baseline survey, which is a prerequisite to conduct a financial access survey on a yearly basis. Moreover, although countries like Kenya conduct detailed financial access surveys every year, Ethiopia does not have even a single survey.

Identifying and mitigating the risks of clients and MFIs

MFIs in Ethiopia have introduced loan insurance to protect their institutions from credit risk, particularly death of a client. There were also support from government and donors to build the capacity of the MFIs to mitigate various types of risks. Moreover, insufficient attention is given in identifying the risk of smallholder farmers and developing interventions to mitigate or reduce their risks. There is a need to assess the risk involved in various activities of clients and recommend interventions to reduce risks. Moreover, there is a need to assess and identify the various risks of MFIs in Ethiopia.

Saving behavior and mobilization

Although attempts have been made by MFIs and financial cooperatives in Ethiopia to develop standard saving products, there are very limited evidences to show the changes in saving behavior of the financially excluded population. There is a need to study how saving behavior is linked to financial literacy, money management skills, household income, culture and tradition, trust on the finance providers, educational level, exposure to banks and other finance providers, gender, settlement type, etc. The study will provide basic information to develop demand-driven saving products and propose various interventions, at macro and micro levels, to mobilize savings and develop saving culture in the society.

Agricultural finance and sustainable environment

Climate change results in extreme temperature, heat waves, extraordinary rainfall events, and more intense and prolonged droughts and floods. Soil

erosion caused by poor farming techniques, water, soil and food contamination through abusive use of fertilizer and pesticides; improper irrigation techniques that waste water; desertification resulting from overgrazing are all examples demonstrating that agriculture can have a highly negative impact on the environment if it is not practiced properly. The climate change poses environmental stress creating severe challenges to rural communities because they are dependent on natural resources. On top of the existing environmental challenges in Ethiopia, various models suggested that Ethiopia and Bangladesh will possibly suffer the most negative effect of climate change in the future. Moreover, agricultural finance is one of the activities that can affect the environment directly/indirectly or negatively or positively. On the other hand, agricultural finance, particularly insurance products, is considered as tool to mitigate environmental risks. There is a need to conduct a study on the risks of climate change to develop mitigating tools and ensure that financial resources delivered to increase the income of farmers do not contribute to environmental degradation.

Financial access to women

Women in Ethiopia play a major role in producing, processing, and marketing and in managing the family budget that is often impossible to disassociate from the business budget. Women have a major role in planning cultivation, undertaking a large portion of crop and livestock production and managing micro businesses and are often in charge of marketing the products. About 54% of the clients of deposit-taking MFIs are women. Women in Ethiopia have proven repayment capacity. However, there is a need to develop tailored financial products to foster accessibility and eligibility of loans to women and mainstream the activities of finance providers to serve women. The study will be a prerequisite to develop women-centered financial products and propose interventions to address the challenges of women at macro and micro levels.

8.4. Financial cooperatives

The three successive regimes in Ethiopia (the Imperial, Derg, and Ethiopian People Revolutionary Democratic Front, EPRDF) issued different proclamations, directives and introduced regulatory frameworks to reflect their policies and political systems. Currently multipurpose and financial cooperatives or SACCOs are expected to play a critical role in implementing the various policies/strategies/programs of the government such as the poverty reduction; food security; rural development; industrial development; marketing strategies; Ethiopian Commodity Exchange; etc. Moreover, the financial cooperatives, as part of the financial sector development in the country, are expected to provide sustainable financial services in rural and urban areas. Unlike banks and MFIs, financial cooperatives have a unique feature of addressing the financial needs of the excluded population, particularly in remote areas.

8.4.1. Development of financial cooperatives in Ethiopia

The Five Year Development Plan of the Imperial regime envisaged the importance of cooperatives in transforming smallholder farming in Ethiopia. To this end, the regime issued the farm workers cooperatives decree (No. 44/1960) in 1960. The then Ministry of National Community Development and Social Affairs was entrusted with the task of promoting the cooperative societies (Golden Africa Capacity Center 2010). Subsequent to the 1960 decree, Proclamation No. 241/1966 was issued, which was more comprehensive and gave the legal foundation to promote cooperative societies. According to the report, the proclamation (No. 241/1966)

distinguished between primary and secondary societies and gave cooperatives the option to be established as either limited or unlimited liabilities as they choose. Following the relatively conducive legal framework during the imperial regime, the first SACCO was established by the Ethiopian Road Authority in 1954 (Golden Africa Capacity Building 2009) followed by the Ethiopian Airlines in 1964 (AEMFI 2008). It was during the imperial regime that SACCOs established their own national apex body, known as Ethiopian Thrift and Cooperative Societies Ltd (ENTACCS) which was also a member of the Africa Confederation of Co-operative Saving and Credit Association (ACCOSCA). However, the movement faced unprecedented challenges during the Derg regime.

Derg aggressively promoted the cooperative movement to build a socialist oriented economic and political system. The regime issued Proclamation No. 138/70, and 138/1978 to promote, regulate and supervise different types of cooperatives (producers' cooperatives; service cooperatives; thrift and credit cooperatives; and housing cooperatives) under different ministries. Consequently, SACCOs (Thrift and Credit Cooperatives as they were called then) were licensed and regulated by the National Bank of Ethiopia, as part of the financial sector. However no effort was made by NBE to come up with specialized directives or regulatory framework for the development of financial cooperatives. The supervision of SACCOs was also constrained by the absence of NBE branches outside Addis Ababa or delegation (AEMFI 2008). Moreover, NBE was limited in facilitating employee-based SACCOs. In fact, the then legislation seemed to limit membership to employees of formal organisations within the urban context as one of the articles qualified membership as people working "... in one undertaking or office". As per this statement, farmers were not considered as people working in offices or undertakings.

The cooperatives during the Derg regime were used intensively to mobilize resources to promote development and administrative functions of the government and meet the political objectives of the regime. Basic internationally accepted principles were violated (what are these internationally violated principles?). As a result, members considered cooperatives as imposition of government, instead of owing them. Although the number of cooperatives and their members increased significantly during the Derg regime, the life-span of such cooperatives was no longer than the political system that incubated them. Cooperatives during the Derg regime were so unpopular that following the demise of the regime in 1992, most of the cooperatives (with the exception of SACCOs) disappeared quickly. The cooperatives were dissolved in such a disorderly manner (e.g. bank loans and other obligations were not settled, no distribution of assets among members, etc) that it created a long lasting suspicion and distrust of cooperatives, the stigma of which is still haunting cooperatives today (Golden Africa Capacity Center 20010). Currently, under the pretext of the poor performance of cooperatives registered during the Derg regime, Banks, such as CBE and Development Bank of Ethiopia (DBE) are reluctant to lend to the cooperative sector(is there any evidence on that- must be supported by surveys; we need to make sure that we focused on financial cooperatives). As a result, the cooperative movement during the Derg regime did more harm than good to the current development of cooperatives by eroding public confidence.

After the immediate downfall of Derg, there were uncertainties on the future of cooperatives in Ethiopia. The confusion was cleared through Proclamation No. 85/1994 under the EPRDF regime (the incumbent government), which was issued to promote agricultural cooperatives in the country. Since there was no clear mandate of a specific ministry or institution in the proclamation to

promote and regulate cooperatives, a cooperative desk was established in the Office of the Prime Minister together with cooperative bureaus at the regional levels and in major cities. The proclamation was followed by a series of proclamations, Proclamation No. 147/98 and No. 241/204 (which have similarities with Proclamation No. 241/1966 of the imperial regime), which provided a new legal and regulatory framework for cooperatives to reflect the market-oriented economic policies. They were issued to promote cooperatives on the basis of internationally accepted cooperative principles, values and ethics. Currently, the legal environment is relatively favorable to support the development of cooperatives at grassroots level. For example, Proclamation No. 147/98 allowed people in rural and urban areas to be free to join cooperatives on their own accord. However, some practices are still against the principles of cooperative promotion.⁴⁴ Also, the proclamations put all types of cooperatives (including financial cooperatives) at varying level of development under one proclamation or legal and regulatory framework.

According to Proclamation No. 147/1998, cooperative societies are to create savings and mutual assistance among members by pooling their resources, knowledge and property, to enable them to actively participate in the free market economic system. It also sets out the legal framework for cooperatives in Ethiopia covering the guiding principles which underscores the independent and autonomous character of the cooperatives. The multipurpose cooperatives and saving and credit cooperatives provide financial, marketing, production and other services to members. These cooperatives shall follow:

(a) Standard principles and approaches of cooperative formation that are mainly established on the basis of democratic principles, voluntary

⁴⁴ Dagne & Wolensu, *Cooperative and Rural Organization*, Vol. II, Oromiya Economic Study Project office, Finfinne, April, 1999, P. 86.

- membership, member owned and managed, equal access to services of cooperatives, equal vote regardless of shares/savings;*
- (b) The cooperative guidelines, regulatory framework, proclamations and directives issued by competent authorities;*
 - (c) Transparency and full participation of members from the very beginning of the establishment of cooperatives; and*
 - (d) Maintaining adequate books of account and other sound management practices⁴⁵.*

As per article 2 of Proclamation No. 147/98, one of the types of cooperatives to be organized is SACCO. The authority to promote, register and supervise the cooperatives is given to the "appropriate authority" which according to the same proclamation (Article 2 Sub Article 7) is "an organ to be established at federal level, or a bureau or an organ established for the same purpose at regional or city administration levels, to organize and register cooperative societies..." Unlike the preceding proclamations which gave the mandate to different ministries and the NBE, all types of cooperatives are, according to the new law to be promoted and supervised within one office. However, as SACCOs are financial institutions, there is no separate legislation and regulatory framework in Ethiopia which supports their growth, sustainability and efficiency. The report of Golden Africa Capacity Center (2010) has identified a number of issues that need to be seriously considered in the Proclamation (147/98) which affects growth, sustainability, incentives, achieving economy of scale and proper monitoring and corporate governance. The report proposes: allowing cooperatives (including SACCOs) to engage in profit making businesses (SACCOs are already profit making institutions);

⁴⁵ *These are basically adopted from the seven ICA principles of (i) voluntary and open membership; (ii) democratic member control; (iii) member economic participation; (iv) education training and information; (v) autonomy and independence; (vi) cooperation among cooperatives; and (vii) concern for community*

allowing the transfer of shares for members holding shares, even shares of less than a year; following the spirit of the 1960 Commercial Code of Ethiopia in dissolving a cooperative; allowing proxy vote; replacing the one member - one vote system into one share – one vote system; lending to non-members on the basis of the stage of development of the cooperatives; introducing tiered regulation with differentiated rules; etc.

In 2002, the cooperative desk was strengthened and transformed into a Federal Cooperative Commission, headed by a Commissioner of Cooperatives, with three departments and two support units. This was followed by the establishment of cooperative bureaus/offices at regional, zonal and Woreda levels to promote cooperatives in their respective areas. As a result of the support, most cooperative offices heavily depended on cooperative promotion staff to strengthen the cooperatives. Though the backup by cooperative promoters is justifiable at the initial stage, it should gradually be replaced with cooperatives members' empowerment by establishing strong primary cooperatives, unions and federations. Since the proclamation (No. 147/98) was biased toward agricultural development, the Federal Cooperative Commission was transferred to the newly created Ministry of Agriculture and Rural Development under proclamation No. 308/2004 (January 2004), which was later renamed as Federal Cooperative Agency (FCA). However, the ministry does not have the required expertise and a focus to promote non-agricultural cooperatives such as the financial cooperatives.

8.4.2. Financial cooperatives as a tool to implement development strategies

Cooperatives (both multipurpose and SACCOs)⁴⁶ are key grassroots level organizations which are very critical instruments in implementing the objectives of the various development programs and strategies such as rural development, poverty reduction, industrial development, agricultural marketing strategies, and food security programs. SACCOs are locally established specialized grassroots level financial institutions geared to meet the financial needs of the community. Since they are established as member-based financial institutions, their responsibility, prudence and credit discipline comes from the fact that their financial resources depend on member savings. SACCOs have simple premises, profits exempted from taxes, managed by elected committees which make their cost structure lower than other finance providers such as banks and MFIs. Most of the borrowers are shareholders, whose financial history, enterprises and character are usually well known to the executive committee or credit committee, which makes the risk of SACCOs lower than other formal finance providers. As a result, the bottom up approach of promoting SACCOs in Ethiopia in rural and urban areas has several advantages. These include:

- * SACCOs stand for both social and economic ends and this wider goal enables them to address different needs of members on the basis of the resources available,*

⁴⁶ *The International Cooperative Alliance (ICA) defines cooperatives as autonomous associations of persons united voluntarily to meet common economic, social and cultural needs and aspirations through a jointly and democratically controlled enterprise. There is a diversity of cooperatives institutions across many regions of the world. However, they are united by a set of shared values and principle, the most crucial and definitive among which is that they are member-based or member-owned organizations. As such, financial cooperatives are distinguished from other financial service providers in that they are owned by members and financial services are commonly targeted at members only. The members of a cooperative are united by a form of social bond, typically determined by their employment, income source, location (community) or economic activity – such as farmers residing in the same village who harvest the same crop/s, or individuals employed by the same organization.*

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- * *SACCOs are schools of democracy. They are utilized to empower the excluded population, by creating conducive environment for women and other disadvantaged groups to access financial services,*
- * *The financially excluded population has easily established viable SACCOs at Kebele level. No minimum capital is required. Members usually fix low share prices and fees that can be met by poor people.*
- * *SACCOs are established through the support of RUFIP.*
- * *SACCOs have legal personality and they are protected by law. They own property, can sue and be sued. This legal background provides members' confidence and security to deposit their savings with SACCOs,*
- * *SACCOs have legally mandated federal level agency, regional and Woreda offices to register, build their capacity, supervise, render audit and provide legal services until they mature and stand by themselves,*
- * *SACCOs are formed at different levels (primary, secondary and tertiary) in rural and urban areas to serve financially excluded population, particularly in remote areas,*
- * *Modern SACCOs, in essence, are not different from some of the indigenous institutions such as Eqqub and this has made them easy to be understood by the rural community,*
- * *SACCOs are established, run and owned by members themselves and this has made them approachable, and*
- * *SACCOs have the potential of growing vertically and horizontally to realize different levels of activities and satisfy the need of their members. They, if networked, have the potential to grow and establish cooperative banks.*

An enabling policy environment is important to increase outreach of financial cooperatives to attain growth, operational and financial sustainability. The federal and sectoral development policies, the commitment of governments at

various levels, the performance of the macro economy (the state of the real economy in terms of improving efficiency in agriculture, industry, commerce, etc), the performance of the financial sector, the efficiency of the legal and regulatory system, fiscal and monetary system, and political system influence the delivery of financial services through SACCOs to the excluded population in rural and urban areas.

The Rural Development Strategy of the Federal Democratic Republic of Ethiopia (FDRE), (2002), considers rural finance as a vital tool to implement the Agricultural-Led Industrialization Strategy (ADLI). Improving access to poor rural households plays a critical role in increasing agricultural productivity, production, investment, employment and improving agricultural marketing (both the input and output markets). An efficient rural financial intermediation and functional financial system is the basis to transfer resources from agriculture to other sectors of the economy. According to the rural development strategy, cooperatives are expected to play a useful role in the delivery of financial services to members and non-members by linking their activities with formal banks and MFIs. Cooperatives can even establish their own cooperative banks and other specialized banks to meet the financial needs of cooperatives at various levels. However, subsidized credit to cooperatives should not erode the repayment culture of rural households, which has been the case during the Derg regime. Although the rural development strategy considers the commodity-based or multipurpose cooperatives as one of the tools to delivery of financial services to poor rural households, it does not separately mention the development of financial cooperatives or SACCOs as key intervention area. It should also be noted that the commodity-based cooperatives are not the appropriate institutions to deliver such specialized financial services in a sustainable way. Efforts should be made to support and build the capacity of SACCOs at various levels

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(primary, union and federation), in urban and rural areas. The financial cooperatives or SACCOs and their unions, as independent and self-governed financial institutions, would have to develop their own strategies to establish cooperative banks.

The second generation of poverty reduction strategy paper, known as the Plan for Acceleration and Sustained Development to End Poverty (PASDEP) gives due emphasis to rural finance as a vital tool to implement ADLI and other sectoral development programs. It identifies access to finance as one of the main constraints in promoting private sector development, agricultural development, micro and small enterprise development, and investment in general. About 1/3rd of households need to travel about 20 km or more to reach the nearest financial service providing centre. About 77% of the population in urban areas has access to financial services within 5 km radius, while the proportion is 17% in the rural areas. Despite the emergence of many financial providers, only 6% of smallholder farmers in Ethiopia had access to the services in the last decade. (PASDEP has already phased out).

In the PASDEP access to micro-finance by the rural communities was envisaged to promote off-farm activities and contribute to poverty reduction. SACCOs with other micro-finance service providers remained important instrument in promoting micro-enterprises that can generate employment and income to the poor, and thereby contribute to meaningful poverty reduction in the country. The strategy identified strengthening of cooperatives to achieve the twin goals of poverty reduction and economic growth as crucial. In the past 5 years, the government has also been successful in increasing the number of primary cooperatives to meet the various development objectives. Several unions are engaged in importing fertilizer and coffee export and two federations of agricultural marketing cooperatives are already established at

regional levels. As a result, importing of fertilizer through cooperative unions increased from about Birr 406 million in 2004/05 to about Birr 2.12 billion in 2007/08⁴⁷ (Table 8.19).

Table 8.19: Fertilizer imports and CBE loans to unions (2004/05 – 2007/08)

Year	Total fertilizer imported (tons)			Size of loan (Birr)
	DAP	Urea	Total fertilizer	
2004/05	100,000	-	100,000	406,000,000
2005/06	175,000	75,000	250,000	828,232,000
2006/07	178,700	50,000	228,700	661,638,000
2007/08	223,750	103,750	327,500	2,122,912,235

Source: Federal Cooperative Agency (FCA) (2008). Co-operatives annual magazine published by FCA

The five years Food Security Project (FSP), financed by a World Bank credit, Italian and Canadian Government grants, and the Government of Ethiopia, provided grants to beneficiary communities for a community initiated income generating or asset building activities and the promotion of community based child growth promotion initiatives, b) institutional capacity building, c) information, education and communication interventions and d) project administration and monitoring.

Beneficiary communities have opted to place grants provided to them through the Food Security Project into revolving funds. The funds have been managed primarily by Multipurpose Cooperatives, Kebele administration and Woreda finance offices. The revolving fund has been implemented through Kebele Development Committee (KDC) in Oromiya and SNNP, while the multipurpose cooperatives took the responsibility of administering the community revolving

⁴⁷ Wolday Amha and Gebrehiwot Ageba (2010) State and structure of agricultural finance in Ethiopia. A paper submitted to International Growth Center (IGC) draft.

fund in Tigray, Amhara and SNNP. The various review reports of the project have raised concerns that revolving funds established through the project have not been properly managed, which has resulted in low repayment rates, and limited on-lending of repaid funds. The project finally decided to transfer the revolving funds to financial cooperatives or RUSACCOs and strengthen community participation in managing the funds. To this end, the Ministry of Agriculture and Rural Development prepared guidelines for joint management of revolving funds by RUSACCOs and the community (Wolday Amha 2010d).

The transfer of the revolving fund from multipurpose cooperatives, Kebele administration, and Woreda offices to RUSACCOs proved to be effective and sustainable for two major reasons: (i) the program employed RUSACCO promoters and accountants (with BA degree in cooperative management and cooperative accounting) from the market, on contract basis, to support the RUSACCOs and manage the transfer process. The evaluation of the transfer process reveals that RUSACCO promoters and accountants played a key role in establishing and strengthening viable RUSACCOs, which are capable of managing the revolving funds in sustainable manner; and (ii) the revolving fund gave the RUSACCOs the confidence and the opportunity to gain interest income to cover their operation costs. Government and donor programs should take the positive experience of the credit component of the food security program in designing sustainable intervention in rural finance. On the other hand, they can learn from the weaknesses of the food security program, which include; (a) delivery of limited and supply-driven financial products, (b) low repayment rates due to poor loan follow-up, (c) unrealistic terms of credit including subsidized interest rates and limited opportunities for repeater and step up loans, (d) channeling credit through inappropriate and unsustainable

finance providers such as Woreda Finance Office, Kebele administration and multipurpose cooperatives, and (e) distorting the rural credit markets⁴⁸.

The project provided capacity building support in establishing new RUSACCOs in the target Kebeles or strengthen existing RUSACCOs, if there are any. Although the project was aware that injecting the revolving fund can undermine the financial-sustainability and savings-first principles, the training and sensitization of the community through the project and a RUSACCO waiting, at least 12 months and start lending from their own sources, before managing the revolving fund helped the RUSACCOs to clearly understand the whole objective of the revolving funds.

Table 8.20: Status of the newly established RUSACCOs and RUSACCOs which are managing the revolving funds

Region	Number of RUSACCOs to be established	Number of RUSACCOs established	Number of RUSACCOs received capacity building support	Number of RUSACCOs managing revolving fund	RUSACCOs managed by RUSACCOs (in million)
Amhara	461	350	200	48	21.3
Oromiya	335	204	116	25	6.0
Tigray	278	265	223	106	33.1
SNRP	200	200	194	129	50.8
Total	1272	954	733	282	111.2

Source: Federal Cooperative Agency (FCA) (2008). Co-operatives annual magazine published by FCA

After the decision to channel the revolving funds through RUSACCOs, the project has been successful in establishing 954 RUSACCOs in 2010, out of

⁴⁸ Renate and Wolday Amha (2009), *Ibid and Wolday Amha (2009) Assessment of the credit component of government financed household food security package program. A paper submitted to BSF/FAO Office. Addis Ababa.*

which, about 733 RUSACCOs and 282 RUSACCOs received the capacity building support and managed the revolving loan fund of the project, respectively (Table 8.20.). Although the project has empowered the community to decide on all aspects of the community revolving fund, there is a need to educate the community, KDCs, multipurpose cooperatives and RUSACCOs on how to design a financial product that fits the needs of the beneficiaries of the project. This will involve orientation and sensitization of the community on how to set loan size, lending interest charged, the repayment schedule, loan period, etc. and how to build sustainable rural finance institutions, such as the RUSACCOs.

Within the framework of the newly launched Five Year Development and Transformation Plan of Ethiopia (2010/11 – 2014/15), economic growth projections are expected to reach an average growth rate of 14.8% every year from a base year, 11%. It is clearly stated that agricultural growth will be the engine of the development and transformation plan⁴⁹. By the end of the five year, saving to GDP ratio will increase from 9.4% in the base year to 18%; smallholder farmers receiving agricultural services will increase from 5.1 million to 16.4 million; consumption of fertilizer will increase from 820,000 ton to 1,665,000 ton; the number of primary cooperatives will increase from 26,847 to 50,000; and additional 300 unions and 6 federations will be established in the coming five years. The resources required to finance the five year transformation plan are expected to be mobilized from domestic sources. To this end, increasing saving mobilization through banks, MFIs, and SACCOs is critical in implementing the ambitious five year development and transformation plan. However, the transformation plan does not provide

⁴⁹ Ministry of Finance and Economic Development (2010). The performance of the last five year development plan (2004/5 - 2009/10) and the new five year development transformation plan (draft summary of the key targets). Addis Ababa

details on financial sector development and a framework to promote rural finance. Building the capacity of SACCOs should be one of the viable approaches to mobilize savings from millions of rural households and provide loans and other financial services to increase agricultural productivity, production, marketing and processing.

8.4.3. Financial products

SACCOs in Ethiopia accept savings from members, both compulsory and voluntary. The quantum of compulsory savings varies from member to member depending upon his/her capacity. However, on top of the compulsory saving, each member pays a fixed (one time) membership fee and buys shares from a SACCO. The fees, size of compulsory saving and shares vary from one SACCO to another. For example, in Embeba Haya RUSACCO in Endamekoni Woreda (Tigray), the membership fee is 5 Birr and the ratio of compulsory saving to share (leverage ratio) is 3.5:1, which is applied to all RUSACCOs in Tigray and Amhara regions. The leverage ratio for urban SACCOs in Amhara region is 6:1. If a member saves 450 Birr, the 350 Birr is the compulsory saving while the remaining 100 Birr is the share. Dividend is based on the share and compulsory saving of a member. The amount of compulsory saving, share prices and membership fees are kept low to enable women and persons with limited means to join a SACCO.

In the first year, SACCOs normally accept only savings from members. This facilitates the inculcation of saving discipline and internalization of the management process. Interest rates on voluntary savings are decided by SACCOs themselves which is usually lower than the interest rates on compulsory saving. In many of the cases, voluntary savings can be withdrawn at any time, in some cases by giving one weeks' notice. However, compulsory

savings of SACCOs are withdrawn when a member decides to terminate his membership. At the beginning, all members deposit their monthly savings on a designated day, starting from the time of their subscription as a member. This is a prerequisite to continue membership and access loan from a SACCO. The savings of members are deposited with MFI or bank on the same day. Once the number of members exceeds 50 and management capabilities improve, fortnight/weekly savings are accepted. Apart from the compulsory and voluntary savings, there are also special saving products of SACCOs such as child savings and fixed-time savings for holidays.

A SACCO in Ethiopia usually starts lending operations in the second year. A member should save at least for one year to be eligible for a loan. The loan is restricted to about 75% of the savings, keeping in view of the liquidity position of a SACCO. Another member should sign as guarantor for the loan. The guarantor should be a member of the SACCO, who does not have an outstanding loan from the society. The loan eligibility of a member is gradually increased by considering the demand for loans (all members may not borrow), liquidity requirements and the prudential norms. Interest on loans is fixed taking into consideration: (a) the market rate, (b) financial cost, (c) operating costs, (d) the need to strengthen the resource base, and (e) the need to service capital. In the first few years, the maximum loan repayment period is usually one year. With experience in handling loans and support of a union, SACCOs offer different saving and loan products to match the needs of members. However, this takes longer time, particularly in rural context. Some sustainable SACCOs in Ethiopia have been paying dividend to members. As per the law, SACCOs can distribute 70% of the profit as dividend to members, and the remaining 30% is allocated to expand the activities of the societies. Many of the primary SACCOs in Ethiopia usually do not have paid employees. However,

as the operations grow, SACCOs need to employ part-time if not full time bookkeepers.

The finance needed for development and growth of a SACCO can be generated from three sources: (i) members' savings; (ii) net surplus generated by cooperatives; and (iii) external finance such as loans from development projects, banks and MFIs. The best source of finance for SACCOs is savings from members. The more financing members provide, the less the SACCO business will need to borrow from other sources. In the Ethiopian context, SACCOs sell common shares to members to raise capital which are not usually tied to voting rights. Non-members cannot buy shares. How much debt capital a SACCO can borrow (e.g. from banks or MFIs) depends on how much equity capital members initially invest, cash flow, quality of governance and management, and the degree of risk. Currently, there is a huge demand for loan in the SACCOs. It will take several years of operation to meet the loan demand of members. Thus, there is a need to have a line of credit for SACCOs and link them with banks and MFIs.

SACCOs in Ethiopia provide traditional and limited saving and loan products to the rural and urban population. A report by Golden Africa Capacity Center (2010) provided a support to this. Only about 33% of members accessed loan services from the SACCOs⁵⁰. About 77% of the sample respondents in the study indicated that members were satisfied with the saving products of financial cooperatives which helped them to access loan and increase the capital of the SACCOs, while the remaining 23% were dissatisfied as the saving products did not match their income flow; access to savings was restricted; amount of saving was too small, etc. Members received saving interest rates on

⁵⁰ Golden Africa Capacity Center (2010), *Ibid*

compulsory savings varying from 0% to 11%. More than 60% of members reported that they received less than 4% interest rate on compulsory saving. About 1.2% reported that financial cooperatives did not pay them interest rates on savings. About 31% of the respondents did not know the interest rates they get on their compulsory savings.

According to Golden Africa Capacity Center (2010), about 33% of the SACCOs members have voluntary saving. The interest rates on voluntary savings varied from 0% to 12%. While about 17% of respondents did not receive interest rate on their savings, about 53% and 16% received interest rates ranging from 1% to 4% and 4.5% to 12%, respectively, on their voluntary savings. About 14.3% indicated that SACCOs did not pay for the voluntary savings. Weak management of SACCOs, unattractive interest rates, small size of loans that match savings of members, and a lack of easy access to the savings even when members face emergency, were among the weaknesses of SACCOs' saving products. The huge demand for loans by members cannot be met due to the small savings of members and shortage of SACCOs' loan capital from other sources. There is potential for SACCOs to mobilize more savings, even from the existing members if the right measures are taken⁵¹.

Members of SACCOs took loans (in cash and in kind) ranging from Birr 100 to Birr 40,000 for a wide range of purposes⁵². However, members are not required to specify the purpose of loans. The respondents ranked their preferred use of loans: to buy consumer items; animal rearing; and animal fattening. About 86% of the respondents stated that they borrowed at least once during their membership life. The reasons for not using loans from SACCOs for the remaining 14% of the respondents include: loan size too small;

⁵¹ Golden Africa Capacity Center (2010), *Ibid*

⁵² Golden Africa Capacity Center (2010), *Ibid*

fear of indebtedness; and not fulfilling requirements of the SACCO. The range of repayment frequency stretches from weekly to once a year. Repayment starts one month after borrowing, irrespective of whether or not a borrower has started generating cash flow from his/her business or other means of income. As a result, borrowers' repayment capacity and borrowers' income are least commonly used factors in determining the frequency of repayment. In spite of the mismatch and lack of flexibility, default rates of SACCOs were very low, only 3% reported default. Since SACCOs had limited capacity, about 20% of the respondents took loans from various sources, other than SACCOs, mainly from friends and relatives (67%), moneylenders (10%), traders (8%), multipurpose cooperatives and unions (10%). As the loans requests of members are not rejected, about 90% of the respondents indicated that they preferred loan from financial cooperatives as compared to loans from MFIs. Those who preferred loans of MFIs indicated access to big loans, easily accessible, no big collateral requirement as their main reasons. About 53% indicated that SACCO products have improved compared to the past. However, 44% stated that there is a need to improve the products in terms of improving the loan size; increasing loan ceiling and extending maturity period; increasing members; solving administrative and management problems of SACCOs; etc.

The traditional approach assumed that the saving potential in rural areas was so low that it was not worthwhile to mobilize savings or to offer savings facilities in rural areas. The vicious circle could only be broken by channeling external funds into rural areas to help raise the low investment rate⁵³. The SACCOs established through the support of RUFIP have proved that the rural poor can save if they are provided with affordable, flexible and quality saving

⁵³ Zeller M., G. Schrieder, J. von Braun and F. Heidhues (1997). *Rural finance for food security for the poor: Implications for research and policy*, Food Policy Review 4. International Food Policy Research Institute: Washington DC.

products. Frequently recommended specific interventions to develop saving culture, design tailored saving products and mobilize savings to on-lend to members of SACCOs include: (a) improve the macro-economic management to provide high positive real rates of returns on saving; (b) implement effective supervision of deposit taking finance providers; (c) develop demand driven saving products; (d) conduct regular financial education to members and the public at large; (e) build the image of finance providers to develop the confidence of members and non-members; (f) promote flexible hours of operations of finance providers to suit the existing and prospective clients; (g) promote mobile banking to reach remote areas; and (h) introduce an explicit deposit insurance.

SACCOs' financial products lack diversity, flexibility, and quality. There is a need to develop demand-driven financial products and services that can play a key role in developing a robust sector and enhancing outreach, which in turn lead to greater economies of scale, thereby improving profitability and enhancing sustainability⁵⁴. In addition to traditional saving and loan products, poor rural households in Ethiopia require other financial products such as insurance, remittance and efficient payment system. Delivering these products would assist both the SACCOs and excluded population to be more efficient in transferring risk and allow them to better manage liquidity. Thus, the availability of formal insurance can protect poor rural households against unexpected output losses and other damage and marketing risk. SACCOs hardly provide tailored micro-insurance services and interventions which address the insurance needs of producers and agribusiness operators in rural areas. Moreover, despite the fact that most crop insurance schemes funded publicly have generally not worked for poor rural households, catered as they are only too large commercial farmers, there is a need to develop new

⁵⁴ Golden Africa Capacity Center (2010), *Ibid*

schemes in Ethiopia, single-peril (drought, windstorm, hail, etc) to avoid moral hazard and adverse selection problems and keep premiums affordable for financially excluded households. There is also a need to use other risk reducing instruments which help to manage price and production of smallholder farmers, such as forwards, futures, options, and swaps, need to be cautiously promoted.

Moreover, SACCOs that desire growth need to understand the financial needs of both their existing and potential members. Developing financial products and innovative lending methodologies which match the needs of members are very critical to improve agricultural production and productivity and expand the activities of micro-business operators. Innovative lending methodologies, which reduce the lending costs for members, should be piloted to increase the demand for loans and expand the frontier of finance. These products will also create additional values, if they reduce the transaction costs of accessing financial services. This could be materialized by improving the capacity of the financial cooperatives so that they can identify the needs of their members better, improve the quality of their services and/or reduce prices of financial products. Moreover, focusing on what is of value to members of SACCOs influences the operational efficiency and profitability of financial cooperatives as well as the satisfaction and retention of clients. Products tailored to the needs of members will have a greater impact in helping members to be effective and efficient in managing their agricultural and micro-businesses. The financial products designed for members should also be tied to their cash flows that improve their repayment capacity and allow SACCOs to sustain their operations.

8.4.4. Outreach and performance

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Outreach of SACCOs is measured in terms of the number of active members (with outstanding loan), loan size, number of saving members, volume of savings, percentage of loans to members below poverty line, percentage of female members, range of financial and non-financial services offered to members, the level of transaction costs and the extent of member satisfaction with respect to financial services.

Table 8.21: The outreach of urban SACCOs in Ethiopia, 2010

Region	No. of SACCOs	Membership size		
		Male	Female	Total
<i>Oromiya</i>	676	39,759	14,285	54,044
<i>SNNPR</i>	172	25,668	20,985	46,653
<i>Amhara</i>	324	15,216	9,597	24,813
<i>Afar</i>	27	178	679	857
<i>Tigray</i>	35	1,334	1,667	3,001
<i>Somali</i>	NA	NA	NA	NA
<i>Gambella</i>	7	NA	1,812	1,812
<i>BSG</i>	28	496	335	831
<i>Harrari</i>	36	845	1,037	1,882
<i>Dire Dawa</i>	129	1,478	3,822	5,300
<i>Addis Ababa</i>	2852	144,922	109,546	254,468
Total	4286	229,893	163,765	393,658

Source: FCA and regional cooperative bureaus, 2010

With regard to their number, there were 670 SACCOs which provided Birr 155.2 million outstanding loans (NBE 1998). In 2000, the number of SACCOs in Ethiopia increased to 716 with an outstanding loan of Birr 162 million and asset worth of Birr 220 million⁵⁵.

⁵⁵ Renee Choao-Beroff et al (2000) and the Team, *Enhancing Rural Financial Inter-mediation in Ethiopia*, Addis Ababa; June, 2000, P. 32.

As per the information collected from the FCA and regional cooperative promotion bureaus, there were about 4,286 urban SACCOs in Ethiopia in 2010 (Table 8.21). There were about 393,658 members of urban SACCOs, out of which about 42% (163,756) were women. About 67% (2,852) urban SACCOs were concentrated in Addis Ababa, followed by Oromiya, Amhara, SNNPR, and Dire Dawa. The savings of SACCOs increased from Birr 1.2 million in 1994 to Birr 1.4 billion in 2008 and the average saving increased 16 times within the same period (Dagnew Gessese 2010).

Table 8.22: The outreach of rural SACCOs in Ethiopia, 2010

Region	No. SACCOs	Members			Saving (Birr)	Working capital (Birr)	Loan disbursement (Birr)
		M	F	Total			
Afar	10	169	453	622	78,250	101,250	
Tigray	553	23,306	12,319	36,625	31,945,219	14,961,335	19,928,278
Amhara	873	58,296	23,599	81,893	42,255,778	12,083,710	41,822,374
Oromiya	1954	43,236	81,545	124,781	10,200,396	24,441,399	25,673,261
SNNPR	773	41,905	33,385	75,290	20,408,597	10,590,931	29,785,644
BSG	83	2,167	1,021	3,188	1,077,937	185,654	141,468
Gambella	26	436	232	668	361,592	309,330	130,500
Somali	65	482	3,536	4,018	1,279,198	783,943	898,306
Total	4337	170,995	156,090	327,085	107,576,967	63,457,558	118,379,780

Source: Berhane Kidanu (2010) Current status and future prospects of financial cooperatives: A proposal to support the RUSACCOs in Ethiopia. A paper submitted to the design of RUFIP II. Addis Ababa

As a result of the support of RUFIP in the last seven years, the number of RUSACCOs increased from 132 in 2003 to 4,337 in 2010 (see Table 8.22) The table indicates that the RUSACCOs provided savings of about Birr 108 million and loans of about Birr 118 million to 327,035 members, out of which about

48% were women. Oromiya had the highest number of rural SACCOs followed by Amhara, SNNPR, and Tigray. About 1,412 RUSACCOs have established 54 unions. The unions mobilized about Birr 87.4 million of savings and disbursed about Birr 119 million (Berhane Kidanu 2010). However, it should be noted that the 4,286 urban SACCOs and 4,337 RUSACCOs currently operating in Ethiopia meet only a very insignificant demand for financial services of the potential demand in urban and rural areas.

8.4.5. Issues

SACCOs have real local presence with concomitant advantages of low transaction costs and enforcement. Since SACCOs are managed and controlled by elected members on a voluntary basis, their transaction costs are relatively lower. They solely depend on the savings of their members to finance their lending activities to members. SACCOs have the advantage of being grassroots level institutions with lower transaction costs (better information, enforcement of repayment, etc.) and have a comparative advantage of providing financial services to remote areas. However, if financial cooperatives are to serve as sustainable finance providers in providing financial services to the financially excluded population, there are several issues that need to be addressed. These include: building the image of cooperatives; capacity building; improving governance and leadership; developing client-centered financial products; integrating the financial cooperatives into the proper financial system; establishing financially viable SACCOs and having the capacity to capture economy of scale; separating the promotion and regulatory activities; reducing the dependency on promoters; developing a separate law to regulate and supervise financial cooperatives; establishing a federation of financial cooperatives; establishing cooperative banks; reducing the involvement of multipurpose cooperatives in the delivery of financial

services; establishing reliable source of fund to meet the growing needs of members; establishing a data bank to measure the performance of SACCOs and unions; monitoring and supervising activities of financial cooperatives; providing business development services to members on a sustainable basis; increasing the participation of women; building the capacity of unions to provide financial, technical and managerial support to primary SACCOs; etc. The current issues and challenges of developing a vibrant financial cooperative sub-sector in Ethiopia are identified by the four studies, namely, Golden Africa Capacity Center (2010), Dagneu Gessese et al (2009); Berhanu Kidanu (20010); and AEMFI (2008). Although the challenges are many, this report identifies only the key issues as follows:

A strategy and a separate regulatory framework to develop financial cooperatives

The cooperative movement in Ethiopia is currently guided by Proclamation No. 147/98, a law that has relatively addressed most of the critical issues for promoting member-owned, member-managed, need-based and sustainable cooperatives on the basis of internationally accepted cooperative principles. The law uniformly treats all types of cooperatives, regardless of their stages of development and experience, size, degree of sophistication of their members as well as their potential and opportunities they face. It does not separately address the critical issues facing financial cooperatives. This is aggravated by a lack of clear policy and strategy to guide and direct the development of financial cooperatives in the country. Although regulation and supervision are very critical to ensure sustainability, financial performance and growth of financial cooperatives, the existing cooperative law does not provide the necessary guidance to regulate and supervise financial cooperatives as part of the financial sector (AEMFI 2008). Moreover, if significant resources are to be channeled through financial cooperatives, there is an urgency to issue a

separate law and a separate regulatory framework to supervise and monitor financial cooperatives' activities. This will help financial cooperatives to carry out fiduciary responsibilities and protect deposits of members, government and donors (who may inject funds through various programs). Developing a separate law is expected to contribute to the establishment of stable and efficient financial cooperatives.

There are arguments against prudential regulation and supervision for saving and credit cooperatives on the grounds that they are restricted to their members who have a stake in the cooperatives, and are not open to the public, and there is no risk to public deposits. However, absence of separate regulatory framework for the saving and credit cooperatives affects the development of the micro-finance sector as a whole. There is a need to harmonize financial standards to be implemented for MFIs and SACCOs. There should be similar financial statement formats, prudential ratios, and reporting requirements. SACCOs, as financial institutions require commensurate supervision and prudential regulations to provide: a framework to licensing requirements; governance standards; safeguards (capital adequacy, reserves, reserves, liquidity, loan loss provisioning, etc); disclosure and reporting requirements; inspection; limits on risk exposure; etc. However, although regulation contributes to stability, efficiency and outreach, effective regulation and supervision of financial cooperatives entail significant cost. In the Ethiopian context, although the mandate of supervising activities of RUSACCOs has been transferred from the NBE to the regional cooperative bureaus, there is a need to have an oversight through a specialized regulatory institution. In spite of the cost, there is a need to establish a separate department under FCA and regional cooperative bureaus to handle both the promotion of SACCOs and regulation and supervision. The departments are

expected to have two independent units, one focusing on promotion and the other one on regulation and supervision.

Establishing cooperative banks

Improving access to credit and other financial services to the financially excluded population in Ethiopia does not necessarily involve the establishment of state-owned or subsidized banks. Historical examples are available, especially in today's rich countries such as Germany, Denmark, and Norway, which show that cooperative banks are key institutions in providing financial services to the excluded population. Since state-owned agricultural banks in these countries were primarily involved in providing credit to large commercial firms, there was a need to establish cooperative banks which focus on the delivery of financial services, mainly savings and credit, to farmers and others who are financially excluded. There were many different types of cooperatives, providing activities like joint marketing, joint production, joint input purchase, irrigation/drainage, product quality control, timeshare for machine, and credit. Denmark was a pioneer in marketing and production cooperatives, while Germany led the way in the development of credit cooperatives (Ha-Joon Chang 2008). Although with less success than the rich-countries, some developing countries, notably India, have promoted cooperative banks. In the Ethiopian context, there hardly exists a cooperative bank in its proper sense. Since there is no separate regulatory framework to form cooperative banks, the recent initiatives to establish the Cooperative Bank of Oromiya and Addis Cooperative Bank in Ethiopia ended up in establishing conventional commercial banks, as per the banking act. There is a dire need to fill this regulatory gap.

Establishing a federation of financial cooperatives

The existing 56 unions of SACCOS lack uniformity. Membership of a union of SACCOS is a mix of primary agricultural multipurpose cooperatives, primary

SACCOs; processing and marketing cooperatives, and others. The rationale for the mixed membership in SACCO unions is resource mobilization and expansion of the marketing horizon and ensuring sustainability of unions. The unions are not uniformly distributed in the regions. There are some regions with 14 unions and some with one union. Although the formation of a federation at a regional level may have some problems, there is a dire need for a federation of SACCOs at federal level. Establishment of SACCO federation is one of the preconditions to strengthen the financial cooperatives in Ethiopia. It has a vivid advantage of establishing a central finance facility; mobilization of external resources; representation on vital decision forums; linking the financial cooperatives with worldwide cooperative movement; standardization of systems for financial cooperatives; provision of audit services; provision of supervision services (if delegated); collection and dissemination of information; provision of development services; image building; etc.

Institutional capacity building of SACCOs

Weak governance and a lack of technical and management skills are critical challenges of financial cooperatives in Ethiopia. This is aggravated by a lack of technical skills and financial knowledge on the part of the cooperative promoters themselves and limited knowledge of the elected committee members to oversee the activities of SACCOs. As a result, SACCO promoters provided limited support in the process of establishing and strengthening sustainable SACCOs and unions and preparing viable business plans for members. SACCOs have limited capacity to keep financial and other records properly. On top of a lack of accounting and business knowledge, MIS is a serious issue of financial cooperatives. Although there has been a significant increase in the number of SACCOs, reaching 8,623 in 2010, this has an implication in the collection of reliable data, measuring their performance (against agreed indicators) and monitoring their activities. However, these

financial cooperatives, particularly in rural areas, have sub-optimal or very low membership size which affects their sustainability as viable businesses and constrains them from exploiting the advantage of economies of scale. SACCOs in Ethiopia also provide very limited range of financial services (mainly savings and loan) which do not respond to the needs of members. Any intervention to support the financial cooperatives in the country needs to focus on the institutional capacity building through capacitating elected members, members and promoters at various levels.

Appropriate government structure to support financial cooperatives

The FCA and the regional, zonal, and Woreda cooperative promotion bureaus/offices have a dual role of promoting and regulating cooperatives (both multipurpose and financial cooperatives) in Ethiopia. The agency that is now tasked with promotion and regulation of cooperatives, which is housed under the Ministry of Agriculture and Rural Development, is biased towards promoting agricultural cooperatives in rural areas. Limited attention is given to the development of urban-based financial cooperatives. As a result, the urban cooperatives are promoted, supported and regulated by the Ministry of Trade and Industry. Moreover, the Ministry of Agriculture and Rural Development has instructed FCA to refrain from involving in market development, by dismantling its marketing department. There is a need to move FCA from the ministry and restructure it to be an autonomous institution and separate promotion and regulation to eliminate conflict of interest.

8.4.6. Research agenda

Survey of the current status and performance of financial cooperatives

There is hardly any reliable and available information at regional and federal levels on the outreach of SACCOs such as membership size (by gender), type

and volume of savings and loans, availability of other financial products, purpose of loans, etc., and financial performance. There is a dire need to conduct a national baseline survey to understand the status of financial cooperatives in the country. Once this baseline survey is conducted, there is a need to regularly conduct a study on an annual basis.

The impact of the new input credit system

The Ethiopian government has been heavily involved in providing agricultural input loans to farmers in the last 15 years. Despite the commitment and support of the government, it was clear from the outset that channeling input loans through non-financial institutions is unsustainable which takes all the energies of the staff of the Ministry of Agriculture and Rural Development at various levels, collecting loan repayment throughout the year. However, as a result of the agricultural price increases in 2008/09 (assuming that this has increased the income of farmers), the government believed that farmers are capable of buying agricultural inputs in cash, instead of credit. There is a need to study how the new system affects the consumption of agricultural inputs, particularly poor households, and analyze which categories of smallholder farmers have the capacity to buy agricultural inputs in a sustainable way. The proposed study will also look for sustainable financing alternative arrangements that can address the challenges of input credit in the country by involving sustainable finance providers.

Managing the risks of members through insurance products

The availability of formal insurance can protect members of financial cooperatives against production, marketing and environmental risks. Property and liability insurance covers can encourage financial cooperatives to provide loans and other financial services to members. Although there has been a

relative success in increasing the number of financial cooperatives, in a short span of time, they failed to provide tailored micro-insurance services and interventions which address the insurance needs of members. This is partly explained by a lack of awareness and tailored micro-insurance products to members. There is a need to conduct a study to assess the micro-insurance demand of SACCOs and pilot the product and upscale the results.

Linking SACCOs with commercial banks and MFIs

Many of the members of SACCOs need loan from the societies. The high inflation for agricultural products has also contributed to the significant increase in the average loan size and the volume of loan required by poor rural households. Without a line of credit, meeting the demand for loans through savings mobilized by the SACCOs themselves will take longer time. Since the SACCOs have limited capacity to provide loans from their own sources, particularly in the short-term, there is a dire need to link SACCOs and unions to commercial banks and MFIs.

8.5. Missing financial markets, products and institutions in Ethiopia

The above sections discussed issues in the Ethiopian financial sector including the structure, performance and infrastructure development of existing financial institutions and legal and policy environment under which the institutions operate. It can be observed that the Ethiopian formal financial market is characterised by limited and fragmented financial services and very few market participants, barriers to entry to foreign investors in the sector, lack of competition and absence of organized capital markets. There are theoretical underpinnings and empirical evidences on the influence that the

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financial sector development has on aggregate expenditure and overall economic developments (for more on this, see previous sections). This section identifies some missing financial markets, and discusses prospects and prerequisites to foster a sound financial system.

The products being offered by the financial institutions in Ethiopia are limited and insufficient. For example, commercial banks mainly provide services such as saving deposits, loans, money transfer, letter of credit, foreign exchange, inter-bank money markets and treasury bills. These markets are limited only to money markets, which are short-term in nature. Moreover, these products of all banks are very similar and lack diversity and innovation.

Treasury bills, which are issued by the National Bank of Ethiopia on behalf of the Federal Government, are the only securities traded in the primary market on a fortnightly basis and no secondary markets exist for these bills. With limited number of bidders, (see Table 8.23) there has been a large gap in the amount supplied and amount demanded of these bills. There is also a limited participation in these markets as the yield is very low. Banks have been the major buyers with more than 90 percent share although this figure declines in recent years.

Table 8.23: Banks and non-bank transactions in the treasury bills auction market (2003/04-2008/09)

Particulars	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09
<i>No of Bidders</i>	293	242	187	168	182	261
<i>Demand (MN Birr)</i>	61,143.0	56,896.0	60,604.0	78,922.0	58,889.0	46,767.0

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Supply (MN Birr)	51,645.0	41,263.0	47,794.0	65,315.0	47,717.0	27,840.0
Sold	51,632.0	41,065.0	47,793.0	65,315.0	47,716.0	27,840.0
Banks	92.8	92.0	93.5	89.7	75.1	9.6
Non-Banks	7.2	8.0	7.0	10.3	25.0	90.4
Yield	0.534	0.095	0.036	0.053	0.678	0.743
Gap	9,511.0	15,831.0	12,811.0	13,607.0	11,173.0	18,927.0

Source: NBE Annual Reports

Mainly due to the limited number of banks and excess liquidity, inter-bank money market is underdeveloped and only very limited transactions (23 from its introduction in 1998) were conducted in this market with a value of close to 260 million with interest rate of 7 to 11 percent (NBE, 2009). Saving deposits, which earn negative real returns for the depositor due to mounting inflation, is the only short-term financial market available for ordinary people in the country where deposit insurance is absent. The fact that deposit, measured by its ratio to GDP, is increasing (see Figure 8.2) irrespective of the negative real interest rate is due mainly to absence of other alternative financial markets (i.e. financial investments).

Capital markets such as organized stock markets are currently lacking in Ethiopia. The country started capital market in 1959. A few banks and non-bank companies began by selling shares to the public, mainly banks, and shareholders traded shares among themselves in an unregulated market. However, later in the sixties, the central bank of the country brought together participants and created some formal rules to govern the issuing and trading of securities. This process was curtailed during the Derg regime. A resurrection of the development of capital market was made in early 1990s when the current government announced a free market environment including financial markets. As a result, bank and non-bank companies have been issuing

securities. However, two points are in order here. First, this market is thin and very limited in the amount traded, in the number of traders participating and in the diversity of products. It is only the banking sector, which dominated this market for the last two decades. It is only recently that few private companies have sold shares to individuals to raise funds for investment in the manufacturing industries. Even in this case, there are no secondary markets and further financial derivatives. Second, there are no stringent legal, policy and regulatory frameworks and strong and capable institutions to support the existing limited markets. Regarding bond markets, there has been only a very few government bond markets which are limited to the public sector to cover government expenditures. Long-term bond markets are sometimes issued by the government without auction on various occasions to cover some government expenditures. The last auction for government bonds was held in November, 2000 in which commercial banks purchased bonds with a two-year maturity.

In addition to the above thin and insufficient financial markets, there are important products (instruments) which are completely absent in the Ethiopian financial system. These include certificate of deposit, repurchase agreements, commercial papers, mortgage loans, consumer lending and other financial derivatives such as futures and options. Certificate of deposit is a financial product commonly offered to consumers by banks, thrift institutions, and credit unions. Certificate of deposits are similar to savings accounts in that they are insured and thus virtually risk-free as they are money in the bank. However, they are different from savings accounts in that they have a specific, fixed term (often three months, six months, or one to five years), and, usually, a fixed interest rate. It is intended that these deposits are held until maturity, at which time the money may be withdrawn together with the accrued interest.

Repurchase agreements are short-term loans arranged by selling securities to an investor with an agreement to repurchase them at a fixed price on a fixed date. A re-purchase agreement (repo) is the sale of securities with an agreement for the seller to buy back the securities at a later date. The repurchase price will be greater than the original sale price, the difference effectively representing interest, sometimes called the repo rate. The party who originally buys the securities effectively acts as a lender. The original seller is effectively acting as a borrower, using their security as collateral for a secured cash loan at a fixed rate of interest.

Commercial paper is a promissory note with a fixed maturity of 1 to 270 days. It is a money-market security issued by large banks and corporations to mobilize financial resource to meet short term debt obligations. It is only backed by an issuing bank or corporation's promise to pay the face amount on the maturity date specified on the note. Since it is not backed by collateral, only firms with excellent credit ratings from a recognized rating agency will be able to sell their commercial paper at a reasonable price. Commercial paper is usually sold at a discount from face value, and carries higher interest repayment rates than bonds. Typically, the longer the maturity on a note, the higher the interest rate the issuing institution must pay. Interest rates fluctuate with market conditions, but are lower than banks' rates.

Consumer lending refers to making a wide range of loans to consumers by banks for consumable items such as a car, manufactured home, and home equity loan. A mortgage loan, different from consumer lending, is a loan secured by real property through the use of a mortgage note (a promissory note associated with a specified mortgage loan) which evidences the existence of the loan and its encumbrance through the granting

of a mortgage which secures the loan. For instance, a homebuyer or builder can obtain financing (a loan) to purchase or secure against the property from a financial institution, such as a bank. Features of mortgage loans such as the size of the loan, maturity of the loan, interest rate, method of paying off the loan, and other characteristics can vary considerably.

There are other instruments whereby people make financial transactions. Financial derivatives are financial instruments whose value is based on an underlying asset. For example, futures contracts, also called futures, are a derivative. Futures are contracts to buy or sell commodities. The commodities are assets that have real value, while the futures derive their value from the commodities they are based on. Another type of derivative is the stock option. Stock options give an investor the right to buy or sell shares of a certain stock at a specific price. The value of the option rises and falls with the price of the stock, the underlying asset. There are many other, more complex derivatives. Some are based on international currencies, others on changes in interest rates, and still others on combinations of several underlying assets.

Derivatives also allow investors to hedge when buying a certain asset. Hedging is a way to protect against a loss in value of an investment. For example, if the holder of a certain stock is concerned that the stock price will fall, he or she might purchase a type of option whose value will increase if price of the stock falls. The option thus provides a kind of insurance against loss for the stockholder. However, when used for speculative investment, that is buying investments in hopes of selling them quickly for a profit, they hold a great deal of risk. Derivatives have a great amount of leverage. In other words, an investor can control assets worth far more than the original investment. As a result, an investor can also gain profits or incur losses larger than the investment.

A question arises as to what explains the limited and in most cases complete absence of financial markets in Ethiopia. Some studies have attempted to examine empirically why these markets, and in particular capital markets, develop in some countries but not in others (e.g. see Litan et al, 2003). Although decisive conclusions are not yet possible, several research outcomes suggest that domestic policies are important. High and variable inflation, which undermines the demand for local currency can be an important factor. Another factor is narrowness of the local investor base. However, the most important factor, in particular in developing countries, is presence of a system of controls, by governments, that constrains the price mechanism in the allocation of funds. We enlist hereunder the most important prerequisites for financial market development in Ethiopia.

- i. Market determined prices: Market discipline and encouraging market determined prices is important. In particular ensuring share or bond prices are market-determined is the first step in fostering a sound financial system. In practice, however, governments have often sought to hold the interest rate on government bonds and treasury bills below the market clearing level.*
- ii. Legal and regulatory framework: Developing a robust financial market system involves addressing the legal, regulatory, and supervisory framework with a view to ensuring transparency and predictability for investors. An important component of the legal and regulatory framework has to do with the provision of adequate information. Therefore, the legal framework should define the requirements for information disclosure. There is also a need to develop a regulatory environment that fosters market development and enables the enforcement of sound supervisory practices. In particular, market regulation should ensure that secondary*

- market trading is conducted in a transparent and efficient manner. This includes, for example, prohibiting improper trading practices, such as insider trading, fraud, and market manipulation.*
- iii. Investor base: Widening the investor and issuer base is another step towards the development of financial markets in Ethiopia. Non-residents, households, and institutional investors can be big potential for providing the necessary financial resources. Having a wide base of investors for government and private securities promotes market stability and an efficient allocation of resources. A wide investor base minimizes the risk of one group of investors being able to manipulate the market.*
 - iv. Macro-economic stability: Macro-economic and financial stability are essential for developing a well functioning financial market. It helps establish creditor's reputation as an issuer of debts. In particular, developing a record of accomplishments for macro-economic stability in a country enhances the reputation and credibility of the government's willingness and ability to repay creditors. A stable macro-economic environment particularly a credible monetary policy along with supporting fiscal management and financial system stability have been found to be the prerequisites for a country's financial development. These include ensuring low and stable inflation, maintaining optimal fiscal deficits, reducing public debt, and controlling the current account deficits.*
 - v. Establish relevant institutions: Formal, institutional and professional dealers and brokers are essential for the smoothly working of the financial system, in particular for capital markets. Another important institution is investment bank, which assists transactions in the initial sale of securities in the primary markets. It does this by underwriting securities by guarantying a price for a corporation's securities and then sells them to the public.*

In conclusion, a robust and sound financial system is unquestionably important for a smoothly working of an economy. However, the existing financial services and institutions in Ethiopia are limited in the sense that participation is low, many financial products are not developed and some are inactive. There are also important but non-existent financial instruments such as certificate of deposit, repurchase agreement, commercial paper, consumer lending and mortgage loans and other financial derivatives such as futures and options. Studies show that in most countries, domestic policies are crucial for viable financial development. Government's positive attitude towards the market, efficient and enabling legal, policy, regulatory and supervisory framework, high investor base and macro-economic stability are prerequisites to foster a sound financial system in Ethiopia.

Chapter 9

Money and Output in Ethiopia

9.1. Developments in the theory and practice

The relationship between money and income has been the subject of a great deal of research (Auerbach & Rutner, 1975) since the 1950's as economic growth and stability have been the main macro-economic goals of many countries. Hence, the argument on the long-run relationship between them has caused the birth of various schools of thought in economics. For example, proponents of monetary economists such as Milton Friedman believe that money supply cannot be systematically used to affect the long-run level of output and unemployment. Money can affect real variables only in the short-run due to "expectation rigidities" and it can fundamentally derive inflation in the long-run. Consequently, this group of economists has the view that money supply should be kept within an acceptable bandwidth so that the levels of inflation can be controlled. They have constructed their interpretation on the quantity theory of money⁵⁶.

However, a number of other prominent economists have criticized the monetarists' position. For example, Keynesians argue that increase in money supply leads to a decrease in the velocity of circulation and that real income can increase (WAMU, 2009). According to the theory, when there are unused resources in an economy, changes in spending are more likely to impact employment and output rather than prices. Many economists have

⁵⁶ Major assumptions include velocity and output are constant in the short-term; quantity of money is determined exogenously; and that the economy is in equilibrium and at full employment.

subsequently conceded to the Keynesians ideas and arguments. Although they argued that money can affect economic activity, they attached a due importance to fiscal policy. They believe that fiscal actions can have a more direct effect on economic activity, whereas monetary actions can have only an indirect effect via interest rate.

Other economists have also provided a theoretical support on the important role of money. According to endogenous growth models, development occurs only when an entrepreneur makes an innovation—a new technique, product, or way of organizing things—and shifts production coefficients or the rules of the game. The growth models predict that money plays an important role in this process by creating capacity for innovators to obtain resources for research and development. Specifically, as Taylor (2004) put it, money supply is required to allow entrepreneurs obtain resources to innovate, thereby letting money to affect output in the long-run. Lucas (2003) also showed cases in which money can affect real economic activities. He believes that missing markets and nominal rigidities can make changes in money into something other than mere unit (nominal) changes. Missing markets and rigidities are prevalent in developing countries such as Ethiopia potentially preventing nominal variables from responding efficiently to nominal shocks, raising the possibility that a monetary policy shock in some way can bring real impact.

As is the case from the theoretical point of view, there has been a huge disagreement on the relationship between money and output in the empirical front. According to Albatel (n.d), while some researchers question the role of money in explaining output behavior and suggest that it has no significant impact on deviating real output from its potential, others challenge the argument and stress the importance of money and financial intermediaries in pooling funds and lubricating economic activity. The empirical support to the

position that money has no real effect on the economy comes mostly from developed countries where there is mature financial system. Rigidities are less and the speed of adjustments is fast in such countries transforming any monetary shock into prices.

King (2002) and Haug & Dewald (2010) found results supporting the money neutrality proposition. King (2002) showed that money is principally inflationary in England as evidenced by the absence of a long-run relationship between money and output growth. Haug & Dewald (2010) used band-pass filters on major industrial countries to extract cycles to examine the role of monetary aggregates. They found that money growth leads to inflation contemporaneously, but does not affect real output growth, in the longer run. Similar results are obtained by Christiano and Fitzgerald (2003) and Fitzgerald (1999).

The empirical literature is not always skeptical on the role of money in affecting the volume of production. Some works found results that support the position that money affects economic growth. Ogunmuyiwa and Ekone (2010) found that money supply exerts considerable influence on economic activity in both developed and developing economies. According to the authors, low level of money stock is responsible for the fundamental failure of many African countries to attain growth and development. Other studies which found a similar positive impact of money on growth include Mansor (2005) and Owoye and Onafowora (2007).

Despite the developments in the theory and practice in the literature, the relationship between money and output in Ethiopia won the interest of policy makers and researchers only recently when new evidence on their relationship emerged since 2004. Prior to 2004, the country had been controlling the stock

of money supply and the economy expanded only moderately. However, money supply and output grew significantly over the years 2004-2010. This chapter of the report hence aims at investigating the impact of money supply on economic growth in Ethiopia dwelling mostly on the recent relationship.

9.2. Monetary policy objectives and instruments in Ethiopia

The monetary policy objectives of the National Bank of Ethiopia (NBE) include maintaining price and exchange rate stability, supporting sustainable economic growth, and increasing external reserves. The principal monetary policy objective of NBE has been maintaining price stability. Accordingly, the monetary policy in the country has been characterized by inflation-targeting notably following an explicitly defined single digit inflation level. To achieve the inflation target, money supply was strictly controlled under tight monetary policy regime. Reserve requirement, base money and credit cap are the available monetary instruments due to the underdeveloped nature of the financial sector limiting the monetary authority's freedom in the economy. The interest rate has also been frequently changed recently no matter how effective it was.

With regard to the Birr exchange rate stability, after decades of fixed exchange rate regime, the country resorted to a managed floating one since 1992. Since then, NBE had envisaged to keep the exchange rate of Birr close to the equilibrium rate which itself is not explicitly defined. Accordingly, the exchange rate of Birr to US Dollar had shown gradual depreciation in nominal terms. However, the rate becomes significantly managed when foreign currency is scarcer and the central bank starts rationing. Following the scarcity of foreign currency, the urge to increase competitiveness, and the pressure by

international financial institutions, the Birr was subsequently devalued and the exchange rate fluctuated significantly recently.

In addition, the bank has increasing external reserves and assuring output growth as other policy objectives. Although the external reserve was stable on around 2.1 months of imports for longer periods (vis-a-vis the objective of 3-months of imports), the past few years evidenced depleting external reserve reaching as low as 1.6 and 1.7 months of imports in 2007/08 and 2008/09, respectively. However, the recent devaluation and support from IMF, among others, improved the international reserve to 2.1 months of imports (IMF, 2010) although it is still well below the target. On the other hand, by lubricating the economy, and availing investible finance, the sector contributed to the 8% average growth of the economy over the years from 1993 to 2010 and 11.3% growth for 2004-2010.

9.3. Developments in money and output in Ethiopia

9.3.1. Past development

The relationship between money and output has not been the point of concern in Ethiopia for long for a couple of reasons. First, the larger portion of the economy is rather non-monetized. Second, output and growth have largely been dictated by natural factors such as rainfall. Good rain, and not policy instruments, has been key in affecting output and growth. Moreover, following the structural adjustment program of the early 1990's, any surge in money supply was viewed to simultaneously trigger inflation. Hence, the country has been following stringent monetary policy with money supply having no significant surge.

Moreover, inflation had not been a threat in Ethiopia. In spite of the poorly developed monetary policy instruments, the country was able to maintain single digit inflation. During the Derg regime, the monetary overhang did not translate into inflation due to direct price control and the ceiling on investment capital. While inflation in Ethiopia had to do with the supply side, most importantly agricultural production, monetary and fiscal prudence had also contributed to the low inflation rate for the significant period of the EPRDF regime.

Output also grew only modestly during the corresponding periods. More specifically, the economy grew by 2.8% and 4.8% between the years 1976-1991 and 1992-2003, respectively. While extended civil war and economic mismanagement might have contributed to the poor economic performance during the former period, strict control on money supply might be among the factors for the slow output growth in the latter years.

9.3.2. Recent episodes in money supply and output growth in Ethiopia

NBE tends to follow expansionary monetary policy since recently. Accordingly, narrow and broad money supply surged by 18.1% and 19.5%, respectively, over the years 2004-2010. This can be compared with corresponding growth of 9.5% and 12.5% percent, respectively, over the period from 1993-2003. The recent development implies that there is a clear and significant shift from stringent to expansionary monetary policy. Accounting the growth of money supply to its components is also relevant. Of the components of money supply, domestic credit grew by 21.0% during 2004-2009 as compared to 1996-2003 (which was 9.6%) showing a significant expansion in the latter years with a possible important role the recent monetary expansion played on output.

Similarly, net foreign assets (NFAs) with positive impact on money supply grew by 10.6% in the latter period vis-à-vis 11.3% in the earlier years. Other items net grew by the same rate as NFAs over the two periods, respectively, with its depressing effect on money supply.

With regard to economic growth, 2004 emerged as a start of new growth history in Ethiopia. Since then, the economy recorded one of astonishing growth performance, growing on average by 11.3%, after decade of moderate growth of 5.7% over 1993-2003. Although any growth is welcome, especially during the short-run, the nature and composition of the growth is crucial for sustainability and macro-economic stability reasons. As can be observed, Ethiopia's astonishing recent growth performance largely comes from the service sector (51.7% of the growth, itself growing by 15.0% over 2005-2009). The industry and agricultural sectors constitute 11.5% and 36.9% of the total growth during the same period. This poses concerns on its sustainability as the service sector augments demand in the face of sluggish supply response. One clear implication of such demand driven growth on macro-economic stability is inflation.

Accordingly, over the last few years, the Ethiopian economy has experienced a remarkable episode of macro-economic instability and inflation engulfed the economy. For example, for the period from 2004-2009, the inflation rate averaged 16.6% (as high as 21.6% between 2006 and 2009). The historic high and double digit inflation shows that, recently, the stabilization objective of NBE is missed. It seems that growth has become the pioneer policy objective at the expense of stability.

Apart from monetary expansion, various other factors have also been quoted to trigger the recent high inflation rate in Ethiopia. The international

environment has also been disruptive during the past few years. The 2007-2009 food crisis, financial crisis and oil price shocks are supposed to subject the economy to external shocks. Frequent devaluation of exchange rate of the Birr is also believed to have contributed significantly to domestic inflation. Inflation expectation and inflation inertia have been included as additional predictors of Ethiopia's recent inflation.

Recognizing the role of monetary expansion on the heating inflation, NBE introduced various restrictive policies to control monetary expansion. In theory, NBE could use alternative monetary policy instruments such as manipulating base money, the interest rate and reserve requirement; imposing credit ceilings, and/or through open market operations such as through sale and purchase of Treasury Bills.

Most of these policy instruments are not effective in Ethiopia. Interest rate, for example, is not an effective monetary policy instrument as it is generally negative in real terms and it is unlikely that economic agents consider it for making economic decisions. Economic agents put their money in banks just for security reasons. To induce people to respond to changes in interest rates, the interest rate must be positive (Pesek and Saving, 1968 cited in Ghatak, 1994). Moreover, profits from investments are usually so attractive (behavior of immature sectors) that investors may not take lending rates into account when making business decisions. The underdeveloped nature of the financial sector and lack of advanced financial products limited the range in which financial instruments play.

In reality, the money supply in Ethiopia has been controlled mainly by reserve requirement or directly affecting the monetary base to achieve the intended goal of low inflation. Recently credit ceiling on commercial banks is used as

additional monetary tool. Accordingly, the bank changed the reserve requirement twice in July 2007 and March 2008 increasing the ratio from 5% to 10% and from 10% to 15%, respectively. In a view to promote saving, the bank also increased the minimum saving rate by 1 percentage points to 4% in July 2007, and recently to 5%. These measures have not brought about the intended results in terms of reducing inflation to a single digit. Hence, NBE was forced to introduce the credit cap early in 2009. As a result, money grew by 3.0 percentage point lower in 2009 as compared to 2008 before it bounces back by 4.4 percentage points in 2010 after the central bank eased the contraction in February 2010. It is worth noticing that the credit cap on banks is still active despite the continuing growth in money supply questioning the success of government's effort to slow down money creation. It can also be noticed that the share of the private sector from banks' outstanding credit declined by 7.8 percentage points from 81.9% in 2000-2007 to 74.1% during 2008-2010⁵⁷. This implies that the credit cap was actually on loans to the private sector. The balance is taken up by interbank lending.

Table 9.1: Trends in money growth, real GDP growth and inflation

Particulars	Money growth (M2)	Real GDP growth	Inflation
1996-2003*	9.7 (74.7)	4.1 (185.9)	1.3 (245.2)
2004-2010	19.5 (92.2)	11.3 (9.8)	16.6 (727.9)

Source: Own computation based on MoFED and NBE

- * Values in brackets are standard deviations showing within period volatility of growth rates

⁵⁷ Data for 2010 is that of quarter ended December 2009.

9.3.3. The relation between money, output and inflation

To have a clear picture on how money supply, output growth and inflation relate to each other over recent years, we used a business cycle dating procedure on the macro-economic variables. This procedure enables us to identify periods of relatively expansionary and contractionary monetary policy and compare these regimes of monetary policy with trends in output growth and inflation. Later, this procedure will be supported by findings from a more rigorous robust estimation technique.

Preliminary analysis

Money and output: A preliminary analysis to see how money and output were related over the past four decades is presented by studying changes in correlations. As correlations between contemporary values provide no information on the causation, we further examine the correlations between lagged and lead money growth on the one hand and output growth on the other, following Duczynsk (n.d.). Such exercise can shed light on whether money growth precedes output.

Table 9.2 provides some interesting observations. The contemporary correlation coefficient evidenced improved co-movement between money growth and output for sub-sample of recent years. The correlation is both strong and statistically significant. The contemporaneous correlation is, however, silent on the causation issue. Hence, it is instructive to examine the lead and lag impact of money growth. Table 9.2 reveals the existence of feedback relationship between money and output growth for the period after 1992 with positive impact moving from each variable either side. Since the lags of money are more slightly strongly correlated with output than the leads of money, money growth seems to precede output growth in Ethiopia.

Moreover, monetary aggregates are not strongly correlated with output change when we consider the longer periods of 1971-2010 and 1971-2003. A new development seems to emerge during the PASDEP periods of 2005/06-2009/10 and the period of 2003-2010. While the contemporaneous impact is positive and strong, the casual impact is negative moving from money to output.

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Table 9.2: Correlation coefficient (r) between money and output growth

Period	lag			contemporary				lead		
	gm1(-1)	gm2(-1)	moving average		gm1	gm2	gm1(+1)	gm2(+1)	moving average	
			gm1(-2)	gm2(-2)					gm1(+2)	gm2(+2)
1971-2010	0.07	0.17	0.10	0.13	0.10	0.18	-0.13	-0.01	-0.01	0.15
	0.43	1.06	0.59	0.78	0.61	1.15	-0.84	-0.13	-0.03	0.93
1971-2003	-0.03	0.05	0.04	0.04	0.01	0.04	-0.25	-0.24	-0.12	0.01
	-0.14	0.30	0.21	0.20	0.01	0.24	-1.42	-1.11	-0.64	0.02
1992-2010	0.39***	0.43**	0.43**	0.31	0.39***	0.47*	-0.11	0.02	0.35	0.41***
	1.76	1.94	1.95	1.33	1.73	2.17	-0.44	0.10	1.55	1.86
2003-2010	-0.39	-0.64**	-0.6***	-0.49	0.50	0.63**	-0.03	0.29	0.36	0.32
	-1.04	-2.03	-1.82	-1.37	1.39	2.00	-0.08	0.75	0.96	0.83
2005-2010	0.28	0.13	-0.70**	-0.63	0.02	0.16	-0.39	-0.51	-0.09	-0.25
	0.57	0.27	-1.96	-1.63	0.05	0.32	-0.86	-1.19	-0.19	-0.53

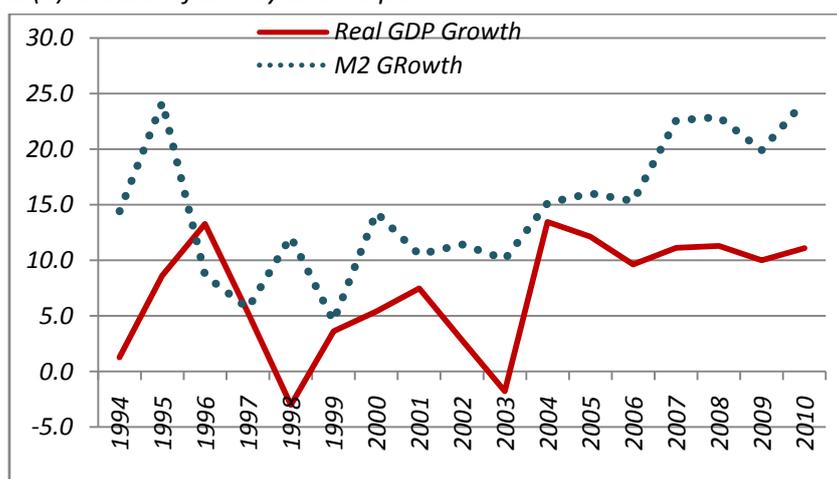
Source: Own computation based on MoFED and NBE

Figures in brackets are t-statistics (*, ** and *** shows significance at 1%, 5% and 10%)

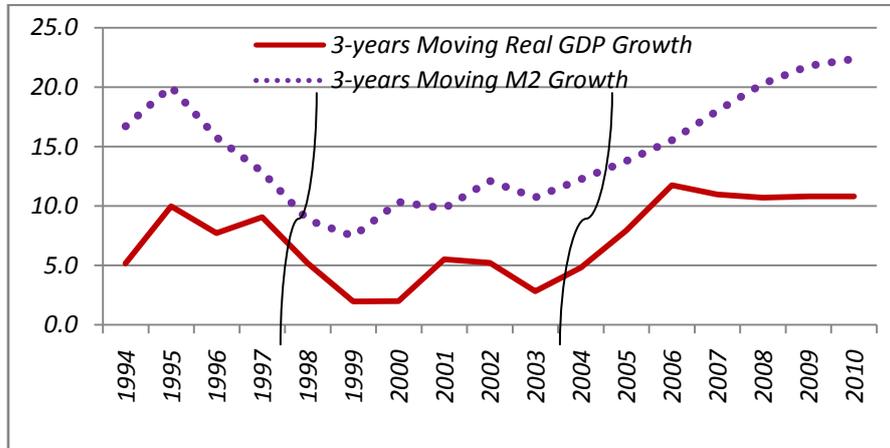
The correlation analysis based on Table 9.2 can be supported by a graphical presentation. As Figure 9.1 Panel (a) shows, money and output growth follow clearly each other with a lag impact moving from money supply to output during the years 1996-2003. Later on, money and output tend to grow together during the years after 2004 (Figure 9.1, Panel (a)). On the other hand, the 3-years moving average presentation in Panel (b) shows a more smooth relationship. However, one can identify three short money-output regimes in Ethiopia for the period since 1993. During the earlier years, monetary contraction is noticed which was accompanied by declining 3-years moving average economic growth. This regime was followed by a stable 3-years moving average money growth which was associated with stable real output growth. The third regime followed since 2004. During this period, money supply grew by 19.5% associated with a robust real output growth of 11.3% (Figure 9.1, Panel (b)).

Figure 9.1: Money and output growth (%)

Panel (a) Growth of money and output



Panel (b) 3-years moving average growth of money and output



Source: Own computation based on MoFED and NBE

If monetary expansion can affect economic performance in Ethiopia, the transmission is through the more direct mechanism of bank lending channel with aggregate demand pressures which could also have a more immediate impact on prices. The indirect transmission mechanism through interest rates is not the effective way in this country. Theoretically, an increase in money supply would bring about a fall in interest rates, all things remaining equal, increasing investment with delayed impact on prices. However, this relationship is non-existent in Ethiopia as the interest rate is not adjusting in response to market forces. The implication, hence, is that to have a non-inflationary impact of money on the economy, the interest rate should emerge as an important pricing mechanism for resource allocation.

Also, the role of money growth on output is governed by the developments in the components of money supply. Domestic credit contributed significantly to the growth in money supply. It contributed to more than 100% of the growth

in money supply in the face of more than 25% expansion in other items net which has a negative impact on broad money (M2). This huge increase in domestic credit might have contributed to the observed output growth. As Tahir (1996) put it, relaxing financial constraints is a key for growth. On the other hand, net foreign asset (NFA) contributes for more than 20% of liquidity growth during the recent periods. See Table 9.3.

Table 9.3: Money growth contribution by components

Year	1971-1991	1992-2009	2000-2009	2003-2009
<i>Shares in growth</i>				
Domestic credit	200.0	105.4	102.7	107.3
Net foreign asset ⁵⁸	-61.6	32.0	23.9	25.4
Other items net	-37.2	-37.4	-26.6	-32.7

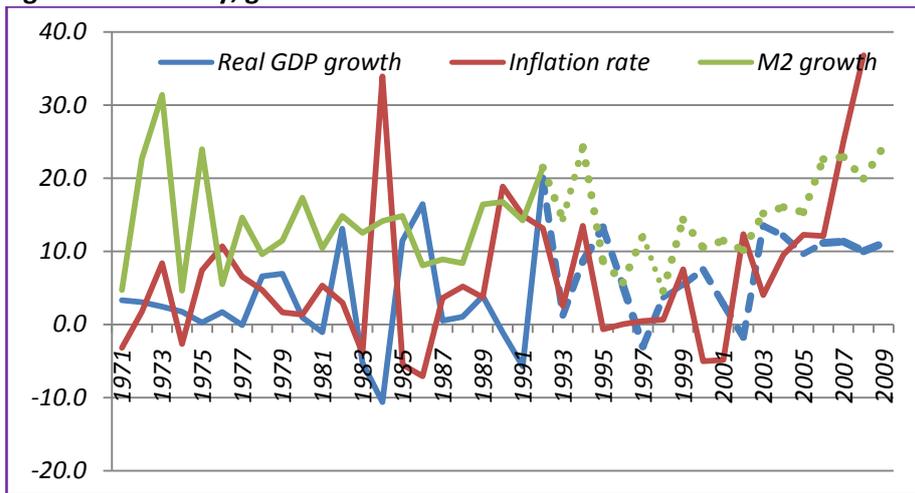
Source: Own computation based on NBE

Money and inflation: Interesting relationships between money and inflation can be viewed by dividing the observations into two major periods: before early 1990's and since early 1990's. During the years prior to early 1990's, inflation had not been a monetary phenomenon in Ethiopia. There was no observed systematic relationship between money and inflation. Hence, money could not be used to predict inflation in Ethiopia during this period. See Figure 9.2. Rather, inflation was significantly and inversely associated with real economic activity. Nevertheless, in the latter period, money, inflation and output tend to move together with a more stable relationship between money and output (see the dotted lines).

⁵⁸ NFA during the 1971-1991 was negative implying that the country had net-outflow of foreign currency possibly affecting the economy negatively.

Moreover, it can be evident that money increased by higher rate than inflation during most of the sample period. This has an important implication on the neutrality or non-neutrality of money. The growth of money supply more than the price level indicates that money can actually affect economic activity as implied by the quantity theory of money identity. However, the years since 2008 show that inflation is by far exceeding growth in money supply implying that any monetary expansion may be inflationary.

Figure 9.2: Money, growth and inflation



Source: Own computation based on MoFED and NBE

As is the case between money and output, we undertook correlations analysis between inflation and money supply. The correlation test shows a positive relationship. However, the correlation was not so strong prior to 1992 confirming the position that inflation has not been a monetary phenomenon in Ethiopia during those years. On the other hand, it became stronger and statistically significant for the years 1992-2010, although the contemporaneous impact was becoming moderate recently, specifically in

terms of statistical significance. The strong contemporaneous correlations between money and inflation for the period 1971-2010 and 1971-2003 shown in Table 9.4 reveals that money growth contains long-run information about inflationary pressure in Ethiopia. On the other hand, the large and statistically strong lagged correlation coefficients for the recent years suggest that causality moves from money to prices. The result also signifies a bi-directional causality between money growth and inflation for the period 1992-2010, with strong causality in the direction from money to price.

Since money supply will continue growing alarmingly (at least the existing trend will continue) due to the planned huge government investment, inflation is expected to persist in the medium-term. The net effect of expansionary monetary policy on output depends on how significant the direct effect of money is on output in relation to inflation and how inflation and output are related. The relative impact of inflation on output in the short and long-run will have to be examined before one can conclude on the net impact of monetary expansion on growth.

Table 9.4: Correlation coefficient (r) between money and inflation

Period	lag				contemporary		lead			
	gm1(-1)	gm2(-1)	moving average		gm1	gm2	gm1(+1)	gm2(+1)	moving average	
			gm1(-2)	gm2(-2)					gm1(+2)	gm2(+2)
1971-2010	0.23	0.21	0.21	0.19	0.31**	0.44*	0.10	0.19	0.18	0.19
	1.44	1.33	1.33	1.19	2.05	3.02	0.65	1.18	1.12	1.22
1971-2003	0.07	-0.01	0.13	0.05	0.22	0.34*	0.03	0.04	0.13	0.09
	0.42	-0.07	0.78	0.29	1.39	2.25	0.15	0.25	0.83	0.55
1992-2010	0.52*	0.44**	0.48*	0.44**	0.70*	0.67*	0.36	0.46*	0.29	0.46*
	2.50	2.02	2.26	2.04	4.00	3.68	1.61	2.16	1.23	2.13
2003-2010	0.74	0.80	0.38	0.37	0.49	0.46	0.01	0.15	-0.13	0.06
	2.67	3.22	1.00	0.98	1.39	1.27	0.01	0.36	-0.32	0.16
2005-2010	0.65***	0.74*	0.22	0.09	0.53	0.44	-0.35	-0.20	-0.96*	-0.84*
	1.70	2.18	0.44	0.18	1.24	0.98	-0.74	-0.40	-6.99	-3.12

Source: Own computation based on NBE

Figures in brackets are t-statistics (*, ** and *** shows significance at 1%, 5% and 10%)

Robust estimation results:

The preliminary relationship observed between money and output in the preceding sub-section is supported by results of the robust four-variable vector error correction (VEC) model presented in the background paper “Money and Output in Ethiopia”. Following the VEC estimation procedure, we examine the relationship between output, money, price and exchange rate. For the purpose of observing the change in economic fundamentals since 2004, we run two models: one running from 1971-2003 and the other running from 1971-2010. We estimate two models for each of the time periods using narrow money (M1) and broad money (M2) as alternative monetary aggregates. Such exercise generates interesting short-run and long-run observations.

Long-run relationship: The estimation based on the 1971-2003 period showed a significant and positive relationship between aggregate money balances and output. More specifically, the coefficients on the narrow money and broad money supply variables indicate that the long-run elasticity of real output to money supply is 0.269, indicating that money supply is inferior in affecting real economic activity in Ethiopia vis-a-vis other variables. When we use the period through 2010, the long-run significance of money evaporates.

On the other hand, inflation turns out to be an important explanatory variable for long-run output with a positive sign when the period through 2010 is considered. The price variables do not pass the long-run exclusion test under the models of 1971-2003 period data showing that the variable is actually irrelevant in explaining long-run output during the same period.

Real appreciation of local currency (increase in the real effective exchange rate) tends to depress output in the long-run as per the 1971-2003, while the variable becomes less important for the period through 2010. Under the

framework of the 1971-2003, the appreciation of local currency can, in the long-run, deteriorate the country's export competitiveness by discouraging exports. Exports being one component of national accounts, output can negatively be affected. Our examination based on the data through 2010, however, showed that exchange rate is becoming less important in explaining output variation from its long-run trend.

In addition to the cointegrated long-run relationship, the adjustment coefficients (error correction terms) contain important information on the long-run relationship between money and output. For the estimation period 1971-2003, the error correction terms of the output equations are negative implying that the independent variables including money supply exert a temporary and adjusting effect on output with a tendency that output will restore back to the long-run level⁵⁹. The size of the adjustment coefficient ranges from 0.112 to 0.698 with consistent result for both the M1 and M2 models. Likewise, output equation under the period through 2010 faced a -0.407 to -0.476 adjustment coefficient signifying convergence to the long-run trend in about 2.2 years after a shock from the lagged right-hand variables.

Furthermore, the existence of cointegration implies the existence of long-run Granger causality at least in one direction. The long-run causality can be evaluated by testing if the adjustment coefficient (α_i) is zero. The result based on the period 1971-2003 shows the existence of feedback or bidirectional long-run causality between output and money and output and exchange rate⁶⁰. This is true under both M1 and M2 models of the period

⁵⁹ According to Roselee, Fazilah & Sonal (2009), the coefficient of the error terms indicate the backward (if negative) or forward movement (if positive) towards equilibrium following a shock to the model over the respective period of time.

⁶⁰ It also tells us that the variables included in the model are not weakly exogenous.

1971-2003. The error correction terms for the period through 2010 show similar bi-direction causal relationship between output and exchange rate. However, there is no long-run causation running from price to output in any of the equations for this period.

Short-run relationship: The short-run relationship between money and output is examined using VEC based Granger causality test, impulse response function and variance decomposition. Given the framework, the formal short-run VEC based Granger causality test for the period through 2003, the VEC based Granger causality test confirmed lack of strong short-run causality that runs from variables included to output. Also, the result found no indirect short-run causality moving from money to output through price.

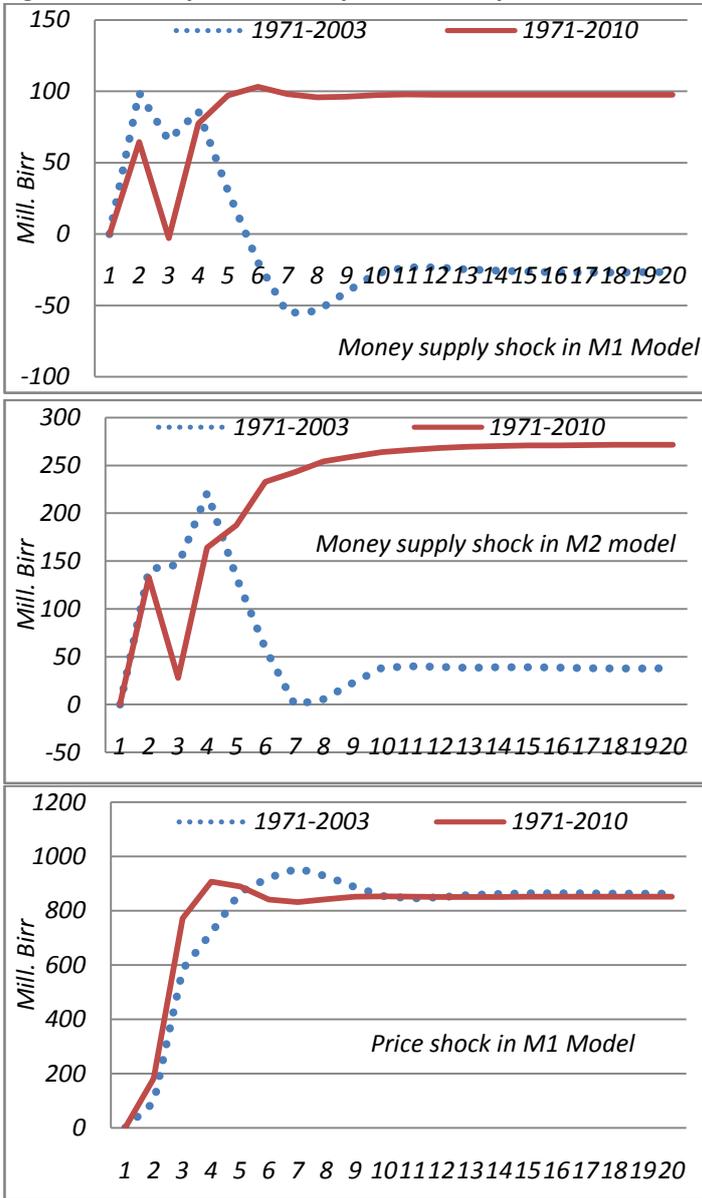
On the other hand, for the estimation period through 2010, output is strongly caused by price under both M1 and M2 models. Similar to the estimation through 2003, money and exchange rate do not directly cause output for the year 1971-2010 as stipulated by the VAR based Granger causality analysis.

Another way of analyzing the short-run impact of money on output is through impulse response function. The VEC based impulse response function shows that monetary shocks have only very temporary effect on output in Ethiopia for the period through 2003. A one percent positive shock in money supply increases output by about Birr 100 million – 200 million (or 0.07 to 0.15% of the 2010 real GDP) before its effect cooled down to just above Birr 40 million in the medium run. For the period through 2010, monetary shocks tend to have a more positive and smooth effect on output specifically after the third-year, increasing output by about Birr 100 million-250 million in the medium run.

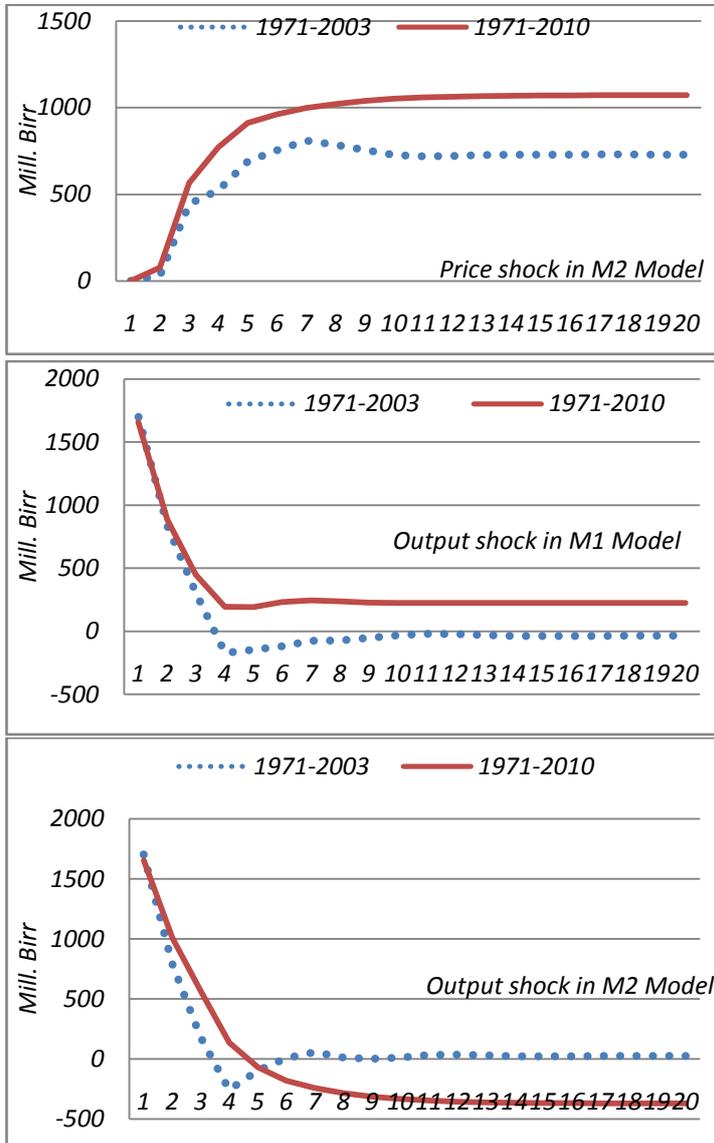
On the other hand, the larger response of real GDP comes from innovations of domestic prices. A one percent shock in the domestic price level can cause output to increase by about Birr 700-800 million (0.5% to 0.6% of real GDP) over 2003. A similar innovation can increase output by about Birr 800-1,100 million (0.6-0.7% of real GDP) when we consider the period 1971-2010 showing that output responds better to prices when we consider the recent years.

Meanwhile, the relative strength of output response to a one percent own shock has conflicting result over the two periods considered under the two models. While the response of output to own shock quickly moves to negative for the M1 Model through 2003, a similar trend is observed for the M2 Model for the period 1971-2010. Generally, output responds significantly to own shock only immediately after a shock before the lagged impact to that one time shock vanishes in three years time. On the other hand, a one percent appreciation of the Birr tends to result in negative output effect and it tends to affect the economy disproportionately for the period 1971-2010. This implies that the economy is becoming increasingly responsive to innovations in the exchange rate since recently.

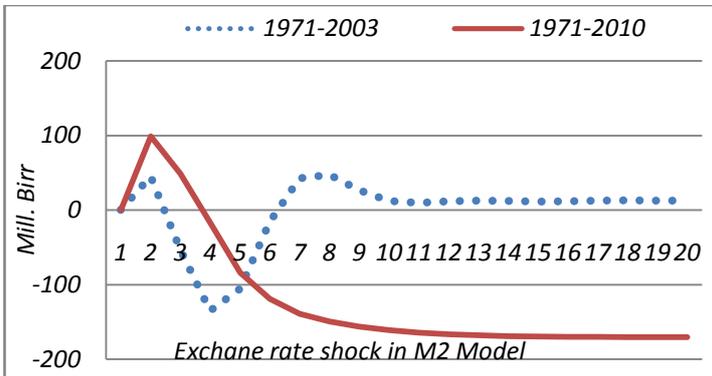
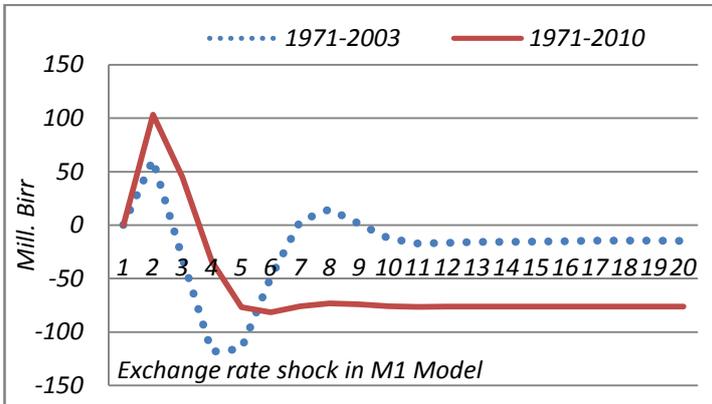
Figure 9.3: Response of output to a one percent shock



(cont'd) Figure 9.3: Response of output to a one percent shock



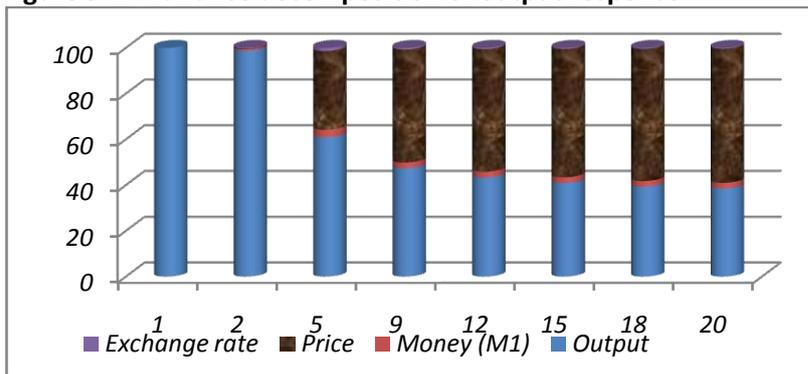
(cont'd) Figure 9.3: Response of output to a one percent shock



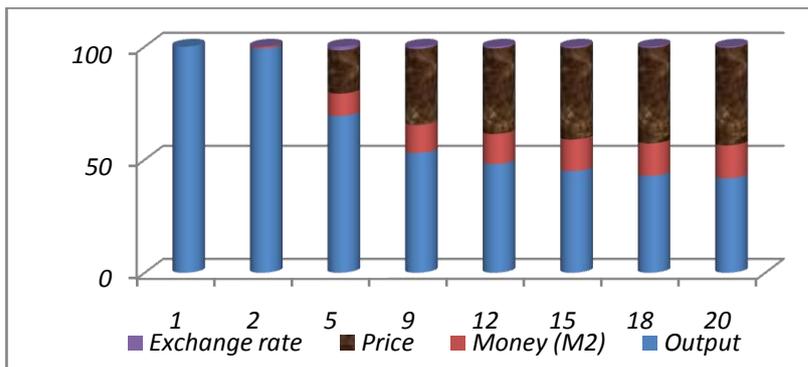
Variance decomposition is another way of depicting the system dynamics. The variance decomposition result shows that money is not adequately useful in predicting output in Ethiopia. However, the role of money in predicting the variance in output and the forgone output from monetary contraction increased when the period 1971-2010 is considered. Money explains close to 10% of the variance in output during this period as compared to only less than 3% for the period through 2003 (Figure 9.4). On the other hand, the result shows that variance of output is caused mostly by its own shock in the

immediate years. Over time, its own causation diminishes significantly (even more quickly when we consider the period 1971-2010) while the contribution of domestic prices gradually rises and overtakes own shock. Innovations to prices explain about 43-79% of the variance in real output. The relative importance of prices increased when a narrower version of money (M1) is considered and the period through 2010 is examined. The contribution of shocks to real exchange rate on the variance or volatility of output is generally low.

Figure 9.4: Variance decomposition of output response

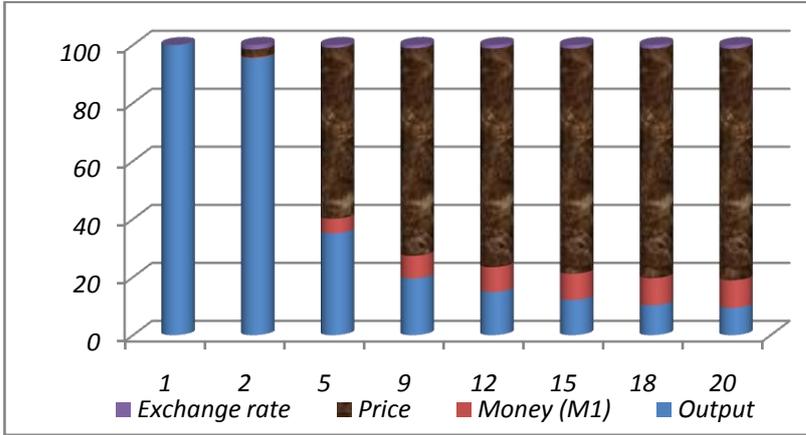


M1 Model for 1971-2003

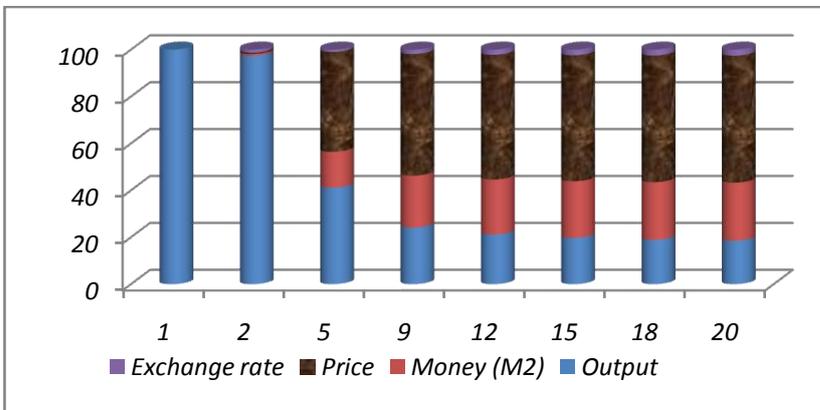


M2 Model for 1971-2003

MONEY AND OUTPUT IN ETHIOPIA



M1 Model for 1971-2010



M2 Model for 1971-2010

9.3.4. Forward looking

Following the economic reform of mid-1992, the country had adopted a tight monetary policy. Associated with that, the country was able to maintain low inflation level. On the other hand, output grew only modestly. Since 2004 money supply, economic growth and inflation showed a regime shift. The expansionary monetary stance followed was accompanied by output growth, on the one hand, and inflationary tendency on the other. Owing to the shift, macro-economists had tough time trying to understand what really was going on in the economy.

Building on recent economy-wide developments, both growth and stability stand as crucial elements in the current Ethiopian context. While growth is a means to assure improved living standard and alleviate poverty, stability is also important for sustainable growth (i.e. economic agents do not welcome economic uncertainty). These goals of growth and stability pose a two-pronged challenge. First, policies that can stabilize the economy may be different from policies that can maximize growth in the short-run. Second, those efforts to stabilize the economy may cost the country in economic growth. The country's ability to stabilize the economy while generating growth depends on the availability of as many effective policy instruments as required. It, hence, demands commitment to reform and develop the financial sector. However, Bradford, Jr. (2005) pointed out that if it is not possible to achieve both objectives of macro-economic stability and economic growth, policies should prioritize the real economy goals of growth, employment, and poverty reduction.

Moreover, short-run inflation due to expansionary monetary and fiscal policies in an effort to trigger growth by augmenting demand can be tolerated as long

as it is followed by quick supply side responses. In a sense, money has to be productive. Any effort by the monetary authority to avoid the long-run cost of inflation will have to be supported by the fiscal authority through effective coordination. Otherwise, fiscal policy can affect the effectiveness of the monetary policy through its effect on demand in the short-run and also through modifying the conditions for economic growth and price stability in the long-run.

9.4. Issues of further liberalizing the financial sector in Ethiopia and its implication

9.4.1. Role of finance for growth in Ethiopia

In the preceding sections, we have examined the long-run and short-run relationship between money and growth in Ethiopia. Despite the positive and long-run relationship between money and output established, the financial sector in Ethiopia is yet to develop to its mature state. The sector has witnessed some degree of liberalization following the structural adjustment program in the early 1990's in line with the context of reform of the entire economy. Among other reasons, the rationale of liberalizing the financial sector was to improve the financial infrastructure so as to allow the economy work smoothly. The financial sector reform program was largely limited to liberalizing the bank and insurance sectors thereby allowing the private sector to operate. Accordingly, the number of actors in the financial sector increased gradually and reached 13 private banks and 13 private insurance companies. Few other banks are in the process of entering the market. Private and government micro-finance institutions started operating in the country formally in a well structured and institutionalized form after the NBE issued

proclamation No. 40/96 in 1996. Since then, micro-financing evolved fairly, and currently there are about 30 MFIs serving close to 3% of the population.

Although the financial sector is in the process of evolution, public-owned financial institutions are still dominating. For example, The Commercial Bank of Ethiopia (CBE) is by far the biggest one. The bank alone accounts for about 33.9% of the total bank branches and 41.5% of total outstanding credit in 2008/09. Besides, the number of banks and bank branches remained small making the population to bank branch ratio one of the largest even as compared to neighboring countries⁶¹. The population to bank branch ratio is as high as 127,000 in Ethiopia as compared to 31,000 in Kenya, 70, 000 in Uganda, and 79, 210 in Sudan (Daily Ethiopia, 2009; and Kasekende & Opondo, 2003). The figure is much larger as compared to an average of 7,000 per bank branch in the Common Market for East and Southern Africa (COMESA) countries (Kasekende & Opondo, 2003).

Hence, despite the partial reform of the financial sector in the mid 1990's, the sector is faced with stagnation and lacked dynamism forced by extended pace of liberalization. Its dynamism is largely limited by policy owing to the weak regulatory capacity of the central bank, among other factors. The human resource limitations in the sector and aspiration failure due to lack of outstanding players in the area contributed their share to the backward and shallow financial products. New financial institutions tend to replicate what the existing institutions are doing without bringing the clients new and innovative financial services, products and approaches.

⁶¹ The number of bank branches in Ethiopia is 596, Kenya 904, in Sudan 522, and in Uganda 359, according to reports from Central Banks of respective countries.

The Growth and Transformation Program (GTP) plans to spur the Ethiopian economy by close to 15% in real terms each year in the best case scenario case for the coming five years up to 2014/15 (MoFED, 2010). Realizing such overambitious development program requires availing long-term credit vis-à-vis short-term credit. However, existing financial institutions (largely banks) are restricted to trade credit and other more profitable short-term activities than providing medium and long-term credit. There are various factors behind the short-term nature of credits in Ethiopia. The short-term nature of deposits; lack of adequate information; lack of dynamic banking staff; and lack of marketable liquid assets to be used as collateral are among the main ones.

The nature of deposits partly governs the type of credit banks can extend to economic agents. According to the IMF-IFS database of 2008, the ratio of demand to time deposits is 78.9% in Ethiopia as compared to 59.4% in neighboring Sudan, and 70.0% in Uganda over the period from 2001-2008. Such short-term deposits are not suitable for financing long-term investments on a large scale because of maturity mismatches. High transaction cost due to lack of information is another factor for the lack of long-term investment finance in Ethiopia in the absence of other financial instruments. Lack of well-trained and skillful credit assessors is another factor behind the credit constraint. Lack of collateral also acted as a constraint for access to credit for business firms. Small firms are usually less capital intensive, and thus have limited collateral and very restricted access to finance limiting their capacity to aid the increasing economic roles of the government.

Genrally, the domestic banking system in Ethiopia plays a sub-optimal role in facilitating development finance to promote economic activity. Most of the available financial resources in the banks is allocated to finance trade-related businesses. In spite of the dominance of the agricultural sector so far, the

sector received limited credit access from the banking system. The industry and infrastructure sectors are also deprived of the required level of finance. See Table 9.5.

Table 9.5: The sectoral distribution of banking credit in Ethiopia

Sector	2000	2005	2008
Agriculture	8.2	9.3	13.3
Industry	13.6	23.6	19.1
Services	78.2	67.1	67.6
o/w trade	36.2	33.4	42.1

Source: National Bank of Ethiopia

All cases for liberalization steam from the relaxation and particular advantages that the financial sector liberalization provides. The advantages include efficient allocation of resources, saving mobilization, attracting foreign direct investment, and availing affordable financial resources to citizens. With mature financial system, the market will assure optimal use of resources across alternative possibilities. Under such systems, the interest rate will stand as an essential tool for resource allocation. Moreover, as the financial sector is becoming open, adequate saving instruments can diffuse to the economy allowing for higher amount of national saving. With a repressed and controlled financial system, these benefits cannot be assured. Reforming the financial sector in Ethiopia should, therefore, be a priority at this point in time as the country is executing the resource demanding GTP without having fundamental change on the lubricating sector.

The resource intensive GTP assumed a target of 17% gross domestic saving rate at national level. However, the subsistent and unmonetized nature of the economy may challenge the target. It is expected that a large proportion of

savings in rural Ethiopia is in kind and this requires penetration of financial institutions with innovative financial products into the rural economy.

9.4.2. Areas of financial liberalization in Ethiopia

Improving access to finance and benefiting from the economic role of the financial sector requires further reforming the sector. Areas of reform include allowing foreign financial institution (banks) operate in the country probability on a selected basis, relaxing tight capital controls, introducing short-term money markets and introducing capital markets (primary and secondary share markets). One of the arguments of the government for the absence of capital market and restriction to foreign investment in the sector was the limited ability of NBE to control and supervise. Two decades have passed since then. The central bank, hence, has to take steps to mature itself so as to be able to support financial institutions to introduce innovative and missing financial products.

Opening up the banking sector

Banks are the main financial institutions in Ethiopia with the main role of bringing financial capital from savers to borrowers. This process can be smoothly carried out if the banking sector transforms itself and performs well. Although the sector has experienced major reform in the early 1990's, banks in Ethiopia are providing only basic financial products and lack financial innovation. There is no actually visible product differentiation among them and banks are not providing alternative financial services from each other. Competition is actually non-existent. Resided by over 80 million people, the number of banks in Ethiopia is just 17 vis-a-vis about 46 in Kenya; 30 in Sudan;

and 22 in Uganda. The high capital requirement even as compared to SSA countries might limit entry⁶².

Moreover, the sector is facing a slow pace of liberalization as foreign banks are not yet allowed to operate in domestic markets. This makes Ethiopia one of the very few countries in Africa, if not the only non-fragile state where foreign banks are not allowed to operate. Foreign banks are believed to help in deepening investible domestic and foreign capital to support economic growth. It is expected that, consumers of financial products will also benefit from alternative, innovative and affordable financial products due to the expected competition.

Another benefit from introducing foreign banks can be an increasing flow of foreign direct investment (FDI) by multinational corporations from home countries of the financial institutions as the corporations could be affiliated with them in one way or the other. The increased flow of FDI could support the development process apart from the bridging role of the banks between savers and investors.

Capital account liberalization

One of the restrictions imposed on the Ethiopian financial sector is the capital account. So far, capital inflows to Ethiopia are mainly in the form of FDI while non-FDI related transactions are highly restricted. As the economy is integrating itself to the world economy, it will have to liberalize its capital account. The World Trade Organization (WTO) may also pressurize the country to open its capital account. Although it was relaxed a little since 2006, there is still a limit to foreign currency accounts in domestic banks by non-resident

⁶² The data reveals that the paid-up capital requirement in Ethiopia is Birr 75 million (USD 7.5 million) as compared to USD 1.7 million in Uganda,

Ethiopians and non-resident Ethiopian origin (maximum of USD 50,000.00, according to Directive No. FXD/31/2006). Moreover, Ethiopian residents are not allowed to hold foreign currency of above USD 1,000.00. No one is also allowed to operate a forex bureau unless and otherwise affiliated with a bank.

Liberalizing the repressed capital account can help increase access to international finance; allowing domestic economic agents to choose where and how to borrow, invest and exchange assets; improve in resource allocation through improved competition for financial resources; and the increased availability of resources to support investment, and to finance trade, and other significant economic entities (Johnston, Darbar, & Echeverria, 1997). However, capital account liberalization is such a complex issue that it also involves risks suggesting some prerequisites. There should also be a special treatment to long-term financial inflows vis-à-vis short-term financial inflows which are more risky.

Development of the money market

The financial sector in developing countries such as Ethiopia usually starts with building the money market. This market deals with short-term money capital. According to Ghatak (1994), the functions of mature money market can be summarized as i) effectively allocating saving into investment; ii) promoting liquidity and safety of financial assets thereby encouraging saving and investment; iii) promoting financial mobility; and iv) increasing the chance for successful implementation of the monetary policies of the central bank.

However, the money market in Ethiopia is underdeveloped, dominated largely by T-bills market. The yield from T-bills is significantly negative in real terms. The interbank money market is one feature of the Ethiopian money market. The market was introduced in 1998 under directive number IBM/02/1998.

Nevertheless, influenced by excess liquidity in the banks and collateral requirements, there were only 23 interbank money market transactions worth Birr 259.2 million since its introduction (NBE, 2009). The lending interest rate ranges from 7% to 11%. At national level, financial saving is so low and saving, if at all, is in the form of land, livestock and gold holding rather than the holding of financial assets. Coupled with the poor saving habit and capacity of the society, underdeveloped money markets create huge disparity between the demand for and supply of loanable funds. Mobilizing the required amount of domestic resources will be challenging for the success of the GTP unless the money market evolved significantly.

Development of capital markets

Capital markets are different from money markets in that they are markets for securities (debt or equity) where economic agents can raise long-term capital. They can be classified as primary and secondary capital markets. Most economies in Africa have already achieved some level of capital markets as important sources of long-term capital. Nevertheless, banks remain by far the main financial institutions in Ethiopia. The capital markets should develop to complement the banking system. That would help the country raise the required capital through sale of government bonds and private shares to adequately finance the resource demanding development projects. Bond markets can also supply enterprises with long-term capital reducing their dependence on short-term bank credit.

Recently, the share market has emerged as a booming primary capital market in Ethiopia as many new and expanding businesses have identified selling of shares as important source of investable resources. As a result, the share market is booming in its own right without appropriate regulatory and policy backups from the regulatory body (NBE). It is commendable that the

regulatory body should draw appropriate rules, regulations, and directives for the market to function in a coordinated and regulated fashion. Unless there are proper regulatory and legal environments, investors will not feel secure and this new way of raising financial capital may be terminated. The government should also view the emergence of the share market as an indication that formal capital markets are on demand in the country. Preparatory works in this regard should be started right now as the country is competing not only with the rest of the world, but also with time. If secondary capital markets develop side by side, that would help create markets for newly issued securities thereby making them very liquid.

Pension reforms

Ethiopia has only one pension system serving the public employees who accounts only 2.8% (CSA, 2007) of the employed labor force leaving the rest of the labor force for provident funds and/or personal savings. While provident funds have stood as an important source of investment capital and security for most private and non-governmental organizations employees, they can at the same time be supported by voluntary pension fund schemes without replacing the provident funds. Provident funds have a peculiar advantage to those covered as compared to pension funds. While provident funds can be invested in personal development and/or asset building, pension funds are not. However, introducing a voluntary private pension fund program should also be viewed as one way of supporting the development of domestic institutional investors (and domestic sources of long-term finance) over and above supporting the labor force during their old age. Withstanding the importance of pension funds for resource mobilization and security of the labor force, there are recently moves to cover the uncovered segment of the society with pension fund services. It should, however, be noted that the success of pension funds requires experienced pension managers who can invest the funds in a

profitable manner. It also requires developed money and capital markets where the fund can be invested in.

9.4.3. Prerequisites of financial liberalization

Despite the long-term advantages of financial liberalization, it can also pose various challenges. Domestic operators can lose their profits if they are not somehow ready enough to confront the new competition. Foreign financial institutions are in a better position than local institutions in terms of efficiency and product quality over competing the local ones. There may also arise other economy wide risks associated with financial liberalization. For example, opening up of the capital account may bring risks related to large capital inflows or outflows which can complicate macro-economic management of the economy. Opening up the sector may also bring a loss of control for policy making.

Preventing and reducing some of the risks associated with opening up the financial sector requires certain considerations: sequencing of reforms, and liberalizing wisely in phases.

Sequencing of reforms: Lessons from the recent global financial crisis imply that there must be a right sequencing of reforms. Liberalization in the nation should be conducted only gradually. For example, according to Walter (2002), a conventional sequence of financial liberalization suggests that fiscal (tax) reforms and price stabilization should precede basic financial liberalization (such as interest rate repression). Lan (2000) stressed that such domestic financial sector reforms should be followed by opening the financial sector (capital account liberalization). Capital account liberalization should also be preceded by exchange rate reforms. Hence, as the Ethiopian financial system

is dominated by the banking sector, the utmost priority should be having a healthy banking system. Once there are strong domestic financial institutions, the pressure associated with opening up of the sector (capital account liberalization) can ultimately be reduced. Strong domestic financial institutions can insulate the dangers of opening the financial sector.

Phasing financial liberalization: Financial liberalization may be executed in phases. For example, foreign banks may be allowed to open branches of limited capacity both in terms of capital and other resources. They can also be made to operate in joint venture with local financial institutions under proper regulation. This still implies strong regulatory capacity.

Apart from the above considerations, relaxing some of the costs of financial liberalization requires certain prerequisites. The requirements of financial liberalization can be spelled out under the following groups.

Strengthening prudential supervision, regulation and the rule of law

While there is extensive literature on the role of financial liberalization, there are also some studies (such as by Ribakova (2005), Özdemir & Erbil (2008)) noting the importance of institutional building and prudential supervision. According to Claessens et al (2010) and Walter (2002), regulatory shortcomings have clearly been key contributing factors to financial crisis observed in the world.

Building market discipline through timely disclosure of information from every institution as much as possible is important in reducing such risks. For example, Lan (2000) asserts that there is a need to establish a legal framework that covers important elements such as transparency, disclosure, and business bankruptcy. Legal institutions should also be capacitated to

implement the existing legal frameworks. A related requirement for effective financial sector liberalization is related to risk management capacity of both the supervisory agency and individual institutions.

Moreover, Barth et al (2002) found that regulatory and supervisory practices that empower and create incentives to actors in the private-sector in monitoring banks are important in promoting bank performance and stability.

Financial literacy

Financial literacy involves literacy on financial issues by regulators, producers and consumers of financial services. It is largely the case that financial sector regulators in Ethiopia do not have the desired knowledge and expertise on how foreign financial institutions are operating. The complex and wide range of financial services they provide makes it difficult. Unless the regulatory body develops this expertise, opening the sector can ultimately make it out of control.

Financial literacy is equally important for local financial service providers so that they can cure the sector from any global financial crises that may arise. The knowledge may be on how to use, invest, price and market financial products. For example, the introduction of security markets requires exercising huge security transactions. Hence, the financial sector should be able to produce as much expertise, who can handle sophisticated financial transactions, as possible. This knowledge can help the local financial institutions compete in the market. See Anantha-Nageswaran (2008).

Likewise, since the majority of the population is not exposed to and aware of advanced financial markets such as security markets, there is also a need to educate the community. This is important for the community to be able to use

and compare between alternative financial assets for productive investment. Financially literate society can create markets for innovative financial products, hence, help expand the sector.

Strong sectoral policies and macro-economic environment

Effective financial liberalization requires a right situation. According to Pill & Pradhan (1997), for example, for financial reforms to succeed, they must be implemented in appropriate macro-economic, financial, and institutional environments. Times of macro-economic instability such as inflationary situations and output volatility are not right moments for liberalization. The liberalization process should also be supported by strong sectoral policies including investment and commercialization.

9.5. Conclusion

After years of slow money and output growth, the country is now experiencing expansionary monetary policy with corresponding surge in economic growth. High inflation also characterizes the recent macro-economic environment in Ethiopia. Likewise, the country is planning to sustain economic growth through the coming five years with huge government investments. Building on the findings of this chapter, and in order to support the growth program, the Ethiopian financial sector should at this point in time consider the following three as their most important functions: i) assuring macro-economic stability, ii) financing the development process, and iii) insuring security through risk minimization.

As the discussion based on the robust estimation showed, stability costs the country in terms of economic growth. On the other hand, the recent expansionary monetary stance seems to contribute significantly to the new

growth regime. Nevertheless, the stability objective is clearly missed as evidenced by the historic high inflation. This calls for policy makers to design and adopt optimal monetary policy that can balance the short-run objective of macro-economic stability and the long-run objective of economic achievements. Such optimal monetary policy should be backed-up by effective demand management through fiscal policies. The financial sector should also foster long-term growth through financing long-term development projects over and above short-term trade financing. The significance of rural economy requires innovative rural financing. The targeted 17% gross domestic saving cannot be met unless rural financing evolved significantly. Achieving such overstretched goal may also call for further reforming the financial sector including introducing foreign banks. On the other hand, a financial sector is not complete without a working insurance sector. Although discussing on the role of insurance is not what this section is intended for, it is worth mentioning that insuring security and minimizing risk is an important way through which the sector can assist the growth process. This is, thus, another area where the financial sector should focus.

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Annexes

Annex 1: Ethiopia: Political Regime and Development Policies: Analysis of ADLI

Kenichi Ohno (GRIPS); June 30, 2009

Background to ADLI

Agricultural Development Led Industrialization (ADLI) is the policy principle adopted by Ethiopia, a low-income country, to promote its national development. The initial idea of ADLI was formulated with the establishment of the Interim Government in the early 1990s, which was subsequently elaborated in stages and put into serious implementation in the early 2000s.

The main motivation behind ADLI is the recognition that Ethiopia is predominantly an agrarian society in which the bulk of the population, about 86 percent, resides in rural areas earning a livelihood from land. However, the policymakers came to realize the limitations of the first phase of implementation of ADLI through SDPRP. By the time the second phase of the program (SDPRP II), more commonly known as A Plan for Accelerated and Sustained Development to End Poverty (PASDEP) 2005/06-2009/10, was prepared there was sufficient recognition of the problems associated with the agricultural development strategy which was exclusively rural centered. The productivity in the agricultural sector did not show significant improvement and output remained volatile because of heavy dependency on the amount and timing of rainfall. During the 2002/03 season, the output of the crop sub-sector contracted by 16.5 percent following the decline of 3.7 percent in 2001/02. It was only in 2003/04 that growth in the agricultural sector and especially the crop sub-sector started to recover significantly. However, from a long-term perspective, the labor productivity of agriculture has been on a declining trend (World Bank, 2007). Although agriculture has shown strong performance in recent years thanks to favourable weather, this does not necessarily reflect a significant structural change in the sector such as crop diversification or productivity improvement. PASDEP 2005/06-2009/10 made important adjustments over SDPRP 2002/03-2004/05 as it broadened the policy

scope from smallholder agriculture to other sectors, especially the industry sector and the urban sector. In what may be called Enhanced ADLI, strong emphasis was placed on growth acceleration which was to be attained through the two main thrusts of commercialization of agriculture and private sector development (PASDEP, Eng. p.46).

Issues in ADLI

The greatest question concerning ADLI is whether the proposed strategy is powerful enough to propel industrialization in Ethiopia to the extent that the policy makers desire. This fundamental question is discussed in the two subsections below.

(1) Can the ADLI Strategy generate accelerated industrialization?

If the ADLI Strategy is interpreted strictly and narrowly as the “strategy to achieve initial industrialization through close input-output linkage between agriculture and industry as the main engine of growth,” it is difficult to find such an example of economic take-off in East Asia. Such cases are probably also very rare in the rest of the world. We do have historical examples in which agriculture grew relatively strongly prior to the period of full-scale industrialization and provided resources for industrialization through taxation and foreign exchange earnings (for example, silk and tea exports in late 19th century Japan, rice and sugar production in Taiwan up to the 1960s, and the rice export tax of Thailand up to the 1980s). There are also cases in which robust agro and fishery exports ameliorated the immiserization of rural communities often associated with globalization (for example, fish and shrimp exports of Southeast Asia).

Let us be more precise. We are not arguing that industrialization based on the Core ADLI linkage is impossible. Depending on the choice of sectors and products, the strategy may work well. In fact, the Ethiopian leather industry which uses domestic animal hides and skins as inputs to produce finished leather and leather products has grown rapidly in recent years with the support of the government and donors, and we expect its growth to continue in the future. What we doubt is not the physical feasibility of Core ADLI but whether that linkage is strong enough to serve as the main engine to pull the entire economy into growth acceleration. In our opinion, it may become too difficult to find a sufficient number of economic locomotives if Ethiopia self-imposes too many restrictions on prospective industries. We would rather advise that the government examine all options

in search for potential industries in its industrialization strategy. The development strategy of Ethiopia, while maintaining Core ADLI at its center, should also encompass sectors and products which do not necessarily fulfill all of the requirements and links that are considered desirable. Industrialization is a hard task for any landlocked latecomer country.

If this is agreeable, the following implementation rules may be added to the ADLI Strategy without re-drafting its key documents⁶³.

(i) The two-track approach: close input-output relationship between agriculture and industry is ideal, but that should not be demanded for each concrete sector or product to be targeted. In principle, the agricultural development strategy and the industrialization strategy should be separable. Agricultural and rural development strategies may be formulated without direct linkage with industry, and the policy menu for industrialization can include strategies without strong agricultural impact such as FDI absorption, the use of imported inputs for manufacturing, and the creation of industrial zones and clusters in the vicinity of Addis Ababa.

(ii) Flexible application of policy requirements: as noted above, the implementation of ADLI calls for export orientation, maximum use of domestic resources, and labor-intensiveness. These conditions should be applied flexibly and case by case.

(iii) Resource mobilization based on selectivity and concentration: considering the limited financial and human resources, the strategy to simultaneously improve a large number of sectors and products should be avoided. The selection of targets must be backed by appropriate information and analysis. For selected industries, sufficient financial and human resources should be provided, international cooperation should be mobilized, and management and technical assistance should be made available for a reasonable amount of time. The leather industry is already promoted in this way, but the approach should be applied to other sectors.

⁶³ These recommendations were made by the GRIPS researchers at the first JICA-GRIPS policy dialogue with the Ethiopian Government organized in Addis Ababa on June 2, 2009. However, as reported in section 6 below, it was discovered that the movement toward broadening the policy scope for industrialization was already underway in the Ethiopian Government and the donor community, and that its general direction was roughly in line with our proposal.

(2) Feasibility of productivity breakthrough by small farmers

Whether smallholder subsistence farmers, who are the dominant majority as well as the chosen coalition partner of the developmental state, can be commercialized and improve productivity and income is the most fundamental question to ADLI. From the experiences of East Asia, we must conclude that such a strategy is extremely difficult to realize in the short run.

In Northern and Central Highlands where the majority of the Ethiopians reside, small farmers are scattered across vast mountainous terrains with often very difficult road access. They live on what they produce with little external sale or purchase. Agriculture basically depends on the whims of rainfall, the use of fertilizer is inadequate, and the arable plot of each family is very small which is being further subdivided under population pressure. In Southeastern Dry Land, pastoralists lead nomadic lives. The productivity breakthrough from such initial conditions is a very long-term endeavor. For these reasons, it becomes necessary to review the practicability of maintaining the development strategy that centers on the transformation of small farmers into independent commercialized farmers with expected productivity improvement. The present Ethiopian agricultural strategy features both smallholder agriculture as future suppliers of commercialized crops and industrial materials as well as capitalist agriculture with sufficient technology and large investments (for example, flowers). Even if productivity gains may be made, linking small farmers immediately and directly to urban or international markets or the industrial sector may be unrealistic.

**Annex 2: Ethiopia's Agriculture Sector Policy and Investment Framework:
Ten Year Road Map (2010-2020) (MOARD, 2010, pp 17- 19)****Current Sources of Agricultural Growth**

Understanding the sources of agricultural growth helps diagnose what policies have been effective in achieving growth and what policy changes may be needed for the future. In the current decade (2000/01–2008/09), area increased at less than half the rate of the previous decade. That suggests that the processes that were bringing additional land into cultivation, including recovery of area taken out in earlier decades were running down. That further suggests that rates of area increase would continue to decline. The potential offsetting impact of increased irrigated area is discussed in a later section.

The striking change is that yields per hectare increased at a rapid rate. That is an important finding that demands explanation. A logical explanation would be increased use of modern inputs – seed and fertilizer. However, that seems not to be the case. Data shows that fertilizer use has grown at somewhat less than 4% per year from 1995 to the pre-drought year 2000/01, and at a little over 5% annual rate since then. Applying a 5% increment to the then current level of consumption of about 400,000 tons, or around 200,000 tons of nutrients, provides an annual increment of 10,000 tons of nutrients. Applying a normal response coefficient of 10 tons of cereal output for 1 ton of nutrients provides a contribution to growth of only 100,000 tons per year. There is some evidence that the actual response has been lower – e.g. the CSA data comparing yields using fertilizer and fields not using. Using the more typical 10 to 1 response adds about 1% to output and explains only 28% of the 3.5% growth rate attributable to yield increase. And, that assumes that all the fertilizer was used on cereals, and it assumes a response coefficient which is probably much higher than the one actually obtained by Ethiopian smallholders. Using a response coefficient of 7 to 1 – still profitable but barely so, however is probably closer to Ethiopian smallholder conditions reality, a rate of yield increase of 0.5 percentage points per year is explained, leaving 3.0 percentage points unexplained. The year 2000/01, the first year of the period was probably a fairly normal year for weather. For the next two years production declined substantially, due to very poor weather and consequent large scale reduction in crop yields. It is conservative but

reasonable to measure the growth rate from the normal year at the beginning to the end of the period. That period gives a 7% average annual growth rate. The growth rate was of course far more rapid for the next few years. Indeed it averaged 12% for the three years 2004/05 – 2007/08, and then gradually dropped off to 7% in the year 2007/8 to 2008/09. If modern inputs do not provide much of the explanation for output growth, what does explain it? The yield increase only shows up in the most recent decade – and mostly in the last half of the decade. The increased yield was coterminous with greatly expanded extension services. It is important to note that by international standards, the increase in extension effort was huge. Not only it brought a high density of extension agents, but also put an emphasis on increased labor input into agriculture, means of utilizing labor productively and changed rural attitudes towards increasing agricultural production. According to IFPRI surveys these services were well regarded by farmers and, given the very low level of yields it is not surprising if improvements in husbandry encouraged by the extension agents provided increased yields. This experience is similar to that of India in the period of stability that followed independence and the large increase in expenditure on community development, including extension agents.

However, the important point from this analysis is that both sources of growth, increased land area and improvements in traditional husbandry cannot be expected to continue indefinitely. They give an immediate upward shift in production and create conditions for other changes to be more productive but they are not in themselves the basis for sustained growth. If judged by the Indian experience, both may be running out in the near future. This is confirmed by the comparison between yields on farmer's fields with best practices and yields for commercial farmers with yields obtained by all other farmers. The data available in Ethiopia in this respect suggests that several years of yield increase may still be possible with the existing stock of knowledge. However, an important point should be noted. Some of the differences in yields are due to differences in soils and climate; some are due to innate differences in skill among farmers. It is not reasonable to expect all farmers to get the level of yields of the currently highest. Indeed, the scope for closing the yield gap may be quite modest. Given that possibility, it is prudent to expand the research capacity rapidly in order to generate new technologies, i.e. new sources of growth.⁶⁴

⁶⁴ It is tempting to envision the bulk of production increase coming from raising the less productive farmers to the level of the best farmers. In that case new research is not needed. There are two problems with that argument. First and most important, bringing the poorest farmers up to the best is a once and for all process, but poverty reduction and economic transformation require constant growth, that requires lifting the best as well. Second, efforts to close the yield distribution are rarely successful except in a modest way. For example on 40 years of intensive extending effort to New York State the yield distribution did not change

Implications of the Future Role of Inorganic Fertilizer, Seed and Irrigation to Growth

If fertilizer use were to accelerate from its current growth rate of about 5% to 15%⁶⁵, on a base of 500,000 tons (projecting ahead a few years) of material or 250,000 tons of nutrients, that would add 37,500 tons of nutrients which would increase rapidly with compounding of the growth rate. With a normal response coefficient of 10 to 1, that would add 375,000 tons of cereals equivalent output annually. That would add 3.5 percentage points to cereals output growth rate. However, the improvement in seed and in the technical capacity of the extension services should increase the productivity of the base level of fertilizer use. That also increases profitability that in turn accelerates the growth rate. The current base is probably a 7 to 1 response – consistent with moderate profitability which in turn is consistent with the current relatively slow rate of growth of fertilizer use. Increasing the response to the current base of 200,000 tons of nutrients from 7 to 1 to 10 to 1 adds 600,000 tons of output. That is a 5% increase in production. Spread over five years that comes to 1% a year.

If land area expanded at two-thirds the pace of the last ten years (expanding by 2% per year), that would provide a 6.5% growth rate from just these three forces. Of course the land area from traditional sources cannot continue much longer to grow at that rate. However, the GoE plans to double the irrigated area in the next five years. The irrigated area is currently equal to 6% of area. With double the yield of un-irrigated land that would roughly balance the current growth in area. Thus expansion of the irrigated area would gradually take over from the current expansion of the traditional land area.

– production increase see *shifting the whole distribution, led by the best farmers using the latest research results* (K. L. Robinson, Cornell University.)

⁶⁵ What India achieved at a similar stage of development, Mellor et. al. 1968

Annex 3: Livestock and related products production (2007/8 and 2008/9)

Products	Unit	2007/08			2008/09		
		Plan	Achieved	Achieved (%)	Plan	Achieved	Achieved (%)
<i>Meat</i>							
Cattle	(000) Tons	340	--		463	379.59	81.98
sheep	(000) Tons	89	--		121	90.81	75.05
Goats	(000) Tons	82	--		112	80.97	72.29
Local poultry breed	(000) Tons	21	--		95	36.02	37.92
Improved poultry	(000) Tons	66	--		9	1.72	19.11
Camel	(000) Tons	8	--		29	7.29	25.14
Total	(000) Tons	606	531.8	87.76	821	615.56	74.98
<i>Hide and skin</i>							
Skin	In millions	3			4	0.37	9.25
Sheep's hide	In millions	9			10	3.1	31
Goats hide	In millions	9			10	1.78	17.8
Camel skin	In millions	0.15			0.2	0.01	5
Total	In millions	21	5.112	24.34	24.2	5.26	21.74
<i>Eqq production</i>							
Local poultry	(000) Tons	21	--		28	22.97	82.04
Improved poultry	(000) Tons	4.7	--		5.1	5.14	100.8
Total	(000) Tons	25	75.42	301.68	33.1	28.11	84.92
<i>Milk production</i>							
Local dairy	(000) Tons	2466	--		2,825	2,764.80	97.87

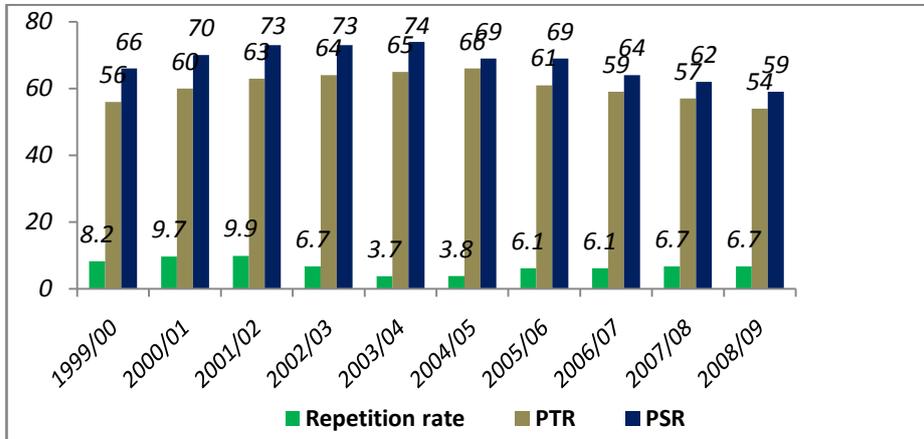
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Annex 3 continued...

<i>Improved dairv</i>	(000) Tons	429	--		435	-	
<i>From Goats</i>	(000) Tons	51	--		90	-	
<i>From Camel</i>	(000) Tons	299	--		404	162.14	40.13
Total	(000) Tons	3,245.00	3471	106.96	3,754.00	2,926.94	77.97
<i>Fish</i>							
<i>Lakes</i>	(000) Tons	14.6			16.8	14.5	86.31
<i>Rivers</i>	(000) Tons	2			2.6	0.2	7.69
<i>SWB and reservoirs</i>	(000) Tons	1.9			2	--	
<i>New Water Bodies</i>	(000) Tons	0.8			1.3	2	153.85
<i>Aquaculture</i>	(000) Tons	0			0.1	-	
Total	(000) Tons	19.3	40.5	209.84	22.8	16.7	73.25
<i>Honey and Bee wax</i>							
<i>Honey</i>							
<i>From modern hives</i>	(000) Tons	31	--		38	2.14	5.63
<i>From transition hives</i>	(000) Tons	25	--		32	0.49	1.53
<i>From traditional hives</i>	(000) Tons	19	--		19	37.02	194.84
Total	(000) Tons	75	42.18	56.24	89	39.65	44.55
Bee wax, total	(000) Tons	4.87	4.07	83.47	5.46	3.77	69.05

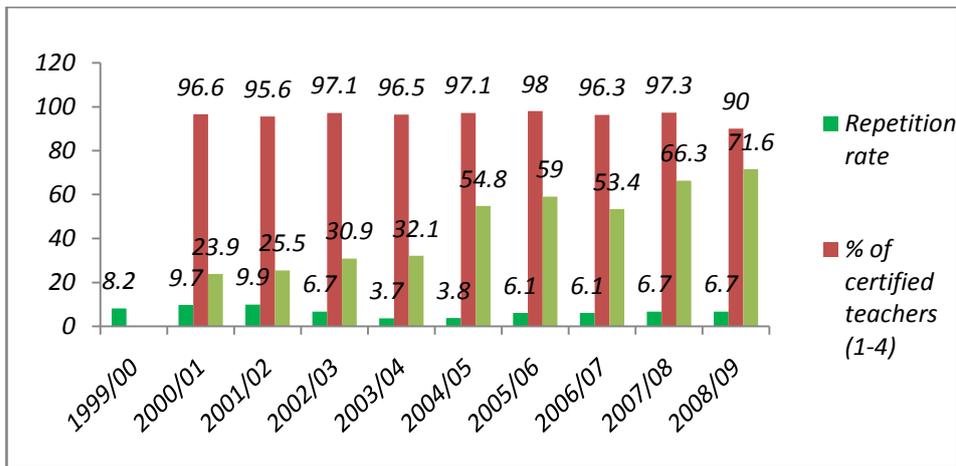
Source: PADEP 2008-9 report based on the CSA data and reports from regions

Annex 4. The association of primary repetition rate to primary school PTR and PSR at national level.



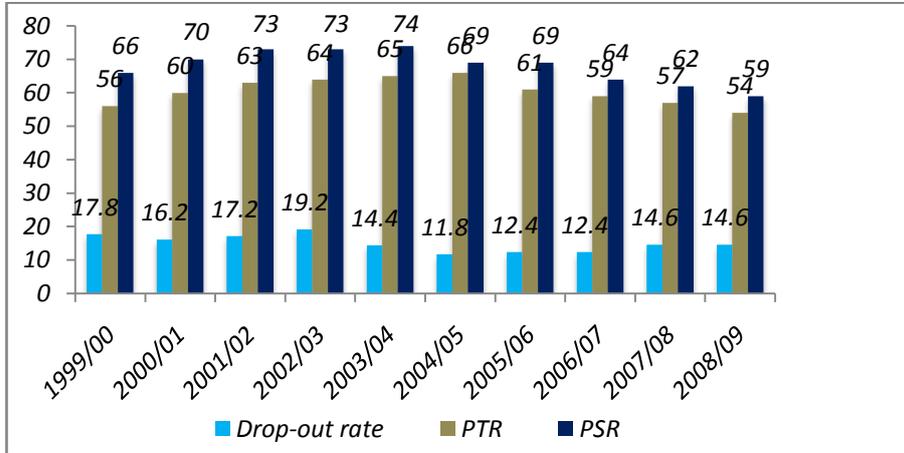
Source: Data from the MoE annual abstracts; and author's calculations

Annex 5. The association of primary school repetition rate to percentage of certified primary teachers.



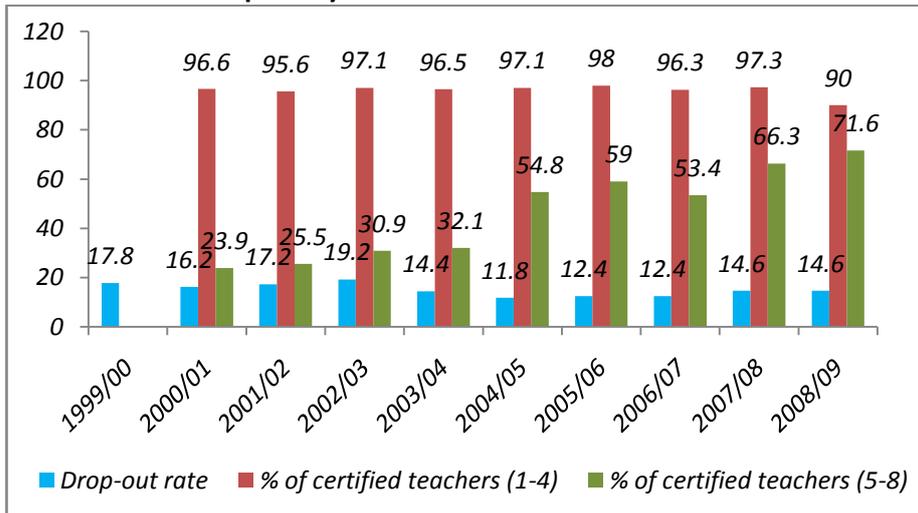
Source: Data from the MoE annual abstracts; and author's calculations

Annex 6: The association of primary drop-out rate to primary school PTR and PSR at national level.



Source: Data from the MoE annual abstracts; and author's calculations

Annex 7: The association of primary school repetition rate to percentage of certified primary teachers.



Source: Data from the MoE annual abstracts; and author's calculations

Annex 8: Performance of the insurance industry - life insurance (in millions of Birr)

	Gross Premium	Net-Premium	Total Asset	Total Capital
2001	19	18	147	20
2002	23	19	164	20
2003	26	22	178	20
2004	29	27	184	20
2005	36	32	201	20
2006	46	40	237	24
2007	62	55	274	24
2008	74	61	340	34
2009	100	83	421	37
2010	115	98	499	37

Source: NBE

Annex 9: Gross premium for life insurance by insurance company (in millions of Birr)

Year	EIC	Awash	Nile	Africa	Nib	Nyala	Unic	E-Life	Total
2001	18	0	0	0	1	-	-	-	19
2002	20	0	1	0	1	-	-	-	23
2003	22	0	1	0	2	-	-	-	26
2004	23	1	2	0	3	-	-	-	29
2005	27	1	3	1	4	-	-	-	36
2006	32	2	3	4	1	4	-	-	46
2007	38	2	4	5	4	8	-	-	62
2008	45	3	7	6	1	4	8	-	74
2009	53	5	9	9	4	11	8	-	100
2010	58	7	11	11	5	13	6	3	115

Source: NBE

Annex 10: Net-premium for life Insurance by insurance company (in millions of birr)

Year	EIC	Awash	Nile	Africa	Nib	Nyala	Unic	E-Life	Total
2001	16	-	-	-	1	-	-	-	18
2002	17	-	1	-	1	-	-	-	19
2003	21	-	-	-	1	-	-	-	22
2004	22	1	2	-	1	-	-	-	27
2005	26	1	2	1	2	-	-	-	32
2006	30	2	2	4	1	1	-	-	40
2007	36	2	4	4	4	4	-	-	55
2008	44	3	4	6	1	1	3	-	61
2009	49	5	5	8	3	9	3	-	83
2010	54	6	7	10	4	13	1	2	98

Source: NBE

Annex 11: Total asset for life Insurance by insurance company (in millions of birr)

Year	EIC	Awash	Nile	Africa	Nib	Nyala	Unic	E-Life	Total
2001	126	4	5	4	7	-	-	-	147
2002	138	5	6	4	10	-	-	-	164
2003	149	5	7	5	11	-	-	-	178
2004	156	6	8	4	10	-	-	-	184
2005	172	7	8	2	12	-	-	-	201
2006	196	8	9	8	5	12	-	-	237
2007	219	11	11	12	6	15	-	-	274
2008	256	14	15	18	11	8	19	-	340
2009	299	19	20	24	15	16	25	4	421
2010	336	25	24	36	17	25	32	5	499

Source: NBE

Annex 12: Total capital for life Insurance by insurance company (in millions of birr)

Year	EIC	Awash	Nile	Africa	Nib	Nyala	Unic	E-Life	Total
2001	4	4	4	4	4				20
2002	4	4	4	4	4				20
2003	4	4	4	4	4				20
2004	4	4	4	4	4				20
2005	4	4	4	4	4				20
2006	4	4	4	4	4	4			24
2007	4	4	4	4	4	4			24
2008	4	4	4	4	10	4	4		34
2009	4	4	4	4	10	4	4	3	37
2010	4	4	4	4	10	4	4	3	37

Source: NBE

Annex 13: Performance of the insurance industry – non-life insurance

year	Gross Premium	Net Premium	Total Asset	Total Capital	Paid up Capital	Profit after tax
2001	450	331	1,011	332	196	68
2002	554	356	1,127	356	204	76
2003	556	386	1,187	386	221	74
2004	568	403	1,189	389	235	38
2005	640	456	1,296	456	244	70
2006	797	552	1,563	544	252	94
2007	972	686	1,694	545	262	100
2008	1,187	840	1,967	591	282	116
2009	1,379	949	2,270	683	337	135
2010	1,825	1,222	2,722	769	366	235

Source: NBE

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Annex 14: Gross premium by insurance company for non-life insurance (in millions of Birr)

	EIC	Awash	Global	Nile	Nice	Africa	Nib	Nyala	Unic	Lion	Oromiya	Total
2001	211	36	9	57	13	44	50	30		-	-	450
2002	296	38	6	61	16	46	51	40		-	-	554
2003	268	38	5	59	17	59	21	47	41		-	556
2004	273	45	6	68	20	47	21	53	36		-	568
2005	302	50	8	78	25	54	33	57	33		-	640
2006	345	68	11	98	30	68	47	73	57	-	-	797
2007	416	87	13	108	35	83	66	83	81	-	-	972
2008	496	100	15	107	41	107	100	96	111	-	13	1,187
2009	584	115	16	119	46	121	132	94	115	34	5	1,379
2010	775	138	19	137	60	176	171	125	126	54	44	1,825

Source: NBE

Annex 15: Net premium by insurance company for non-life insurance (in millions of Birr)

	EIC	Awash	Global	Nile	Nice	Africa	Nib	Nyala	Unic	Lion	Oromiya	Total
2001	142	30	7	48	11	32	36	25		-	-	331
2002	150	30	4	54	13	32	38	34		-	-	356
2003	162	34	4	50	15	32	17	39	34		-	386
2004	159	38	4	60	18	36	17	41	30		-	403
2005	180	44	6	64	22	39	27	49	26		-	456
2006	202	61	8	76	26	46	38	59	35	-	-	552
2007	251	73	9	89	31	56	55	63	59	-	-	686
2008	286	89	11	86	33	82	86	80	78	-	9	840
2009	332	106	12	88	38	91	113	76	65	26	4	949
2010	396	128	15	114	50	129	141	83	93	41	31	1,222

Source: NBE

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Annex 16: Total Asset by insurance company for non-life insurance (in millions of Birr)

	EIC	Awash	Global	Nile	Nice	Africa	Nib	Nyala	Unic	Lion	Oromiya	Total
2001	535	71	17	111	18	87	108	64		-	-	1,011
2002	617	78	16	119	20	95	112	70		-	-	1,127
2003	630	77	15	119	22	105	37	106	76		-	1,187
2004	627	79	15	127	24	102	38	114	63		-	1,189
2005	669	85	23	152	26	109	62	109	61		-	1,296
2006	773	106	30	181	32	158	73	124	87	-	-	1,563
2007	780	134	37	192	40	175	99	127	112	-	-	1,694
2008	870	153	44	186	44	230	126	143	147	-	23	1,967
2009	971	182	54	195	51	238	193	151	173	32	30	2,270
2010	1,092	227	60	222	58	295	248	202	207	55	56	2,722

Source: NBE

Annex 17: Total capital by insurance company for non-life insurance (in millions of Birr)

	EIC	Awash	Global	Nile	Nice	Africa	Nib	Nyala	Unic	Lion	Oromiya	Total
2001	140	30	10	47	7	33	37	29		-	-	332
2002	144	31	10	50	7	43	40	30		-	-	356
2003	155	30	10	52	8	41	16	41	33		-	386
2004	166	25	10	50	9	37	16	50	27		-	389
2005	215	28	12	54	7	38	25	52	25		-	456
2006	262	36	17	51	10	47	28	52	41		-	544
2007	246	42	19	49	13	44	35	53	45		-	545
2008	271	46	20	44	15	46	30	52	56		11	591
2009	297	49	23	48	16	50	46	65	54	8	26	683
2010	266	71	23	82	20	56	64	80	73	13	21	769

Source: NBE

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Annex 18: Paid-up-capital by insurance company for non-life insurance (in millions of Birr)

	EIC	Awash	Global	Nile	Nice	Africa	Nib	Nyala	Unic	Lion	Oromiya	Total
2001	57	22	8	33	6	21	25	24		-	-	196
2002	57	24	9	33	6	25	25	25		-	-	204
2003	57	24	9	34	6	26	14	25	26		-	221
2004	57	26	9	36	7	26	20	28	27		-	235
2005	57	26	11	36	8	26	24	30	27		-	244
2006	57	26	15	36	9	26	26	31	27	-	-	252
2007	57	29	17	36	9	26	29	31	28	-	-	262
2008	57	31	18	40	11	26	20	31	30	-	17	282
2009	57	34	20	40	13	26	33	31	40	18	26	337
20010	57	40	20	41	14	26	47	31	43	19	28	366

Source: NBE

Annex 19: Profit after tax by insurance company for non-life insurance (in millions of Birr)

	EIC	Awash	Global	Nile	Nice	Africa	Nib	Nyala	Unic	Lion	Oromiya	Total
2001	35	6	1	8	-2	8	9	3		-	-	68
2002	39	4	1	10	0	8	10	3		-	-	76
2003	40	4	0	8	1	6	2	7	4		-	74
2004	39	-4	0	2	1	1	-4	6	-4		-	38
2005	49	4	1	6	-1	0	6	7	-1		-	70
2006	47	5	1	6	2	12	3	10	7	-	-	94
2007	54	8	1	4	3	4	7	10	10	-	-	100
2008	64	10	0	-3	2	9	12	8	21	-	-6	116
2009	71	7	2	4	2	11	16	18	8	-3	-2	135
2010	101	17	4	31	8	12	21	23	21	4	-7	235

Source: NBE

Annex 20: Basic prudential performance indicators

No.	Indicators	Frequency	Key Users**	Purpose	Tolerance Range*
1.0	Operational Performance Indicators				
1.1	Portfolio at Risk	Monthly	B/MGT/Brch	Indicates the level of default risk	< 15%
1.2	Repayment Rate	Ditto	Ditto	Shows rate of loan repayment	> 95%
1.3	Delinquent Rate	Monthly	Mgt/Brch/FW	Indicates the level of delinquency of Loans	< 5%
1.4	Loan Loss Rate	Quarterly	B/Mgt/Brch	Helps to determine bad debts provisions	< 2%
1.5	Clients' Gender Proportion	Monthly	B/Mgt/Brch/FW	Indicates gender sensitivity	Set goal/planned target
1.6	Disbursement Proportion by Sex	Ditto	B/Mgt/Brch	Ditto	Ditto
1.7	Savings Proportion by sex	Ditto	B/Mgt/Brch	Ditto	Ditto
1.8	Field Worker to Loanee Ratio	Ditto	B/Mgt/Brch/FW	Reflects field workers capacity utilisation	>250 loanee
1.9	Field Workers to portfolio Ratio	Monthly	Mgt/Brch/WF	Reflects field workers efficiency	Birr 200,000
1.10	Field Worker to Active Clients Ratio	Quarterly	B/Mgt/Brch/FW	Ditto	>250 Clients
1.11	Loan Portfolio Growth Rate	Quarterly	B/Mgt/Dept	Growth indicates trends	Planned Target
1.12	Savings Growth Rate	Quarterly	B/Mgt/Dept	Ditto	Planned Target
1.13	Savings to Outstanding Ratio	Quarterly	B/Mgt/Dept	Shows loan surety through clients' savings	>25%

Annex 20 cont'd...

2.0 Financial Performance Indicators					
2.1	Subsidy Dependency Index	Annually	B/Mgt/	Reflects level of dependency on subsidy	Reaching 0% in 5 years
2.2	Financial Self-sufficiency	Bi-annually	B/Mgt	Reflects financial self-sufficiency	Reaching in 5 -7 years
2.3	Operational Self sufficiency	Bi-annually	B/MGT/Brch	Reflects level of operational self sufficiency	Reaching 100% in 3-5 years
2.4	Liquidity Ratio	Quarterly	B/Mgt	Indicates working capital status	1:2
2.5	Return on Equity	Annually	All	Profitability indicator	Opportunity Cost of Capital (15%)
2.6	Cost Per Loan	Monthly	B/Mgt/Brch/FW	Shows the cost of service	Should decrease over time
2.7	Balance Sheet	Quarterly	B/Mgt	Presents the status of asset and equity	
2.8	Income Statement	Quarterly	B/Mgt	Shows operational financial result	
2.9	Capital Adequacy (Ratio)	Bi-annually	B/Mgt	Indicates Proportion of Equity to Asset	10% - 15%

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2.10 Debit Equity

Quarterly B/Mgt

Indicates Degree of Indebtedness

1:8 (12.5%)

Key: B = Board, Mgt= Management, Dept = Departments, Brch = Branches, FW = Field Workers

** Excluding external users like financiers, donors and supervising and regulating authorities

Annex 20 cont'd...

No.	MFIs	Financing Structure				Financial Performance				Efficiency & Productivity				Risk & Liquidity		
		Capital Asset Ratio	Voluntary Deposit to Gross loan Portfolio	Portfolio to Total Assets	Return on Assets	Return on equity	Operational Self-Sufficiency	Financial Self Sufficiency	Operating Expense Ratio	Personnel Expense	Cost per Borrower	Borrowers per Loan Officer	PAR >30 Days	Loan Loss Ratio	Non Earning Liquid Assets	Risk Coverage
1	Digaf	45%	5%	89%	-2%	-5%	86%	51%	13%	8%	156	340	15%	0%	11%	11%
2	Letta	88%	0%	72%	-24%	-28%	16%	4%	40%	17%	120	72	3%	0%	16%	7%
3	Shashemene	48%	5%	57%	4%	9%	137%	50%	18%	10%	527	123	3%	0%	31%	50%
4	Aggar	52%	34%	72%	1%	3%	108%	51%	25%	13%	400	268	2%	0%	27%	523%
5	Harrar	89%	10%	58%	-11%	-12%	43%	17%	11%	7%	232	116	27%	0%	48%	79%
6	Metemamen	78%	0%	70%	0%	0%	102%	39%	18%	11%	141	403	9%	4%	26%	52%
7	Harbu	34%	29%	79%	0%	1%	103%	40%	15%	7%	119	300	2%	1%	11%	60%

8	AVFS	62%	6%	67%	1%	1%	106%	34%	14%	7%	139	323	10%	5%	28%	51%
9	Gasha	28%	2%	87%	2%	8%	112%	49%	13%	8%	162	175	26%	6%	13%	43%
10	Meklit	28%	6%	94%	3%	12%	124%	72%	9%	5%	119	387	4%	0%	4%	166%
11	Sidama	39%	2%	77%	0%	-1%	97%	36%	11%	7%	77	952	8%	0%	7%	53%
12	Bussa Gonofa	44%	0%	73%	7%	16%	145%	82%	18%	11%	142	463	2%	0%	22%	70%
13	SFPI	46%	5%	75%	3%	6%	119%	54%	12%	8%	139	453	4%	2%	10%	72%
14	Benishangul	43%	13%	78%	-3%	-7%	84%	42%	10%	5%	134	558	27%	6%	20%	66%
15	Eshet	26%	15%	86%	0%	1%	101%	62%	11%	7%	146	395	11%	3%	14%	75%
16	PEACE	33%	15%	89%	7%	20%	165%	78%	8%	4%	163	226	0%	0%	7%	69%
17	Wasasa	33%	19%	82%	6%	19%	162%	78%	8%	5%	92	633	2%	2%	12%	40%
18	Wisdom	44%	11%	89%	0%	0%	96%	56%	17%	10%	243	263	3%	0%	8%	60%
19	ADCSI	70%	10%	84%	4%	6%	192%	29%	4%	3%	99	248	3%	1%	14%	23%
20	Omo	9%	12%	89%	2%	23%	129%	73%	4%	2%	87	374	5%	3%	6%	58%
21	Ocssco	22%	11%	90%	4%	17%	153%	63%	4%	3%	71	593	3%	1%	8%	86%
22	DECSI	19%	24%	79%	2%	10%	130%	44%	3%	2%	78	1,012	2%	1%	11%	244%
23	ACSI	31%	31%	79%	8%	25%	240%	88%	3%	2%	73	404	2%	0%	7%	42%

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<i>Average</i>	44%	11%	79%	1%	5%	119%	52%	12%	7%	206	395	8%	2%	16%	87%
<i>Average for Africa</i>	29%	72%	65%	-3%	-546%	115%	100%	42%	19%	187	367	7%	3%	19%	197%