THE ROLE OF FINANCIAL SECTOR IN THE ECONOMIC DEVELOPMENT OF ETHIOPIA: COMPARATIVE STUDY OF PRE- AND POST-REFORM PERIOD

BY

KYDAKI GEZAHEGN

THESIS

Submitted to
School of Public Policy and Management, KDI
in partial fulfillment of the requirements
for the Degree of

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ABSTRACT

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Since the Debt Crisis of 1982 and rapid Voluntary capital inflow restriction to the developing countries, the financial liberalization models increasingly dominant policy advocated by the IMF and the World Bank. Today, it is a conventional wisdom that financial liberalization is the most efficient way for the financial sector and overall economic growth. Thus, the study seeks to make comparative study of the performance of the financial sector before and after the economic reform of Ethiopia.

Thus, the paper is divided into five chapters. The first chapter concerned with introductory part. All the technical questions related to the study such as problem statement, objective of the study, methodology and scope of the study are discussed in this section. The second chapter reviews the literatures that related to this study.

Chapter three concentrates on overall review of the Ethiopian economy in different periods. The fourth chapter is the core of the study that receives a wide coverage in the literature. Finally, the fifth chapter concludes the study and recommends a policy on the bases of the findings.

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ABBREVIATIONS

ADLI Agricultural Development Led Industrializations

AIDB Agricultural and Industrial Development Bank

CBB Construction and Business Bank

CBE Commercial Bank of Ethiopia

DBE Development Bank of Ethiopia

DD Demand Deposits

GDP Gross Domestic Product

GDS Gross Domestic Saving

GFCF Gross Fixed Capital Formation

IMF International Monetary Fund

MEDaC Minister of Economic Development and Cooperation

NBE National Bank of Ethiopia

NGO Non-Government Organization

SCAs Saving and Credit Associations

SD	Savings Deposit
TD	Time Deposit

CHAPTER ONE

INTRODUCTION

1.1 General Introduction

In the past few decades, most developing countries suffered from continuous economic crises and policy shortcomings. Ethiopia is one of these countries, which mainly depends on agricultural production. Agriculture accounts for about 50% of GDP, 80% employment, 90% of export earning and 70% of raw materials for medium and large industries. Ethiopia, with an area of about 1.1 million square kilometers (the 9th largest) and population of about 60 million (the 3rd most populous) country in the African continent. It has diverse physical features with a variety of agro-ecological zones that are favorable for agricultural production. It is also the largest in life stock population in Africa.

However, Ethiopia is the least developed country in the world mainly due to policy failure for many decades. In fact, natural resources are not determinant factors for wealth. The biggest difference between rich and poor countries is the efficiency with which they have used their resources. The World Bank (1989) reports that Hong Kong, Japan, the Republic of Korea, and Singapore have had among the world's highest per capita income growth rates despite their relatively poor resource endowments during the past three decades. Resource-rich Argentina has hardly grown at all (World Bank, 1989:26). The same is true for Ethiopia in resource underutilization predominantly attributed to policy problems. Moreover, drought repeatedly affects the agricultural production owing to the dependence on nature. In 1989, for instance, only 4.6% of the irrigeable potential was put for use. The rapid Demographic change with high dependence ratio as well as long and devastating civil war before 1991 were also contributed for the economic stagnation in the last decades. According to Annual Report on the Ethiopian Economy (1999/2000) recurrent expenditure was rising fast, partly owing to the government's expenditure on defense rising from 14.1% of GDP in 1973/74 to over 26% in 1987/88 out of which general government outlay accounted for 15%.

The monetary and financial policies were directed to fulfil annual plans before the reform. Therefore, the pre-reform period was attributed to policies of discriminatory interest rate, credit allocation and foreign exchange. The financial institutions were made to provide credit to inefficient public enterprises and state farms at preferential interest rates. Due to the government's crowding out effect, very little amount of financial resources were available to the more efficient private sector.

Thus, after the reform, the market-oriented economic policy wishes to establish a modern competitive financial system. The present government adopted a policy undertaking on the basis of gradualism and sequence of financial liberalization. The monetary and credit policies were made to ensure the growth of monetary aggregates consistent with the growth of GDP and inflation. Discriminatory interest rate policy to channel credit to privileged sector was eliminated. The private sector was allowed to participate in the financial sector whereas the specialized government banks were restructured. Since January 1995, auction market for Treasury Bills was introduced to avoid the crowding out effect of government borrowing from the banking system while laying the foundation for the development of capital market. Micro-financing institutions, which are specialized in providing credit to the emerging small enterprises and farmers, were established. The monetary and banking proclamations gave the National Bank of Ethiopia (NBE) increased autonomy to supervise the banking system. Although the NBE has set the minimum deposit rate, the lending rate was deregulated since January 1998.

1.2 Objective of the study

Shortage of financial resource is usually regarded as the most important problem for the development of many developing countries. Therefore, credit has been recognized as one of the important way to finance investment by mobilizing savings. Thus, the general objective of this study is to assess the performance of financial system in the economic development of Ethiopia. Specifically, the study compares and contrasts the performance of financial system before and after the economic reform. To achieve this objective the paper concentrates more on the savings and domestic resource mobilization of the financial system as well as the allocational and operational efficiency of the banks.

The study also tries to overview the activities of informal financial system. In developing countries like Ethiopia informal financial sector provides services to the non-corporate sectors such as individuals, small farmers and small business enterprises. This institution tends to help clients that formal institution often finds too costly or risky to serve. Moreover, in Ethiopia the volume of financial resource that is channeled by the sector is not negligible. It is this sector that covers the majority of population living in the rural areas. Thus, this paper tends to review the change in this sector after the reform with reference to the activities in the pre-reform period.

1.3 Methodology

This study employs descriptive analysis to compare and contrast the performance of the financial system and the overall economy during the two periods. Thus, growth rates, ratios, percentages, etc. are used to make the comparison in the analysis. The period of analysis categorized into two sub-periods in which the country was passed through the two different economic systems. The period from 1983/84 to 1990/91 is part of centrally planned economy and the remaining period from 1991/92 to 1998/99 is the market oriented economic system.

The Economic reform was actually begun in 1992/93. However, the period is assumed as if it started in 1991/92 in the analysis due to the fact that the idea of the market-oriented economic policy and its implementation had begun immediately after the new government took over the power in May 1991 (end of fiscal year 1990/91). In this analysis pairs of years are used due to difference in the fiscal year of Ethiopia and the Gregorian calendar. June 30 of every year is the end of the budget year.

The data for this analysis is collected from various institutions and literatures. Some of the information like credit disbursement by sector is collected from the commercial bank of Ethiopia. Since the commercial bank is the dominant banking industry in Ethiopia and for the lack of data from other banks in some information, the data obtained from the commercial bank has found to be enough to give sound conclusion in the analysis of banking industry. In this study, a lot of efforts are made especially to collect the data and organize them as in the tables due to the lack of well-organized data from the institutions. For the same reason, some of the data is organized from literatures. In addition to the data used for the analysis from various sources, different literatures have been reviewed to enrich the paper.

1.4 Scope and Limitations of the Study

The core interest of this study is to compare and contrast the performance of financial sector during the two different economic systems. Due to limited time available, the analysis gives emphasis only on major activities such as deposit mobilization and credit operation. Detail discussions are not made in some activities of the financial sector like the case in the informal financial sector, which is very important in Ethiopia. Further research is needed to assess the performance and the role of this sector. The information for the analysis is limited to only sixteen years (since 1983/84), excluding the information of the 1960s and 70s. This study also does not compare the financial system of Ethiopia with any other country.

CHAPTER TWO

LITERATURE REVIEW

2.1 Financial Development and Economic Growth

The relationship between development of financial system and economic growth has been extensively studied for a long time. Investment in physical and human capital is the most important factor for economic growth. One of the most important factors determining investment is the availability of financial resource. The common assumption in the model of financial development and economic growth is that saving is a pre-condition to investment and hence economic growth. This assumption is no longer valid in countries with developed banking and financial systems of their own or access to the international financial markets. Therefore, Studart noted that:

> In contemporary post Keynesian theory, finance in monetary production economy is sharply distinguished from saving-which is said to *derive* from, rather than be a precondition for, growth. Investment is the motor of accumulation and finance is what permits investment decision to materialize. The supply of finance is *causally* determined by banks: it is banks, and not

> savers, who hold a key position in the process of growth. Only if they share the optimism of entrepreneurs in periods of growth or are led, for any other reason, to accommodate the demand for investment finance, can the monetary production economy grow. This conclusion would appear to leave no role for savings and, hence, for capital markets, but such is far from being the case (Studart, 1995:1).

Fry (1996) investigates that the role of financial conditions have played in producing the virtuous circles of high saving, investment, output growth and export growth in sample of Pacific Basin countries during the past few decades. In the Pacific Basin regions, as elsewhere, there is much higher correlation between growth and saving ratio than there is between growth and investment ratios (Fry, 1996:140). He argues that the causality runs predominantly from growth to saving, it runs both ways, albeit less strongly, in the case of investment. He demonstrates that Singapore has posted the highest investment ratio in the Pacific Basin region at 41% of GNP in the past decades. However, Hong Kong, Korea, Taiwan and Thailand achieved higher growth rates than Singapore. Hence, high growth rates were associated with high saving ratios but not necessarily with high investment ratios. A high national saving-investment balance depreciates the real exchange rates so stimulates export growth. Since export growth stimulates output growth, this may form the link between saving-investment balance and output growth (ibid: pp.141).

Park also argues that causality can run in both directions. The growth and diversity of financial instruments, markets and participants can stimulate savings and investment, as well as the economy's allocative efficiency. Or financial development can simply be an aspect of economic growth whose main cause is elsewhere (Park, 1994:10).

In the same way, the empirical analysis of Fry shows that the relationship between the real interest rates and growth resemble an inverted U-shape. This implies that both very high and very low rates of interest reduce the growth of output through the effects of the rates of investment productivity. Thus, Fry concludes that a reduction in real interest rates below its equilibrium level by 1% point requires an increase in the investment ratio by 1% point in order to maintain a fixed rate of growth. And he also cited that Polak (1989) reported the same result in his econometric estimates for a sample of 40 developing countries over the period of 1965-85 (Fry, 1996:152). Nam (1992) has noted that the major motivation of still regulating most interest rates in Korea is to keep lending rates from raising too high and to avoid any financial panic for business firms whose capital structure is generally very weak (pp.45).

However, Morisset (1991) argues that because the principal constraint on investment is quantity, rather the cost, of financial resources in developing countries, a rise in the interest rates will increase the supply of credit to finance private investment (pp.3). Policies that impose artificially low interest rate ceilings in developing countries tend to constrain the supply of capital and lead to excess demand for capital.

The theoretical and empirical investigation of the relationship between financial markets and economic growth by Murinde (1996) brings together two of the latest innovations in development economics (new growth theory and the current interest in financial markets), to study the determinants of economic growth. His empirical finding on 7 Pacific Basin countries is weak to support the prediction of the endogenous growth theory that the financial markets have played a significant role in the growth of these economies. Among three financial markets studied, only the stock market has played a significant role. The remaining credit and bond markets are weak to support the theory.

In the other literatures, the credit and bond markets are found to be important determinants of economic growth. Particularly, in the early stages of development, economic policy should be more focused on the creation of efficient banking systems than stock market. Carlin and Mayer (1999) have noted that in countries with high GDP per capita, growth of equity- and high skill-dependent industries is promoted through information disclosure encouraging expenditure on R&D rather than fixed capital formation and through concentrations of ownership providing commitments to other stakeholders. In contrast, in countries with lower GDP per capita, banking systems are important in promoting bank finance dependent industries and dispersed ownership is required to control agency problems in skill-intensive and equity financed industries (Carlin & Mayer, 1999:25).

In their empirical study of interactions between financial development and economic growth, Berthelemy and Varoudakis (1996) concluded that educational development is a pre-condition for growth, while financial development may become a particularly severe obstacle to growth in countries where this pre-condition is satisfied (pp.89)

In general, historical experiences have shown that financial development had begun from simple lending and borrowing arrangements to a system of commercial banking and non-banking financial institutions as well as well-functioning money and capital markets. Although the role of capital market is insignificant largely due to uncertainty and information problem in developing countries, the banking system has played a significant role in channeling investment funds. The observed correlation between financial sophistication and economic growth suggests that financial markets and institutions played a significant role in the economic development of countries.

2.2 Financial Repression

Mckinnon (1973) defined financial repression as:

> Bank credit remains a financial appendage of certain enclaves: exclusively licensed import activities, specialized large-scale mineral exports, highly protected manufacturing, large international corporations, and various government agencies, such as coffee marketing boards or publicly controlled utilities. Even ordinary government deficits on current account frequently limited lending resources of deposit banks. Financing of the rest of the economy

> must be met from meager resources of moneylenders, pawnbrokers, and cooperatives (Mckinnon, 1973: 68-69).

In an economy where bank credits are rationed and capital markets are underdeveloped or very small, the success or existence of firms depends on access to bank loans. For countries, which adopted export promotion strategy, exporters may find it difficult to establish themselves in new international markets and to produce and market new products by learning and acquiring foreign technology at the early stage of the strategy. Due to this risk, the rate of return on investment in export-oriented industries can be less than similar investment for domestic market if all other factors remain constant. To solve this problem, governments in such countries involve in providing low interest rate credit, foreign loan guarantees, direct subsidy, and other trade policies.

According to Shea (1994) the allocations of investment funds in Taiwan has not been completely satisfactory from efficiency point of view. He argues that although the financial system in Taiwan has a good record of stimulating and mobilizing domestic savings, the performance of financial institutions in allocating fund has often been criticized. The criticisms include that collateral was emphasized rather than the profitability or productivity of borrowers and consumption finance was purposely neglected. He emphasized that those public enterprises and large firms, which contributed small portion to value added, had received disproportionately large credit from formal financial institutions, while small and medium enterprises which contributed the greater proportion to the value added obtained credit from curb market in the 1980s. Therefore, he concludes that in the 1950s and early 1960s, the Taiwan economy was short of investment funds; the private sector lacked experienced entrepreneurs; and industries with comparative advantage could be easily identified. Under such circumstances, a strategy to depend on selective credit control policies rather than interest rate mechanism to allocate investment funds might not cause much harm. By the 1970s and 1980s, however, when Taiwan's economy had more investment funds and entrepreneurs and industries with comparative advantage were no longer easily identifiable, the government's dependency on such policies naturally invited distortions and criticism (Shea, 1994).

Similarly, Nam (1992) argues that the credit share for heavy and chemical industries of Korea rose from 27% in 1975 to 31% in 1980, but dropped to 26% during 1984-85 before it stabilized thereafter at a 27-28% level, strongly suggests inefficiency of government-directed resource allocation in the latter half of the 1980s. Even though the variation in the HCI share of bank loans may not look large, they are really significant given that the HCI's share of GDP has risen substantially (from 12.0% in 1975 to 17.2% in 1985, for instance) (Nam, 1992:22).

In general, according to Sikorski inefficiencies under financial repression became apparent in:

1. Resource Mobilization. The policies of low, and often negative, real interest rates provided no incentives to savers, creating a current biased towards consumption and reducing savings to sub-optimal levels. The problem will increase the reliance of financial institutions on the government and create additional demand-pull inflationary pressure.
2. Credit allocation. The portfolio restrictions placed on banks meant credit was allocated on the basis of political and non-economic rationale. The elastic supply of subsidized credit to firms favored by government policy meant firms lacked a discipline to use credit efficiently or effectively and led to misuse of resources. Inefficient investments were also feasible at below market interest rates and were undertaken at the expense of projects within firms being credit rationed.

3. Banking activity. The large amount of government intervention in the financial markets increased the reliance of banks on policy direction. Banks were not required acquiring loan appraisal skills as they often relied on government loan guarantees in extending credit. Problems of asymmetric information were not effectively surmounted and banks were left with portfolios that were severely weakened by non-performing loans (Sikorski 1996: 65-66).

2.3 Financial Liberalization

Until the early 1970s, in accordance with the Keynesian and neoclassical theories, it was assumed that low interest rates would promote investment and economic growth. Mckinnon (1973) and Shaw (1973) provided theoretical and empirical evidences about the cause of financial liberalization in the developing countries in the early 1970s. Since the debt crisis of 1982 and rapid voluntary capital inflow restriction to the developing countries, the financial liberalization models became the main theoretical foundation behind the policies advocated by the IMF and the World Bank. It is now a conventional wisdom that financial liberalization is a means to stimulate growth.

2.3.1 The Effect of Financial Liberalization on Savings Mobilization

The assumption behind liberalization is that low interest rates under regulated financial system do not stimulate savings. The prior-saving argument presented in the financial liberalization models, assumed to maintain that internal saving can be increased by stimulating savings with positive interest rates and by enhancing competition between financial institutions through financial deregulation.

Morisset (1991) reports that the deregulation of interest rates in Argentina in 1977 resulted in a further increase in the real interest rate for deposits and thus there was a dramatic increase of savings through banking system. However, an increase in real rates of interest involved a portfolio shift from capital goods and foreign assets into monetary domestic assets in Argentina (Morisset, 1991:15). Therefore, the policy of financial liberalization does not always lead to increase in the investment funds and thus private investment in capital goods in developing countries. The empirical results of Morisset show that the negative effect is higher than the positive effect in Argentina between 1961 and 1982. Thus, the study concludes that the total effect of financial liberalization is negative on private investment. Gupta and Lensink (1996) describe that if the government finances its budget deficit by borrowing from the banking sector, it is a priori not possible to predict the effect of financial liberalization on the supply of credit to the private sectors (pp.21). However, financial reforms in various East Asian countries have been rated more successful, but common denominator to this success appears to be a very gradual and cautious approach towards financial liberalization (Gupta, 1997: 101).

In addition to the drastic increase in the interest rate, financial dualism will also be assumed as the result of financial liberalization. Medium and small sized firms, which are rationed from official credit markets, rely on curb market and retained earning form of finance to satisfy their financial requirements. Large and export industries, which are favored under financial repression, are highly dependent on bank credit. Therefore, a change in the price of that credit will have a large burden on their behavior. Sikorski (1996) noted that the large increase in credit requirements of the priority firms, combined with the reduction in the credit-creating capability of the state banks, rapidly led to financial problems in Indonesia.

Thus, according to Sikorski (1996) the broad consensus amongst the proponents of liberalization appears to be the liberalization of interest rates is possible and desirable, given (i) a stable macroeconomic environment devoid of fiscal imbalance, (ii) a competitive financial market functioning in relative autarky with active money, bond and equity markets, (iii) the absence of information deficiencies; and (iv) prudent supervisory and regulatory frame works able to discourage excessive risk taking by financial institutions (Sikorski, 1996:112)

2.3.2 Allocative Efficiency of Financial Liberalization

High interest rate due to liberalization is not only increases quantity of investment funds and, therefore, investment but also it improves the quality of investment. Sikorski (1996) demonstrates that under financial repression, it was assumed that inefficient and low yielding investments could be undertaken due to effective subsidy granted to them by low nominal interest rates. Financing such investments implies that higher yielding investment projects are crowded out of the official credit markets, and are thus often not undertaken. A policy which eliminated the subsidy, by raising nominal interest rates, was advocated in order to ration out the lower yielding investments and improving the allocation of resources in the financial system (Sikorski, 1996:75).

Although the financial system intermediates only part of the investible resources, it plays a vital role in allocating saving. According to the World Bank (1989), in the early stages of development, relatives, friends, and moneylenders may be the only source of external finance. As the financial system grows, local banks, the national financial institutions, and finally securities markets and foreign banks become source of funds for investors (World Bank, 1989:29). Sikorski (1996) describes that Kapur (1976) presents a model that illustrates the primary relation in liberalization theory that an increase in interest rates is growth enhancing because it increases the quantity of investment funds and, therefore, investment (Sikorski, 1996:69). The rationale behind this argument is that higher interest rates due to liberalization increase the level of savings, thus expanding the banking sector and hence causing an increase in the quantity of investment. Thus, financial liberalization, characterized by interest rate deregulation, increases both quantity and quality of investment and thereby improves allocative efficiency.

But the improvement in the allocative efficiency, which is induced by financial liberalization, is difficult to measure. Some authors such as Stinglitz(1991) and as cited in the literature of Gupta and Lensink(1996) Galbis(1977) and Cho(1986 &1988) questioned the validity of financial liberalization causes improvement in the allocative efficiency. However, their models to measure the allocative efficiency were subjected to criticism due to measurement problems and data limitations. For example, according to Gupta and Lensink (1996) Galbis did not explicitly consider the role of informal credit markets, which evidently is an important element in their analysis. For South Korea, Cho (1988) used marginal cost as a proxy for marginal return for 68 profit maximizing manufacturing industries due to data limitation for marginal rate of returns. He compared the variances of borrowing costs before and after liberalization and found that the variance was significantly reduced since 1981 compared to the 1970s. He concluded that a reduction in the variance of average cost (as proxy of marginal cost) across sectors signifies an improvement in the efficiency of credit allocation.

Gupta and Lensink have noted that Capoglu (n.d.) also tested the variance of the borrowing costs in Turkey. But he concluded that the variance was lower in 1982 than 1987, thus suggesting that financial liberalization did not results in increased efficiency of credit allocation. However, according to Gupta and Lensink these studies have been criticized on the grounds that the reduction in variance does not necessarily an improvement in the allocative efficiency because such reduction is easily induced by state intervention, requiring lending institutions to allocate credit to favored sectors at uniform rates (ibid). Nam (1992) also cited that Amsden and Euh (1990) argued that a smaller variance of borrowing costs across different industries is not necessarily good indicative of greater allocative efficiency. The more highly developed the industrial sector, they maintain, the fewer the number of new industries requiring special treatment (preferential loans). Basically, the reduced inter-industry variance of borrowing costs is viewed as a result of industrialization, and not necessarily input into it (Nam, 1992: 31).

Gupta and Lensik (1996) describe that a deregulation does not always guarantee an improvement in overall productivity and thus growth. The outcome depends on how two sectors (advanced & backward) react towards the formal and the informal banking sectors as lenders and borrowers, which ultimately affects the portfolio behavior of the two sectors and consequently allocational efficiency. They conclude that in the absence of informal banking sector, interest rate deregulation always leads to an improvement in the allocative efficiency (Gupta and Lensink, 1996).

2.3.3 Operational Efficiency of the Banking Sector

In addition to the effects of interest rate deregulation due to financial liberalization, it is also possible to examine the reduction of cost of financial intermediation. The cost of financial intermediation measures the operational efficiency of banking sector. One way to measure banking efficiency is to examine the spread between the deposit and lending rate. The functional efficiency of the banking system is influenced by several factors such as efficiency in technology and productivity of employees. Under repressed financial system, in which government fixes the deposit and lending rates, operational efficiency of banks remains low. Financial liberalization leads to an increase in both the *effective* deposit and lending rates, whereas an improvement in banking efficiency leads to an increase in the *effective* deposit rate and a decrease in the *effective* lending rate (Gupta &Lensink, 1996:89).

Financial liberalization leads to higher operational efficiency in the long run because of increasing deregulation, which promotes competition. According to the World Bank (1989), in practice, competition will limit the amount by which the spread between deposit and lending rates can be enlarged. Banks that set lending rates too high or deposit rates too low eventually lose business to competitors (World Bank, 1989:79).

Gupta and Lensink (1996) emphasized that in contrast to financial liberalization in the sense of an increase in the deposit and lending rate, an increase in the banking efficiency increases the private sector's disposable income and decreases the cost of capital (pp.94). However, they argue that an increase in banking efficiency on private investment is ambiguous both for the case where the private sector is credit constrained and for the case where it is not credit constrained. For both cases, the analysis suggests that the effectiveness of an improvement in banking efficiency on private investment is greater the lower the degree of substitutability between bank deposits and capital in the private's portfolio and the greater the sensitivity of private investments to changes in income and wealth, assuming that wealth increases due to an improvement in banking efficiency.

Bank's operational efficiency is measured by the interest rate margin. Sikorski (1996) describes that interest rate margins eventually declined as competition began to increase and non-performing loans took their toll. The volatility of interest rates after the reform also forced the banking industry to adjust its lending terms to minimize interest rate risk in Indonesia (Sikorski 1996:221). He also argues that the impact on the profitability of banks was predictably adverse, declining after the reform for all categories of banks. Profit to total asset ratios for all banks in Indonesia declined from 2.7% in 1982 to 1.8% in 1985, mainly as a result of a sharp decline in loan portfolio performance and rise in funding costs (cho and Khatkhate, 1989 in Sikorski 1996:221)

CHAPTER THREE

THE ETHIOPIAN ECONOMY

3.1 The Historical Background of Economic Policies

Ethiopia is the poorest country in GNP per capita terms as in the most recent World Bank reports. The last decades are observed to be poor in the overall economic performance and no change in the structure of the economy. In 1974, it was found that the main problem for the underdevelopment of the country was the economic policy adopted by the feudo-bourgeois regime. Thus, the next regime pursued a policy of rapid economic growth with equal distribution of income under the socialist ideology. However, after seventeen years, the living standard of the society was much worse off than the regime before. Therefore, the new government adopted market-oriented economic policy after the overthrow of the socialist regime in 1991. The strategy of the current government is Agriculture Development Led Industrialization (ADLI). It is believed that the agricultural sector is the driving force for the rest of the economy in the strategy.

In the financial sector, the monetary and credit policies of the government were designed to ensure the growth of monetary aggregates consistent with the growth of GDP and inflation targets. The strategy also wishes to establish a modern competitive financial system. The monetary and financial policies of the previous government were directed towards the fulfillment of the annual plans. Therefore, financial institutions were made to provide credit to inefficient public enterprises and state-owned farms at preferential interest rates. Hence, very little amount of financial resources was available to the more efficient private sector.

Thus, the new government issued monetary and banking proclamations in January 1994. The proclamation gave the National bank of Ethiopia (NBE) increased autonomy to supervise the banking system. It also allowed the private sector to participate in the banking and insurance businesses. Furthermore, the agricultural and industrial bank was restructured and renamed as Development Bank of Ethiopia (DBE) while the Housing and Saving Bank was also restructured and renamed as Construction and Business Bank (CBB) in 1995. The state owned financial institutions were re-capitalized. A proclamation for the establishment of micro-financing institutions was issued on July 5,

1996. Treasury Bills of different maturities were introduced in1996/97. Although minimum interest rate was set for saving, the lending rate was deregulated in January 1998.

3.2 The structure of Ethiopian Economy

It is not only the structure of the economy that did not change, but also the overall economic performance of the country was very poor during the previous regime (1974-91). GDP growth by industrial origin at 1980/81 constant factor cost which averaged 4% per annum during the period 1965-1973, fell to about 1.5% per annum during the period spanning 1974 to 1991(Survey of Ethiopian Economy, 1999:36). The economy was even worse in the later periods of the last regime. As shown in the table 1, the average real GDP growth rate for the last eight years (1983/84-1990/91) of the previous regime was only 1% per year, compared with average population growth rate of 3% per annum, leading to a net decline in per capita income of about 2% per year. If we exclude the abnormal year 1990/91 as politically instable, average annual GDP growth rate can improve to 1.8 % while per capita income will decline by 1.2% per year.

The decline in the overall performance of the economy drastically was reflected in almost all sectors during the previous regime. The agricultural production, accounting for 51% of GDP, grew by only 1.3% on average during the last eight years of the previous regime. On average the industrial sector declined by 0.2%, distributive services (trade, hotels, restaurants, transport and communication) declined by 1.6%, and other services (banking and insurance, real estate, education, health, public administration, defense and others) grew by 3.6 %. The growth of public administration and defense were the major contributors of this growth.

Table 1: The contribution of Sectors to GDP and other major economic indicators.

Year	Growth rate of GDP (%)	AGRICULTURE		INDUSTRY		DISTRIBUTIVE SERVICE		OTHER SERVICE		Rate of inflation (%) (CPI)	Exchange Rate(Birr/US$)
		As % Of GDP	Growth Rate	As % of GDP	Growth rate	As % of GDP	Growth rate	As % of GDP	Growth rate		
1983/84	-6.3	53.3	-12.5	12.7	6.0	14.4	0.3	19.6	0.8	-0.5	2.07

1984/85	−9.7	46.7	−20.9	14.7	4.3	16.1	0.9	22.5	3.8	18.4	2.07
1985/86	9.9	49.3	16.0	14.3	6.6	15.1	3.4	21.3	3.9	4.6	2.07
1986/87	14.1	51.3	18.8	13.5	8.0	15.3	15.0	19.9	6.6	−9.5	2.07
1987/88	−0.01	49.9	−2.8	13.0	−3.8	15.8	3.4	21.3	7.1	2.2	2.07
1988/89	0.4	50.3	1.0	12.1	−6.6	14.9	−5.5	22.8	7.3	9.6	2.07
1989/90	4.1	50.9	5.3	11.1	−4.7	14.9	4.4	23.2	5.7	5.2	2.07
1990/91	−4.3	55.9	5.2	9.4	−11.2	11.9	−23.5	22.8	−5.8	20.9	2.07
1991/92	−3.7	56.5	−2.7	9.0	−7.1	12.1	−2.5	22.4	−5.2	21.0	2.07
1992/93	12.0	53.5	6.1	10.4	28.5	13.2	22.2	23.0	14.8	10.0	4.27
1993/94	1.7	50.7	−3.7	10.9	7.0	13.8	6.2	24.7	9.2	1.7	5.80
1994/95	5.4	49.7	3.4	11.2	8.1	13.9	6.4	25.2	7.7	13.4	6.25
1995/96	10.6	51.5	18.6	10.6	5.4	13.7	9.0	24.1	5.9	0.9	6.32
1996/97	5.2	50.7	3.4	10.8	6.8	14.0	7.7	24.5	6.7	−6.2	6.51
1997/98	−0.5	45.7	−10.3	11.6	6.3	14.8	5.3	27.9	13.3	2.3	6.88
1998/99	6.3	44.8	4.2	11.7	7.6	14.8	5.9	28.7	9.4		7.51

Source: NBE

Note: GDP growth rate at 1980/81 constant factor cost

An improvement in economic performance of Ethiopia has been registered since the introduction of Economic Reform Program in 1992/93. Real GDP by industrial origin grew by an average rate of about 5.8% per annum during the period 1992/93 to 1998/99.

Growth during this period has come from a strong revival in the industrial sector grew at an average of 10.0% per annum, while the distributive service grew at an average of 9.0% and other services sector at 9.6% per annum after the reform. The agricultural sector, accounting for 50% of GDP on average, grew at an average of 3.1% per year during the same period. Due to dependence on nature, the agricultural production was negative in the two bad weather years after the reform. One of the major factors for the underdevelopment of the country is the structure of the economy that is dominated by agriculture. It is impressive to notice that the overall economic growth is highest when the growth in agricultural sector is highest and vice versa.

Historically, Ethiopia is relatively low inflation country compared to other countries. Some of the reasons behind this stability may be the degree of monetization of the economy, the nature of policies such as price regulation before the reform and conservative monetary and fiscal policies after the reform and performance of the agricultural sector after the reform. Fixed exchange rate system for nearly two decades until the reform had been contributed to the poor performance of the economy. Beginning by devaluation of the currency (Birr) gradually followed by introduction of auction based exchange rate system, leading to foreign exchange market stability after the reform.

3.3 Brief History of Financial Institutions

The banking system has a long history in Ethiopia. However, the modern banking system was begun in 1905 with the establishment of the Bank of Abyssinia based on a 50 years agreement with the Anglo-Egyptian National Bank. In 1931, the Ethiopian government purchased the Abyssinian Bank and renamed it as the Bank of Ethiopia, the first nationally owned bank in African content (Belay (1990) and Beforekadu (1995) in Alemayehu, 1999:135).

During the five-years of Italian occupation (1936-41), the banking activity continued to expand and six banks with total of 37 branches were under operation. In 1942, 'The State Bank of Ethiopia' was re-established by the Imperial Charter. The state bank combined together the functions of central bank and commercial bank. The commercial bank of Ethiopia was separated from the National Bank of Ethiopia after re-establishment in 1963. After the separation of the two banks, many other banks were established.

Table 2: Banks in operation before the 1974 Revolution

Years of Establishment	Name of the banks	Number of Branches	Capital at the date of establishment (in Million Birr)
Note dated	Banco di Napoli	1	2.0
1963	Imperial saving and Home ownership Public Association	1	0.6
1963	National Bank of Ethiopia	4	10.0
1963	Commercial Bank of Ethiopia	65	35.0
1963	Addis Bank Share Co.	26	5.0
1964	Ethiopian Saving and Mortgage S.Co.	2	3.0
1994	Ethiopian Investment Corporation S.C	1	20.0
1966	Banco di Roma (Ethiopia) S.C.	8	4.0
1969	Agricultural and industrial Development Bank	5	100.0
Total		113	

Source: Alemayehu (1999:137)

All private owned financial institutions including three commercial banks, thirteen insurance companies and two non-bank financial intermediaries were nationalized on January 1, 1975. The Agricultural Bank of Ethiopia, established in 1945, was re-established as Agricultural and Industrial Development Bank of Ethiopia (AIDB) in 1969 and again renamed as Development Bank of Ethiopia (DBE) since 1994. After nationalization, the AIDB specialized in extending medium- and long-term loans to agriculture and industry. Housing and saving Bank renamed recently as Construction and Business Bank (CBB) was also specialized bank under the socialist regime.

CHAPTER FOUR

THE ROLE OF FINANCIAL SYSTEM AND POLICIES BEFORE AND AFTER THE ECONOMIC REFORM

Monetary and financial policies directly or indirectly influence the macroeconomic performance of an economy. Thus, one of the core objectives of the economic reform program launched since 1992/93 was stabilization of the macro-economy and creation of efficient financial system, which facilitates rapid economic development. The reform program requires many changes in the activity of banking system. In this process the government adopted a strategy of gradualism and strengthening domestic competitiveness before full liberalization of the financial system.

In this study, due attention is paid to compare and contrast the performance of financial system before and after the economic reform. The activities of formal and informal financial institutions are reviewed in the first section of this chapter. In the remaining sections, the development of monetary aggregates, saving and domestic resource mobilization, allocative and operational efficiency of the banking system have been given special attention.

4.1 Over view of the financial system

4.1.1 The Formal Financial institutions

The existence of a dual financial system has a historical background essentially in developing countries. The formal financial market is composed of monetary institutions, other financial institutions, and money and capital markets, which are directed by rules and regulations. The informal financial market is operating various underground activities without any rules and regulations of the central bank. The formal monetary institutions (banks) create credit money while other formal financial institutions like insurance companies cannot create money, but they can mobilize idle funds to finance investments.

There are four kinds of financial sources for the business sector, namely, financial institutions, the curve market (informal market), the money market and the capital market. The money and capital markets are underdeveloped in Ethiopia. The financial instrument that can be transacted in the capital market is only the government bond. Under the money market, only Treasury Bills are operating on bi-weekly auction basis since January 1994/95. Auctioning government securities to the public and financial institution as well as private enterprises has three maturity periods (28,91 and 182 days) on the market. T-Bill is used to avoid crowding out effect of government borrowing from the banking system, by laying the foundation for the development of the market in the country.

Table 3: Financial market

Million Birr

	1995/96	1996/97	1997/98	1998/99
T-Bills Demanded (total)	6669.1	6639.6	6025.6	12945.5
T-Bills Sold	4526.0	5017.2	5090.7	11734.2
Average weighted Yield	4.9	3.9	3.7	3.8
T-Bills outstanding	1266.0	812.4	681.9	2420.0
Banks	781.4	43.0	125.0	694.0
Non-Banks	484.6	769.4	556.9	1726.0

Source: NBE, fourth quarter 1998/99, vol. 14, No.4

Various developments were observed in the T-bills market since the beginning of its operation. The total demanded for T-Bills reached Birr 13 billion in 1998/99 from Birr 6.7 billion in 1995/96. The amount of T-bills sold also rose from Birr 4.5 billion in 1995/96 to Birr 11.7 billion in 1998/99. The weighted average annualized interest rate was only 4.9% in 1995/96 much lower than the nominal 10-11% deposit rate of banks in the same year. The rate was also much lower than the nominal 6% deposit rate in 1998/99.

The financial institutions are the most important financial sources for the business sector. The number of units for each type of financial institution can be observed in the table below.

Table 4: Financial Institutions

	1991/92	1995/96	1996/97	1997/98	1998/99	March 31,2000
Number of commercial Banks	1	5	6	6	8	n.a

- Private banks	0	4	5	5	7	n.a
- Number of Branches	152	202	220	227	246	n.a
Number of Development banks	1	1	1	1	1	1
Number of Branches	16	32	32	32	32	32
Number of Construction and Business Bank	1	n.a	n.a	n.a	n.a	1
- Number of Branches	13	n.a	n.a	n.a	n.a	20
Number of micro-financial Institutions	-	-	2	5	9	n.a
Number of Insurance Companies	1	7	8	8	9	n.a
- Private Ins. Companies	0	6	7	7	8	n.a
-Number of Branches	n.a	50	57	64	79	n.a

Source NBE:

n.a = data not available.

There were three commercial banks during Imperial regime, which were nationalized on January 1,1975 and named as CBE. The commercial bank is the largest in the number of branches. After the reform, the number of commercial banks and their branches were increasing due to the establishment of private banks (see table 5).

Table 5: Private banks

Bank	Number of Branches(as of Oct.30,1999)	Date of establishment	Initial Capital (paid up) (In million Birr)
Awash International Bank	17	10/10/94	24.2
Dashen Bank	16	20/09/95	14.9
Bank of Abyssinia	7	15/02/96	18.8
Wegagen Bank	17	30/04/97	30.0
United Bank	6	01/09/98	20.8
Nib International Bank	2	26/05/99	n.a

Source: NBE and Alemayehu Geda (1999:140)

The Development bank was providing short-term credit for fertilizers, seeds, etc and long term loans for investment in industry and agriculture. It was also providing medium and long-term loans for state enterprises, especially for state farms. The construction and business bank (CBB) was providing loans for residential and commercial constructions. Since CBB was accepting deposits for short term (one-year deposits) and lending for long term, it had been faced shortage of loanable funds. It was mobilizing time deposits and accepting the deposits of Ethiopian Insurance Corporation and Pension and Social Security Authority by the order of government before the reform. As far as insurance companies are concerned, there were thirteen private insurance companies that were nationalized in January 1975 and merged together to form the Ethiopian Insurance corporation. However, after the reform new private insurance companies were established. The eight private insurance companies are Nyala Insurance, Nile Insurance, Africa Insurance, National Insurance, Awash Insurance, United Insurance, Lion Insurance, and Global Insurance.

4.1.2 Informal Financial Initiations

Informal financial Institutions are operating outside the rules and regulations of central bank. Since the private sector was restricted to obtain credit from the formal financial institution during the previous government, informal financial market was the only way to fill the gap. However, the interest rate in this market is much higher than the formal institution. A recent survey by minister of Labor and Social Affairs in 1997 on agricultural employment and rural non-farm employment in Ethiopia found the interest payment as in the table below.

Table 6: Average interest rate paid per annum (%)

Lender	Interest rate
Money-Lenders	31.97
Friends/relatives	11.25
NGOs	9.40
Idri or local Groups	26.65
Banks	10.25
Others	32.49

Source: Annual Report on the Ethiopian Economy, 1999/2000, PP. 338.

According to the report, the interest payment varied from one region to another. For example, it ranged from 19.31% in Amhara to 56.7% in Tigray region for the interest charged by moneylenders. As cited in the Annual Report on Ethiopian Economy, Mauri (1987) was found that interest rate charged by moneylenders varied from 24% to 900% per annum.

'Idri,' a kind of insurance scheme, is one form of informal finance in Ethiopia. The members of 'Idri' make regular contribution periodically and use the funds for emergencies such as burial of the dead and medical purposes. 'Idirs' have strong relation with banks when they deposit their funds in the banks. 'Iqqub' is Ethiopian name for ROSCA (Rotating Saving and credit Association). Members of 'Iqqub' can be the same neighborhood or profession, or the same work place or ethnic background. They contribute the fund and each member can obtain the money by drawing lots. It has chairman and secretary performing every procedure according to the rules and regulations that are set by all the members. In 1995, the National Bank of Ethiopia estimated that 'Iqqub' mobilized funds at 8-10% GDP. There is other many types of informal finance in the country. It requires detailed research to understand the informal financial market fully.

It is difficult to measure the volume of financial transactions undertaken by different market operators in the informal financial market. The Annual Report on the Ethiopian Economy (1999/2000) reported that informal financial transaction was about Birr 7.2 billion in 1998. The ratio of this estimation to the formal financial institution is about

41% of the deposit mobilized and 157% of the credit disbursed in that year. Thus, the contribution of informal financial institutions should not be neglected in the discussion of financial system of Ethiopia. Owing to the shortage of formal financial institutions in rural Ethiopia, the informal financial sector play an important role in disbursing loans for the majority of population in the country.

4.1.3 Semi-Formal and Formal Micro-finance

SCAs (Savings and Credit Associations) or credit union and Credit Schemes Conducted by NGOs are the two main semi-formal finances in Ethiopia. The purpose of SCAs is to encourage savings and use the fund to extend loans to the members. In addition to this purpose, they are expected to improve the knowledge of their members about the importance of banking service. The performance of SCAs is evaluated on the basis of number of cooperatives and their members, saving size, reserve and total assets.

Table 7a: Savings and credit cooperatives in Ethiopia; July 1986-June 30, 1998

Year	No. of coops	Growth rate (%)	Membership (No.)	Growth rate (%)	Contributions & Savings (million Birr)	Growth rate (%)
1985	218	-	38,166	-	12.97	-

1986	264	21	56,885	49	22.93	77
1987	309	17	63,540	12	23.30	2
1988	371	20	38,366	8	30.85	32
1989	419	13	98,973	45	50.41	63
1990	484	16	118,037	19	68.96	47
1991	495	2	119,799	2	78.77	14
Average Growth	-	13		19		32
1992	420	-	108,231	-	87.04	-
1993	426	1	101,299	(7)	86.11	(1)
1994	497	17	112,664	11	99.77	16
1995	522	5	116,619	4	111.17	11
1996	578	11	129,216	11	124.44	12
1997	620	7	147,302	14	159.87	28
1998	670	8	150,468	2	167.06	5
Average Growth		7		5		10

Table 7b: Savings and credit cooperatives in Ethiopia; July 1986-June 30, 1998

Year	Outstanding loans (million Birr)	Growth rate (%)	Reserves (million Birr)	Growth rate (%)	Total Assets (million Birr)	Growth rate (%)	Saving per member (Birr)	Growth of saving per member (%)
1985	12.56	-	0.88	-	19.24	-	340	-
1986	23.52	87	1.74	97	29.89	55	403	16
1987	23.64	0.5	1.68	(4)	30.33	2	367	(9)
1988	33.38	41	2.15	28	42.05	39	451	23
1989	52.10	56	2.17	1	69.93	66	509	13
1990	69.83	34	4.02	85	90.78	30	584	15
1991	79.92	14	4.50	12	102.17	13	658	13
Average Growth		33		31		29		10
1992	89.20	-	5.10	-	109.76	-	796	-
1993	87.47	(2)	5.48	8	112.29	2	850	7
1994	100.39	15	7.40	35	135.37	21	886	4
1995	93.58	(7)	8.16	10	150.71	11	950	7
1996	118.88	27	9.39	15	168.61	12	965	2
1997	148.49	25	10.99	17	196.13	16	1088	13
1998	155.17	5	15.54	41	207.90	6	1114	2
Average Growth		9		18		10		5
		3						

Source: Annual Report an Ethiopian Economy, 1991/2000

SCAs increasing in number, membership, mobilizing saving, outstanding Loans, reserves, total assets and saving per person. However, in terms of growth rates, all the indicators have shown a decline during the post-reform period compared to the pre-reform period. The average annual growth rate in the number of cooperatives, for example, reduced from 13% during pre-reform period to 7% during post-reform period. Some of the reasons for the faster growth during the pre-reform period are: it was mandatory to organize cooperatives; people should form cooperatives for saving in order to get bank credit for investment in some constructions like housing; micro-financing by NGOs was limited and the only source was SCAs. However, some of the above factors were none existent during post-reform period, leading to slow down in the growth rate of all indicators. During both period SCAs is criticized regarding the distribution of the institutions. It is biased towards urban centers.

Because of repeated drought, the growth of NGOs and their activities are increasing overtime. NGO sponsored schemes were successful in achieving their objectives in terms of targeting and selecting the beneficiaries as well as performance and sustainability. Most of them use the Grameen Bank type of credit delivery and repayment enforcement through group pressure. However, NGOs were criticized that they relied heavily on donor funds and they didn't follow the banking system.

As far as the formal micro-financing institutions are concerned, total of Birr 17.3 million of which 80% was made available by International Development Association (IDA) and 20% was contributed by the Development Bank of Ethiopia up to the end of 1997. This fund was required to revolve. After the provision of the proclamation issued in 1996 for the establishment of micro-financing institutions, seven micro-financing institutions were established up to August 1998. Now, it is too early to assess the performance of this institution. Future research should pay more attention regarding this institution.

4.1 Development of Monetary Aggregates

The two major determinants of monetary base are the net foreign asset holdings of the banking system and the total domestic credit. As shown in the table 8, between 1983/84 and 1990/91 domestic credit grew at an average of 11.9% per year, a slightly above the average rate of growth between 1991/92 and 1998/99 which was 11.5%.

Table 8a: Trends in Monetary Aggregates (1983/84 – 1990/91)

(Million Birr)

Item	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	Ave. grow.
Domestic credit	4087.1	4475.4	4839.6	5554.2	6293.7	6790.1	7972.0	8936.7	11.9
-Claims on Gov't (net)	2287.5	2618.5	2766.9	3206.6	3502.2	3886.8	5027.4	6021.6	15.1
- Claims on others*	1799.6	1856.9	2062.7	2347.6	2791.5	2903.3	2944.6	2915.1	7.3
Foreign Assets(net) **	136.3	232.1	579.2	536.4	152.3	203.0	46.5	270.5	73.2
National Bank	21.1	160.1	445.1	409.6	54.0	53.5	(30.4)	140.4	
Commercial Bank	115.2	72.0	134.1	126.8	98.3	149.5	76.9	130.1	
Other Items(net)	839.7	858.5	970.6	1281.9	1207.3	1288.1	1310.3	1248.0	
Broad Money	3383.7	1849.0	4448.2	4808.7	5238.7	5705.0	6708.2	7959.3	13.0
Money (m_1)	2379.3	2692.1	3179.6	3563.5	3910.8	4174.4	4990.0	6131.7	14.6
-Demand deposits***	1096.4	1333.6	1587.7	1820.0	2002.5	1992.6	2253.7	2314.3	11.5
-Currency	1282.9	1358.5	1591.9	1743.5	1908.3	2181.8	2736.3	3817.4	17.3

in circulation									
Quasi Money	1004.4	1156.9	1268.6	1245.2	1327.9	1530.6	1718.2	1827.5	7.3
-Saving Deposits	718.3	814.0	940.3	1054.6	1209.7	1369.0	1576.8	1679.4	12.9
-Time Deposits	286.1	342.9	328.3	190.6	118.2	161.6	141.4	148.1	-5.1

Table 8b: Trends in Monetary Aggregates (1991/92 – 1998/99)

(Million Birr)

Item	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	Ave. grow.
Domestic credit	10105.9	12166.8	12744.2	13873.4	15411	17146	18931	21270.8	11.5
-Claims on	7033.6	7824.9	9616.1	9024.1	7888	8797	9372	9567.6	6.5

Gov't (net)									
- Claims on others*	3072.3	4341.9	3128.1	4849.3	7523	8349	9559	11703.2	22.1
Foreign Assets(net) **	403.1	809.7	3764.6	4658.6	3524.4	5204.4	5434.7	5736.8	74.7
- National Bank	108.5	159.1	2143.1	2344.5	3610.9	2870.5	2165.5	2521.7	
- Commercial Bank	294.6	650.6	1621.5	2314.1	(86.5)	2333.9	3269.2	3215.1	
Other Items(net)	1498.3	2454.5	4910.1	4529.2	3629.4	5744.5	5763.3	8634.2	
Broad Money	9010.7	10522.0	11598.7	14002.8	15306.0	16605.9	18602.4	18373.4	11.2
Money (m_1)	6845.1	7711.9	8373.2	9909.0	9561.5	10073.9	11045.9	10345.7	7.0
- Demand deposits***	2529.5	2826.9	3214.3	4065.7	3869.2	4837.3	6325.8	6182.5	13.8
- Currency in circulation	4315.6	4885.0	5158.9	5843.3	5692.3	5236.6	4720.0	4163.2	1.6
Quasi Money	2165.6	2810.1	3225.5	4093.8	5744.5	6332.0	7556.5	8027.7	20.8

- Saving Deposits	2002.0	2459.5	2844.3	3649.3	4984.0	5685.2	6481.7	7167.4	20.2
- Time Deposits	163.7	350.6	381.2	444.5	760.5	846.7	1074.8	860.3	29.9

Source: NBE, various issues

* Data from only NBE and CBE.

** Excludes data from other financial institutions.

*** Uncleared checks only are netted out from gross demand deposits.

Much of the growth before the reform was accounted for by credit to the central government, growing at an average rate of 15.1% per year mainly to finance budget deficit for which it was only 6.5% per annum after the reform. The growth was negative in 1994/95 and 1995/96 when the central government had started repayment of its loans to the banking system.

The domestic credit to the private sector is a major determinant factor for the expansion of monetary base in the recent years in contrast to the pre-reform period. Thus, the recent average growth of domestic credit on others was three times higher than during the pre-reform period. Another important determinant of monetary base is the net foreign asset holding of the banking system. The net foreign asset grew at an average of

74.7% per year during the post-reform period, slightly faster than the pre-reform period of 73.2%. The increase in the net foreign asset was mainly due to the recovery in export earning, devaluation of the exchange rate, and flow of official development assistance to support the reform program.

The broad money (M_2), influenced by “other items (net)” which is the balancing item, comprises of M_1 (narrow money) and quasi money. The average annual growth rate of M_2 was 13% before the reform since 1983/84, a little faster than the post reform period of 11.2%. The M_1 grew by an average rate of 14.6% per year during the period 1983/84 to 1990/91. Both demand deposits and currency in circulation increased during this period at average annual growth rate of 11.5% and 17.3% respectively. The share of currency in circulation exceeded that of demand deposit during the pre-reform period except in 1986/87 and 1987/88. However, because of extreme price control, the increase in the currency in circulation did not result in inflationary situation. During the post-reform period, the average annual growth rate of M_1 was 7%, half the growth exhibited during the pre-reform period. Although the average annual growth rate in the demand deposits increased from 11.5% during 1983/84 – 1990/91 to 13.8 % during 1991/92- 1998/99, the growth in the currency in circulation reduced substantially from

17.3 to 1.6% during the same period. The proportion of currency in circulation in M_1 declined from 63% in 1991/92 to 40% in 1998/99, leaving the ground for the increase in the demand deposits from 37% to 60% in the same period. The decline in the volume of currency in circulation in both absolute and relative terms indicates the increased cost of holding cash in terms of foregone interest earning during the post-reform period.

Table 9: Structure of Deposit Rates (in % per annum)

	Through Sep.30,1992	Oct.1, 1992- Aug.31, 1994	Sep.1,1994- Jan. 1,1995
A. time Deposits 30 days notice	-	10.5	10.5
3 months to less than 6 months	-	10.5	10.5
6 months to less than 12 months	-	11.0	11.0
1 year to less than 2 years	Differed by ownership and maturity	11.5	11.5
2 Years and above	”	12.0	12.0
Memorandum Items Rate differentials for 1 year and over • Financial Institutions(1Year) • Government owned under takings (1year).	1.0 1.0		-
Individuals, Savings and credit cooperatives, and self-help organizations: 1year.	6.0		-
2 Years	6.5		-

3 Years	7.0		-
5 Years	7.5		-
Others:1 Year	4.0		-
2 Year	4.5		-
3 Year	5.0		-
5 Year	5.5		-
B. Saving Deposits	Differed by ownership and maturity	10.0	10.0
Memorandum Items: Rate differentials: Individuals, Savings and Credit cooperatives, self-help organizations. • Up to Birr 100,000	6.0		-
In excess of Birr 100,000	2.0		-
Others	Not allowed to maintain savings Account		-

Minimum Interest Rates on Time and savings	Jan.2, 1993-Nov.30,1995	Dec.1,1995-May.30,1996	June1,1996-Sep.15,1996	Sep.16, 1996-Dec.31, 1997	Jan.1, 1998-todate
Deposits	10.0	11.0	10.0	7.0	6.0

Source: NBE, Quarterly Bulletin, Vol. 14, No 4, Fourth Quarter, 1998/99

This shows the increase in savings or interest bearing assets other than cash in the one hand and the fast expansion of the demand deposits reflecting the expansion of business activities through written checks instead of cash transfer on the other hand. The minimum interest rates on time and saving deposits in different periods are summarized in the table above.

During the pre-reform period, interest rates on private sector saving deposits were at the level inherited from the Imperial Regime, 6% on deposits up to Birr 100,000 and 2% in excess of this amount. Therefore, the growth in saving deposits was only 12.9% compared to 20.8% when the interest rate in saving deposits rose to 10% since Oct.1, 1992. Others such as government organizations, financial institutions, Cooperatives other than savings and credit associations, state enterprises, etc. were not allowed to maintain saving deposits. However, interest rates on time deposit were revised that differed on the basis of source of funds.

4.3 Savings and Domestic Resource Mobilization

4.3.1 Deposit Mobilization

The prevalence of positive real rate of interest and attainment of economic recovery after the reform, deposit mobilization expanded at faster rate in the banking system when compared to pre-reform period. The three types of deposits (demand, saving and time) are mobilized from individuals, private and public business enterprises, financial institutions and government. This analysis excludes deposits from central government and concentrates on the mobilization of deposits in terms of financial intermediation. Among the three types of deposits, banks usually pay interest rates on saving and time deposits, which the interest on the former is less than the latter. Although real interest rate was negative, the saving deposits had been increasing before the reform mainly due to absence of alternative investment activities.

Table 10a: Deposit by type (Pre-reform)

Million Birr

*Item	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	Ave. grow.
DD	1258 (48.9)	1531 (51.8)	1695 (52.0)	2029 (54.6)	2251 (55.1)	2255 (51.8)	2496 (51.4)	2603 (50.8)	9.6
SD	799.6 (31.1)	849.5 (28.7)	974.5 (29.8)	1085 (29.2)	1267 (31.0)	1433 (32.9)	1639 (33.8)	1753 (34.2)	11.9
TD	515	576	592	602	564	667	719	765	6.1

	(20.0)	(19.5)	(18.2)	(16.2)	(13.8)	(15.3)	(14.8)	(14.9)	
Total	2572.6	2956.5	3261	3716	4082	4355	4854	5121	10.4

Table 10b: Deposit by type (Post-reform)

Million Birr

*Item	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	Ave. grow.
DD	2870 (50.6)	3461 (51.3)	4211 (52.7)	5530 (55)	6260 (52.3)	7343.5 (52.9)	9546.2 (53.8)	9076.9 (50.9)	17.4
SD	2086 (36.7)	2577 (38.2)	3005 (37.6)	3868.5 (38.3)	4984.7 (41.6)	5687.4 (41)	6483.7 (36.6)	7147 (40.1)	19.4
TD	716 (12.6)	712 (10.5)	776 (9.7)	712 (7)	731.1 (6.1)	847 (6.1)	1675.1 (9.5)	1611.8 (9)	13.3
Total	5672	6750	7992	10110.6	11975.9	13877.9	17705	17835.7	17.2

Source: NBE

*Figures in Brackets are percentage share.

DD= demand deposit

SD= saving deposit

TD= time deposit

The annual average growth rate of total deposits was 10.4% which was attributed mainly to the growth in savings deposit of 11.9% on average per annum before the reform beginning 1983/84. Although there was no interest earning on demand deposits, it was growing by 9.6% per year on average during the pre-reform period. Owing to the weak capacity of the economy to save for a long term during both periods and negative real rate of interest on resource mobilization before the reform, time deposits were growing slower than demand and saving deposits. Its annual average growth rate was 6.1% before the reform and 13.3% after the reform. Its percentage share in the total deposits is also very low during both periods for the same reason. The share of time deposit in the total was as high as 20% in 1983/84 and as low as 6.1% in 1995/96 and 1996/97. The proportion of demand deposits was ranging from 49% to 55% while that of savings deposits was from 29% to 42%. The trend in the share of savings deposits was increasing particularly after the reform due to positive real rate of interest.

The pre-reform period witnessed higher growth in the annual flow of funds to the specialized banks (CBB and DBE). This is because of forced saving by public enterprises and non-bank financial institutions that were required to put their deposits in specialized banks at the rate of interest far lower than the official deposit rate which was only 1%. The main purpose was to finance investment or provides credit to the socialized sector and urban housing construction at lower rate of interest.

Thus, the annual average growth rate of deposits of DBE, explained by time deposit was 30.2% while that of CBB was 14% before the reform beginning 1983/84 (see table 11). This is substantially higher than the growth in the deposits of commercial bank, which was 9.8% per year on average. Specialized banks were not primarily established for the purpose of mobilizing funds on commercial basis but to provide credit for priority sectors administratively. The commercial bank, Ethiopia's dominant baking institution especially in terms of deposit mobilization and credit operation, accounted for about 88% of total deposits on average before the reform beginning 1983/84 and about 91% after the reform. Although the growth of deposits in both DBE and CBB was faster than CBE before the reform, the share of DBE and CBB in total deposits were very small, accounting for 2.8% and 8.9% respectively.

Table 11a: Deposit by mobilizing Bank (Pre-reform)

Million Birr

Item	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	Average growth
All	2572.6	2956.5	3261.5	3716	4082	4355	4854	5121	

Banks									
CBE	2311 (89.9)	2684 (90.8)	2978 (91.3)	3264 (87.8)	3571 (87.5)	3777 (86.7)	4202 (86.6)	4415 (86.2)	9.8
DD	1258	1531	1695	2029	2251	2255	2496	2603	-
SD	761	813	940	1053	1208	1367	1575	1677	-
TD	292	340	343	182	112	155	131	135	-
CBB	213 (8.3)	223 (7.5)	236 (7.2)	320 (8.6)	376 (9.2)	441 (10.1)	469 (9.7)	521 (10.2)	14.0
DD	-	-	-	-	-	-	-	-	-
SD	38	36	34	32	59	66	64	76	
TD	175	187	202	288	317	375	405	445	
DBE	49 (1.5)	50 (1.7)	48 (1.5)	132 (3.6)	135 (3.3)	137 (3.1)	183 (3.8)	185 (3.6)	30.2
DD	-	-	-	-	-	-	-	-	-
SD	06.6	0.5	0.5	-	-	-	-	-	-
TD	48	49	47	132	135	137	183	185	-
PRIVATE	-	-	-	-	-	-	-	-	-
DD	-	-	-	-	-	-	-	-	-
SD	-	-	-	-	-	-	-	-	-
TD	-	-	-	-	-	-	-	-	-

Table 11b: Deposit by mobilizing Bank (Post-reform)

Item	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	Average growth
All Banks	5672	6750	7992	10111	11976	13878	17705	17835.7	
CBE	5022 (88.5)	6228 (92.3)	7436 (93.0)	9598 (94.9)	11194 (93.4)	12702 (91.5)	15519 (87.6)	15017 (84.2)	16.9
DD	2870	3461	4211	5504	6038	7065	9197.5	8579.5	
SD	1999	2451	2844	3649	4585	5090	56231	6000.1	
TD	153	316	381	445	571	547	697.5	437.3	
CBB	485 (8.6)	359 (5.3)	386 (4.8)	393 (3.9)	409 (3.4)	557 (4.0)	568.1 (3.2)	554.4 (3.1)	2.1
DD	-	-	-	11	38	37	26.8	39.9	
SD	87	126	161	201	219	261	256	265.3	
TD	396	233	225	181	152	259	285.3	249.2	
DBE	165 (2.9)	163 (2.4)	170 (2.1)	86 (0.8)	10 (0.1)	38 (0.3)	632 (3.6)	776.0 (4.4)	189.3
DD	-	-	-	-	9.4	36	29.6	15.0	
SD	-	-	-	-	-	2.1	2	2.1	
TD	165	163	170	86	0.3	0.1	600.4	758.9	
PRIVATE	-	-	-	34 (0.3)	363 (3.0)	581 (4.2)	986.8 (5.6)	1488.4 (8.3)	693.8
DD	-	-	-	15.1	174.7	205.5	292.3	442.5	292.1
SD	-	-	-	18.5	180.7	334.3	602.6	879.5	272.0
TD	-	-	-	-	7.8	40.9	91.9	166.4	453.4

Source: NBE

Note: figures in the brackets are shares of banks

CBE= commercial bank of Ethiopia

CBB= construction and business bank

DBE= development bank of Ethiopia.

Both the share and the growth of total deposits in DBE and CBB were attributed to the growth and share in time deposits, essentially due to restriction to maintain saving deposits by many organizations and institutions as well as the restriction to hold demand deposits during the pre-reform period. The growth of total deposits in CBB slowed down from 14% per year on average before the reform to 2.1% after the reform attributed mainly to the removal of forced savings. The recent faster growth rate of time deposits of DBE from 30.2% before the reform to 189% per year on average after the reform was mainly due to positive real interest rate. The annual average share of time deposits of the private banks in the total time deposits was 5.4% per year ranging from 1.1% in 1995/96 to 10.3% in 1998/99. The increase in both share and growth of time deposits in CBE and the decline in CBB was mainly due to the removal of forced savings in the specialized banks.

Deposit mobilization had gained greater momentum in all banks except CBB after the reform as the result of maintenance of real interest rate. The growth rate of total deposits increased from 10.4 % per year on average during pre-reform to 17.2 % after the reform. This growth is specially characterized by the annual average growth of total deposits in the CBE, which rose from 9.8% during pre-reform period to 16.9% during post-reform period.

The emergence of private banks since 1994/95 was a new feature in the development of financial sector in Ethiopia. The share of deposits in the private banks in the total deposits has shown increasing trend with annual average share of 4.3% ranging from 0.3% in 1994/95 to 8.3% in 1998/99 predominantly associated with the share in saving deposits.

The declining trend in the dominance of CBE in terms of share in the deposit mobilization is mostly attributed to the increasing share in the private banks. The average annual growth rate of deposits in these banks was 693.8% mainly associated with the growth in the time deposits.

Table 12 reveals the break down of deposit by ownership in the CBE since 1987/ 88. The annual average growth rate (5.3%) of demand deposits before the reform since 1987/88 was attributed to the growth in demand deposits of private and individuals, central government, domestic banks and non-residents.

Table 12a: mobilization of deposit by sector, CBE (Pre-reform)

Million Birr

	1987/88	1988/89	1989/90	1990/91	Ave. Growth (%)
Demand Deposits	-	-	-	-	-
Private and Individuals	393.1	417.4	476.9	528	10.4
Cooperatives	286.5	282.1	301.6	275.3	-1.2
Public Ent. and Agencies	935.9	988.3	1131.9	1073.1	5.0
Central Gov't	124.5	144.6	163.9	159.9	8.9
Domestic banks, and others	321.5	253.8	181.3	374.3	18.9
Foreign bank, their acct.	59.6	44.7	42.7	46.7	-6.6
Non Residents	99.9	93.4	107.2	128.3	9.2
Total demand Deposits(1)	2221	2224.3	2505.5	2585.6	5.3

Total demand deposits(2)					
% of National total(3)	98.7%	98.6%	100%	99.3%	
Saving Deposits					
Private and Individuals	1190.7	1351.9	1558.6	1661.9	12.6
Cooperatives	16.1	15	15.9	14.8	-2.4
Public Ent. & Agencies	1.2	-	-	-	-
Domestic Banks & other	-	-	-	-	-
Total saving deposits	1208	1366.9	1574.5	1676.7	11.7
% of National Total(3)	95.3%	95.4%	96.1%	95.7%	-
Time Deposits	-	-	-	-	-
Private & Individuals	102.3	110	122.4	129.9	-
Cooperatives	7.1	8.9	7.7	4.2	
Public Ent. & Agencies	-	-	-	-	-
Domestic Banks & other	2.4	36.4	0.7	0.7	
Total Time Deposits	111.8	155.3	130.8	134.8	9.1
% of National Total(3)	19.8%	23.3%	18.2%	17.6%	-
Total Deposits	3540.8	3746.5	4210.8	4397.1	7.5

Table 12b: mobilization of deposit by sector, CBE (Post-reform)

Million Birr

	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	Ave. Growth
Demand Deposits	–	–	–	–			(%)
Private and Individuals	700	761.6	1082.9	1426.83	1568.63	1568.51	20.9
Cooperatives	230	207.6	195.65	209.1	243.52	326.34	4.2
Public Ent. And Agencies	1258	1313.4	1540.57	1908.00	1690.66	2241.44	13.9
Central Gov't	235	307.2	443.02	568.90	823.92	798.06	31.9
Domestic banks, and others	268	312.4	304.51	341.23	471.68	278.84	-4.4
Foreign bank, their acct.	48	224.7	362.00	646.09	840.47	1315.69	99.6
Non Residents	106	202.2	244.77	377.65	308.68	353.39	27.0
Total demand Deposits(1)	2842	3132.6	3811.36	5448.4	5107.09	5578.21	16.7
Total demand deposits(2)	2887	3357	4173.36	6094.49	5947.56	6893.9	
% of National total(3)	99%		99.1%	98.8%	99.2%	96.7%	
Saving Deposits							
Private and Individuals	1983.8	2229		3611.59	4523.46	5019.88	
Cooperatives	15.2	17.8		29.82	72.98		

Public Ent. & Agencies	–	–	–	–		0.158	
Domestic Banks & other	–	–	–	18.18			
Total saving deposits	1999	2246.8	2844.3	3660.9	4596.44	5106.42**	20.4
% of National Total(3)	95.8%	–	94.64%	95.08%	95.45%	89.5%	
Time Deposits	–	–	–	–			
Private & Individuals	148.1	307.4		459.68	466.37	456.24	
Cooperatives	4.2	1.2	–	0.996	1.82	4.26	
Public Ent. & Agencies	–	–	–	7.82	95.02	25.84	
Domestic Banks & other	0.6	0.6	–	0.58	30.04	75.65	
Total Time Deposits	152.9	309.2	381.2	444.5	593.25	562.01	30.6
% of National Total(3)	21.4%	–	49.1%	62.5%	75.8%	64.6%	
Total Deposits	4993.9	5885.1	7375.9	9553.8	11200	12613.2*	19.3

Source: Alemayehu Geda,1999, pp. 144

* Total doesn't add up. This is attributed to deposits of foreign bank (1315.69) and trust funds, external finance (50.87), which are foreign currency balances converted at ruling exchange rate of the balance sheet data. In 1996/97 in the demand deposits total includes Resident account of 11.64.

* * Including government deposit of 86.38.

1. Values after and including 1993 here are given as reported on the balance sheet. The demand deposit figures reported in the text of the annual reports are very close to the sum which includes foreign banks, their account (probably this is assumed as demand

deposit).

2. Is the balance sheet figure plus foreign banks.

3. The percentages are computed from NBE Annual and Quarterly Reports. There are minor differences between the figures given by CBE and NBE about deposits of CBE.

Cooperatives and foreign banks have shown a decline of 1.2% and 6.6% respectively during the period. However, the 16.7% annual average growth of demand deposits after the reform ending 1996/97 associated with the growth in the demand deposits of private and individuals, central governments and non-residents. The substantial growth in the demand deposits of foreign banks was mainly due to the devaluation of exchange rate that appreciated foreign currency nominated accounts particularly in 1992/93 in the commercial bank. The demand deposits of public enterprises and agencies, the dominant depositor as a share of total demand deposit, grew at an average rate of 5% per year before the reform and 13.9% after the reform.

The growth of total saving deposits in the CBE (11.7% before the reform and 20.4% after reform) was associated with the growth of saving deposits of private companies and individuals during both periods mainly due restriction to maintain saving deposits by other institutions. In the same way the growth of time deposits was essentially attributed to the growth of private companies and individuals. The shares of saving and time deposits of private companies and individuals in their respective category were 98.6% and 91.5% in 1987/88 and 98.3% and 81% in 1996/97 respectively. The share of total deposits of private enterprises and individuals in the total deposits of CBE was 52.8% in 1990/91 and 55.9% in 1996/97. This suggests that the private sector is the biggest source of funds for the commercial bank of Ethiopia.

The major factors that seem to have contributed to the growth of deposits of commercial bank after the reform were: the conducive business environment favoring firms and individuals to use checking accounts; keeping the real deposit rate positive which would enable savers to gain real return. The absence of other alternative high-yielding monetary instruments to shift savings in the one hand and the growing inflow of foreign currency into the country coupled with further depreciation of the birr exchange rate enhanced the equivalent foreign currency denominated demand deposits on the other were also contributed.

4.3.2 Trends in saving and Investment

It is widely accepted that the financial system have played a significant role in producing the virtuous circle of high saving, investment and out put growth. In poor countries like Ethiopia, it requires historically unprecedented level of savings both from domestic and foreign sources. It was estimated that Ethiopia is required to ensure a saving rate of 16% of GDP to achieve a 10% growth rate of GDP (Annual Report on the Ethiopian Economy, 1999/2000:31). However, it has historically very low level of savings as a percent of GDP. Policy makers in the Imperial Regime identified traditional pattern of consumption as an important impact on savings and designed a policy of voluntary private saving in the first two national plans of the Imperial government (1957-62) and (1963-67). Still the ceremonious culture of the society with so many holidays and extravagant spending on these holidays and other occasions have been identified as an important factors to affect savings in Ethiopia. In fact, a very low-income situation of the society is the serious problem in affecting savings. Gross Domestic saving (GDS) as a percent of GDP had reached the highest figure of 13% in the last years of the Imperial regime (Berhanu and Seid, 1999:23).

The socialist regime believed in the increase in the GDS by reducing conspicuous consumption of the ruling class and the sacrifice it anticipated from the lower classes.

However, the policy of imposing capital ceiling actually became a serious disincentive to the saving class and further encourages conspicuous consumption on the one hand and there was monetary deepening on the other hand. Due to price control, increase in money supply induced savings as additional money in the hands of individuals were not used for keeping real money balances leading to higher savings. There was also no alternative investment opportunity that associated with the increase in money supply. Therefore, the GDS as percent of GDP was 7.5% per year on average during the pre-reform period beginning 1983/84, slightly higher than the post reform period of 6.1% (see the table below). The percentage before the reform had shown a significant fluctuation whereas it was steady and increasing trend during the post-reform period indicating that the raising deposit rate contributed a little to encourage savings. However, the reduction in the minimum deposit rate reduced the percentage of GDS from 9% in 1997/98 to 4.4% in 1998/99.

Table 13: Gross Domestic Saving (GDS), Gross fixed capital Formation (GFCF), Resource Gap, consumption and total Debt (1983/84-1998/99)

Year	GDS as % of GDP	GFCF as % of GDP	Resource GAP	External debt as % of GDP	Debt service ratio	Public consumption as % of GDP	Private consumption as % of GDP	Total consumption	National Saving as % of GDP(At current market price)
1983/84	8.1	16.8	-8.7	31.7	16.1	17.3	73.6	91.9	10.9
1984/85	2.8	10.7	-7.9	33.8	24.8	15.3	81.8	97.1	6.5
1985/86	8.6	16.4	-7.8	36.1	25.6	15.8	75.6	91.4	13.1
1986/87	7.6	15.6	-8.0	37.4	37.2	15.7	76.7	92.4	10.3
1987/88	12.5	20.4	-7.9	41.3	43.5	18.1	69.4	87.5	14.2
1988/89	8.9	14.4	-5.5	41.2	39.2	19.4	71.7	91.1	11.3
1989/90	7.9	12.5	-4.6	43.1	58.9	19.2	72.9	92.1	9.9
1990/91	3.4	10.4	-7.0	39.1	69.9	16.5	80.1	96.6	5.6
Average	7.5	14.7	-7.2	38.0	39.4	17.2	75.3	92.5	10.2
1991/92	3.0	9.2	-6.2	31.5	82.5	10.5	86.9	97.4	7.0
1992/93	5.6	14.2	-8.6	70.4	53	11.2	83.8	95	12.9
1993/94	5.0	15.2	-10.2	90.8	56.9	11.7	83.8	95.5	11.4
1994/95	6.7	16.4	-9.7	81.8	36.7	11.6	82.5	94.1	16.4
1995/96	6.6	19.1	-12.5	71.4	34.5	11.7	82.5	94.2	15.6

1996/97	8.3	19.1	-10.8	63.9	40.5	12.1	80.7	92.8	15.0
1997/98	9.0	20.2	-11.2	61.8	15.7	12.4	39.7	94.1	16.8
1998/99	4.4	17.8	-13.4	-	-	7.9	80.8	95.7	9.8
Average	6.1	16.4	-10.3	67.4	45.7	12.0	82.6	94.6	13.1

Source: MEDaC and NBE Annual bulletin: various issues.

Gross capital formation (GCF) as percent of GDP was 14.7% per year on average during the pre-reform period. The percentage rose to 16.4% during the post-reform period. The gap between investment and domestic saving (the resource gap) averaging 7.2% and 10.3% before and after the reform respectively, requiring foreign saving that came in the form of grants and loans from other countries. This is reflected in the Ethiopia's debt burden, which is measured by the country's external debt as percent of GDP increased from 31.5% in 1991/92 to a peak of 91% in 1993/94 with average of 67.4% per annum during the post-reform period ending 1997/98. It is substantially higher than the ratio in the pre-reform period of 38%. However, the majority of both savings and the external debt used to finance military expenditure during the pre-reform period. Hence, public consumption as percent of GDP was 17.2% on average before the reform, a substantially higher than 12% after the reform. As the result private consumption as a percent of GDP increased from 75.3% during pre-reform to 82.6% after reform.

National saving as a percent of GDP was 10.2% during the pre-reform period increased to 13.1% on average per year during the post-reform period. The increase in the national savings is mainly associated with the growing transfer from other countries. In absolute terms, without any adjustment in the exchange rate, national savings rose from Birr 1.1 billion in 1990/91 to Birr 7.6 billion 1997/98.

4.4 Credit Allocation

Under socialism, until May 1991, the monetary and financial policies of government were directed to fulfil the annual plans. The state farms and cooperatives were not required collateral security when loans were granted. The balance sheet of the DBE at end of 1991 indicates that its outstanding loan was Birr 3.0 billion of which 80% was for the state farms (Annual Report on Ethiopian Economy, 1999/2000:294). Among its loans to the state farms and public enterprises about 92% and 38% were non-performing at the end of 1991, respectively (ibid). Keeping the nominal lending rates artificially lower than the market clearing was invited the diversion of credit from the most efficient investment by the private sector to the inefficient public sector.

Table 14: Structure of lending rate (by CBE and specialized banks) (%)

Sector	Through June 30,1986	July 1, 1986-Sep.30,1992			Post reform	
		Cooperatives	State	Private	Oct.1, 1992-Aug.31, 1994	Spt.1,1994-July 1,1995
Agriculture	9-10.5	5	6	7	11-12	Lending to all sectors:14-15
Industry, mining, power resources	9.5	6	8	9	13-14	Lending to the central government:12-13
Domestic Trade	9.5	6	8	9.5	14-15	National bank lending to :
Transport & Communications	9.5	6	8	8	13-14	CBEs(discount rate) 10.5
Export trade	9.5	6	6	6	13-14	Other financial institutions 10.5
Import trade(agricultural Inputs)	8.5	5	6	7	14-15	Inter-bank lending 10.0
Import Trade(other)	9.5	6	8	9.5	14-15	
Hotels and tourism	9.5	6	8	9	14-15	
Construction	9.5	6	8	9	11-12	

Housing 1. Purchase	10	6	6	8	11-12	
2. Construction	9	4.5	4.5	7	11-12	
Central government	3-5	-	3-5	-	12-13	
Banks and financial institutions	5-6.5	-	2.5-4	-	10	
Personal loan	10	-	-	10	14-15	

	Jan.2,1995- Nov.30, 1995	Dec.1,1995- May 30, 1996	July 1,1996- SEP.15,1996	SEP.16,1996 -dec.31,1997	Jan.1,1998- todated
Maximum lending by commercial banks & other financial institutions, except for central gov't	15	16	15	10.5	Liberalized
Central Government	12	12	12	12	12

Source: NBE, Quarterly Bulletin, fourth Quarter, 1998 and Annual Report on Ethiopia Economy 1999/2000:288

Since July1, 1986 the previous government reduced lending rate for all categories of borrowers with the exception of personal loans and lending to the central government which kept at 10% and 3-5 % per year respectively. Regardless of the economic sector for which credit was channeled, cooperatives were the most favored borrowers followed by public enterprises since July1986. During the post-reform period (especially Oct.1992 to Aug.1994) banks were allowed to determine lending rate within the given range. Gradually banks were further allowed to determine lending rate to all sectors without discrimination among sectors with given maximum (Sep.1, 1994 – Jan.1995). The rate was deregulated since Jan.1, 1998.

The clients of bank credit other than the central government are classified into three broad categories, namely the private sector, government-owned public enterprises, and cooperatives.

Table 15a: credit Disbursement by client and Source (Pre-reform)

Million Birr

Client	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	Ave. Growth
Public Enterprise	694	478.9	454.4	482.4	517.4	454	387.5	207.5	-13.7
Coopera	76.3	35	60.2	94.2	169	178	139.7	119.8	17.7

t.									
Private	285	230.3	211.1	172.4	205.4	187.6	204.3	216.5	-3.0
Total	1055	744.2	725.7	749	891.8	819.6	731.5	543.8	-7.7
Sources	1055	744.2	725.7	749	891.8	819.6	731.5	543.8	Share
CBE	643	404.4	361	411.3	438.6	416	337.9	340	53.6
DBE	363	300.4	345.2	301.4	342.9	330	315.6	156	39.1
CBB	49.4	39.4	19.5	36.3	110.3	73.6	78	47.9	7.3
Private Banks	-	-	-	-	-	-	-	-	-

Table 15b: credit Disbursement by client and Source (post-reform)

Million Birr

Client	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	Ave. Growth
Public Enterprise	229.8	627.8	239.7	216.8	621	379.1	164	185.9	27.3
Cooperat.	74	124.7	99.4	425.4	524.7	494.5	550	933.8	54.6

Private	247.1	723.8	1411	2695.9	2947.9	3145.3	3867	3077.7	51.4
Total	550.9	1476.3	1750.1	3338.1	4093.6	4018.9	4581.3	4197.4	38.4
Sources	550.9	1476.3	1750.1	3338.1	4093.6	4018.9	4581.3	4197.4	Share
CBE	364.3	1271	1455	2886.8	3436.5	3004.9	2586.2	2501.2	74.6
DBE	158.4	165	185.2	336.3	447.7	595	1137.7	840.2	16.4
CBB	28.2	40.4	109.9	115	209.4	179.1	63	33.5	3.7
Private Banks	-	-	-	-	-	240.2	794.2	922.5	15.1

Source: NBE

Credit to the central government witnessed a substantial growth due to widening government budget deficits before the reform. Thus, credit to the non-central government (i.e. Private sector, public enterprises, and cooperatives) exhibited declining trend at an average annual rate of 7.7% during pre-reform period beginning 1983/84. This was associated with the decline in the credit to the private sector at average annual rate of 3% and the public enterprises at the rate of 13.7% before the reform. The falling in the growth rate of private sector was mostly because of the restriction of private activity on the one hand, and bureaucratic procedures in the financial process such as strict collateral requirement, lengthy paper works and regulations on the other hand as well as higher interest rate on loan as the result of discrimination. Inspite of the attention paid to public enterprises, their credit intake has shown declining tendency mainly due to huge government capital budget allocated to them when new investment and expansion of these enterprises were undertaken. Credit to cooperatives, however, has shown a steady increase at average annual growth rate of 17.7% during the pre-reform period beginning 1983/84.

The reform removed the restriction on the private sector and allowed banks to determine their lending rate to all sectors without discrimination. This has been ensured though amending the investment code, relaxation of business licensing requirements and regulations. These measures have been successful in shifting the flow of financial resources to the more efficient sectors. This is evidenced by the change in the structure of credit disbursement after the reform. The average annual share of credit to the private sector stood from 28% before the reform to 70.4% after the reform while that of public enterprises reduced from 57.7% during pre-reform to 17% during the post-reform period. This is the result of the on going privatization of public enterprises and limited new investment in these enterprises as well as removal of restriction on the private sector. Immediately after the reform, the share of private sector rose substantially from 49.1% in 1992/93 to 80.6% in 1993/94 while the public enterprises drastically dropped from 42.5% to 13.7% during the same period and even dropped further to only 3.4% in 1997/98. The share of cooperatives was reduced from 14.3% per year on average before the reform to 12.5% after the reform.

The annual average growth rate of total credit has shown increasing trend of 38.4% after the reform from the declining trend of 7.7% before the reform. As soon as the reform took place, the highest growth was registered in the total credit disbursed at the rate of 170% per year on average in 1992/93 which is associated with the growth of 193% in the private sector 174% in the public enterprises and 69% in the cooperatives.

As far as the source of credit is concerned, with the elimination of discriminatory credit to public enterprises through the specialized banks (DBE and CBB), a substantial portion of loans after the reform came from CBE accounting for 74.6% on average, rose from 53.6% before the reform. Hence, the average annual share of credit disbursed by DBE and CBB was 39.1% and 7.3% of the total respectively during the pre-reform period since 1983/84. The average annual share of these banks, however, reduced to 16.4% for the DBE and 3.7% for the CBB after the reform. This was due to a significant increase in the share of CBE as the result of abolition of preferential loan to public enterprises from the specialized banks.

It is impressive to notice that private banks have gained a greater momentum in channeling credit in the recent years. With in four years of their deposit mobilization and three years of credit disbursement the share of private banks in the total loan disbursement reached 22% by 1998/99. The annual average share for the three years was 15.1% much higher than the share in annual average deposit mobilization accounting for 4.3% for the four years.

Table 16 exhibits sectoral disbursement of loans during both periods. The annual average rate of decline in the total credit by 7.7% in the above discussion had been experienced by the agricultural sector and internal trade, which exhibited the largest share and the highest decline during the pre-reform period.

The average annual rate of decline of credit to agriculture was 12% while that of international trade was 14.3% which were accounting for 32.8% and 17.6% of total volume of credit respectively during 1983/84-1990/91. The industrial sector, domestic trade, and housing and construction registered annual average growth rate of 9.5%, 9.8% and 15.5 in which their shares were 14.7%, 15.8% and 9.4% respectively before the reform beginning1983/84.

Table 16a: Loan Disbursement by sectors (Pre-reform)

Million Birr

	1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	Ave. Growth
SECTORS	1055.4	744.2	725.7.	749	891.8	819.6	731.5	543.9	-7.7
Agriculture	331.6	266.6	326.4	272.3	358.4	234.9	222.7.	83.1	-12.0
Industry	95.8	105.9	82.7	80.3	82	176.8	145.3	117.4	9.5
Domestic Trade	123.8	81.1	129.9	101.6	93.6	161.6	110.6	145.8	9.8
Int. Trade	336.6	158.3	92.9	154	132	129	83.3	67.1	-14.3
Export	85.8	77.8	76.8	49.5	59.8	71.9	57.5	46.3	-11.3
Import	250.8	80.5	16.1	104.5	72.2	57.1	25.6	20.9	40.4
Housing &Con.	70.2	59.6	31.1	49.5	139	88.1	95.9	54.1	15.5
Others	78.1	58.9	45.6	62.2	74.4	38.9	43.9	55.7	

Table 16b: Loan Disbursement by sectors (Post-reform)

Million Birr

	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	Ave. Growth
SECTORS	550.9	1476.4	1750.1	3338.1	4094	4018.9	4581.3	4197.4	38.4
Agriculture	119.4	125.1	92.5	461.3	664.4	679.8	830	992.9	63.3
Industry	112.5	426.7	325.4	271.3	484.5	387.6	680	512.6	42.9
Domestic Trade	148.9	381.8	741.2	1249.7	1490.	1274.4	1035	1071.4	36.8
Int. Trade	38.4	273.4	111.5	255.6	614.6	673.9	1030	566.6	52.3
Export	27.6	127.4	49.3	111.2	255.7	317	215	136.8	67.2
Import	10.8	146	62.2	144.4	258.9	356.8	815	429.8	181.7
Housing &Con.	62.1	57.9	123.7	124.8	130.3	194.7	130	128.8	19.5
Others	58.1	188.4	328.1	948	809.7	808.5	595	925.1	

Source: National Bank of Ethiopia

The flow of credit to the industrial sector, domestic trade, and housing and construction has been gained even greater momentum since 1991/92 with annual average growth rate of 42.9%, 36.8% and 19.5% respectively. Credit to the agricultural sector and international trade grew at an average rate of 63.3% and 52.3% per year respectively from their declining trend during the post-reform period. The proportion of total credit extended to the agricultural sector and international trade, however, declined from 32.8% and 17.6% prior to the reform to 15.5% and 13.4% per annum respectively on average after the reform. The annual average share of credit to the industrial sector and domestic trade rose from 14.7% and 15.8% during pre-reform period to 15.6% and 31.1% during post-reform period respectively.

The loans and advances to both government and non-government to deposits were 14% per year on average with declining trend during the pre-reform period. The trend was reversed with annual average rate of 19% after the reform due to substantial increase in the demand for credit. The declining trend before the reform reflects lower lending to the private sector and severe foreign exchange constraint.

In general, most of the credit was channeled to the domestic trade (31%) followed by the industrial sector (15.6%) after the reform, which was directed to the agricultural sector (33%) through interest rate subsidy before the reform. This reflects the diversion of credit to the most efficient investment activity in the domestic trade and industrial sector after the reform from the inefficient investment in the agricultural sector, particularly the state farms that absorbed the majority of the credit disbursed before the reform. The reform did not only improve the quality of investment but also it increased the quantity of investment demonstrated by the substantial increase in the volume of credit disbursed. The amount of total credit disbursed rose from Birr 0.6 billion at the beginning of the reform (1991/92) to Birr 4.2 billion in 1998/1999 (by seven fold) in the eight years. It is also impressive to notice that the majority of this credit was disbursed to the private sector, the most efficient sector, through commercial banks after the reform. It is safe to conclude that much of the increased credit came from the funds that were rotating in the informal market due to low real deposit rates in the formal financial sector during the pre-reform period, keeping the liquidity position remains constant. Thus, the financial liberalization in Ethiopia results in improvement in the allocative efficiency.

4.5 Operational Efficiency of the banking sector

4.5.1. Interest rate margin

A good measure for the operational efficiency of banking sector is the cost of financial intermediation. This is expressed by the spread between the deposit and lending rate. Financial liberalization leads to an increase in both the effective deposit and lending rate in the short run and an increase in effective deposit rate and a decrease in the effective lending rate in the long run due to increased competition. Thus, the long-run effect of financial liberalization is an improvement in the operational efficiency of banks.

Table 17: Interest rate margin

	Jan.21995 -Nov.1995	Dec.1,1995-May.30,1996	June 1,1996-Sep.15,1996	Sep.16,1996 - Dec.31,1997	Jan.1, 1998-Todate
Maximum lending rate by commercial banks and other financial institutions, except	15	16	15	10.5	Liberalized (10.5-12.0 as 4th Quarter of

for central Gov't loan					1998/99)
Central Gov't loan	12	12	12	12	12
Minimum Interest rate on Time and Savings Deposits	10	11	10	7	6
Interest rate margin for non-central Gov't loans	5	5	5	3.5	4.5-6.0
Interest rate margin for central Gov't loans	2	1	2	5	6

Source: organized from table 9 and 14

The interest rate margin for non-central government loans began to narrow since sep. 16,1996 because of substantial reduction in the maximum lending rate. However, it started widening since Jan1, 1998 mainly due to the decrease in the deposit rate. The margin for loans to the central government was even started widening at a greater rate over time. Although the interest rate is not weighted average, there is an indication that no improvement in the operation efficiency of banks. It needs further liberalization of interest rates.

As we have seen in the above discussions, there were various liberalization efforts in the financial sector under the strategy of gradualism and strengthening domestic competitiveness before the sector is fully liberalized. However, there are many problems with this approach. International financial institutions, the IMF and the World Bank, which advocate financial liberalization, are not satisfied with the liberalization efforts and hence the IMF has temporarily suspended its support. Although we are behind the schedule set in the policy framework for various reasons, this as a whole had not led to disagreement. In general, Ethiopia is not in a good shape to compute if something is done on the commercial bank for its dominance and allow foreign banks to enter. It takes time to privatize the commercial bank and allow entry of foreign banks. Even though it is not enough, the improvement in the performance of overall economy and the strategy of gradualism and its over overall reform direction need to be appreciated and be supported by the IMF and the World Bank.

4.5.2 Bank profitability

The structure of income and expenses has undergone a substantial change in the last few years. Table 18 shows the consolidated profit and loss accounts of banks since 1989/90. Net interest income (interest income minus interest expense) and non-interest income minus tax gives ‘net income after tax’. Non interest income comprises of service charges and commission income and other income. Total non-interest expenses include employee’s salary and general expenses.

Table 18: Trend in the profitability of banks (000 Birr)

Year*	Banks***	Net Income after tax	Total Non Interest Expenses	Net Profit/Loss	Net Profit/loss per Loan
1989/90	CBE	125903	88376	37527	111.1
	DBE	79614	146032	-66418	-210.4
	CBB	13578	8585	4993	64.0
	PRIVATE	-	-	-	
	ALL BANKS	219095	242993	-23898	-35.3
1990/91	CBE	100263	86926	13337	39.2
	DBE	81888	103904	-22016	-141.1
	CBB	12391	12695	-304	-6.3
	PRIVATE	-	-	-	
	ALL BANKS	194542	203525	-8983	-108.2
1991/92	CBE	120687	84849	35838	98.4
	DBE	80655	160991	-80336	-507.2
	CBB	12476	12320	156	5.5
	PRIVATE	-	-	-	
	ALL BANKS	213818	258160	-44342	-403.3
1992/93	CBE	193301	141705	51596	40.6
	DBE	93328	207309	-113981	-690.8
	CBB	9927	9724	203	5.0
	PRIVATE	-	-	-	
	ALL BANKS	296556	358738	-62182	-645.2
1993/94	CBE	288614	120931	167683	115.2
	DBE	31839	42564	-10725	-57.9
	CBB	388	8554	-8166	-74.3
	PRIVATE	-	-	-	
	ALL BANKS	320841	172049	148792	-17.0

1994/95	CBE	427728	217350	210378	72.9
	DBE	52599	17285	35314	105.0
	CBB	12457	10430	2027	17.6
	PRIVATE(Awash)	6537	3423	3114	
	ALL BANKS	499321	248488	250833	195.5
1995/96	CBE	535154	178234	356920	103.9
	DBE	73863	19810	54053	120.7
	CBB	25798	16989	8809	42.1
	PRIVATE(Awash	15442	8627	6821	
	ALL BANKS	650257	223654	426603	266.7
1996/97	CBE	548272	514483	33789	11.2
	DBE	66318	50649	15669	26.3
	CBB	22903	20692	2211	12.3
	PRIVATE	45890	35927	9963	41.5
	ALL BANKS	683383	621751	61632	91.3
1997/98	CBE	779169	458023	321146	124.2
	DBE**	79338	53776	25562	22.5
	CBB	28230	21100	7130	113.2
	PRIVATE	58712	45628	13084	16.5
	ALL BANKS	945449	578527	366922	276.4

Source. NBE and table 15

*Fiscal year ending: June income statement (Audited)

** 1997/98 figure for DBE was not audited.

*** Two newly established private banks are excluded.

The major share in the total expense account of banks was interest payment accounting for 50.7% per year on average during 1989/90-1996/97. The proportion of interest income to the total income of all banks accounted for 82% per annum on average during the same period. Thus, the analysis of the structure of income and expense accounts is predominately justified by the interest income and expense.

The last two years before the reform and the first two years after the reform exhibited loss in all banks due to loss posted by the DBE. The CBE, the dominant institution in the banking industry, has made a significant profit throughout the year under consideration. The annual average growth rate of the net profit of CBE was 160.8% during 1989/90-1997/98. The growth in the profit was mainly attributed to the interest rate reform.

The DBE has registered a significant loss during 1989/90 to 1993/94 because of low interest rate mainly for agricultural sector for which the bank was established. Provision for doubtful loans were also very large on the expense accounts. However, after the elimination of interest rate discrimination among sectors since August 1994, the bank has made a large net profit. The annual average growth of net profit per loan of the DBE was 50.9% for four years since 1994/95. The CBB has made a net profit except for the loss it exhibited in 1990/91 and 1993/94. Thus, the net profit per loan of all banks grew by annual average rate of 355.8% for four years after the loss they had made for five years since 1989/90. Hence, the operational efficiency of the banking sector was improved in terms of profitability in the last few years although financial liberalization mostly leads to lower profit after reform period due to increased competition.

4.5.3 Productivity of banks

One of the indicators of productivity is the deposit mobilized or loan disbursed per employee in the banking industry. An employee mobilized deposits amounting Birr 0.108 million on average before the reform beginning 1983/84 rose to Birr 0.234 million on average after the reform.

Table 19a: Total Deposits and Loans per Employee (Pre-reform)

		1983/84	1984/85	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	Aver. (real)
CBE	Deposit	2311	2684	2978	3264	3571	3777	4202	4415	
	Loan	643	404	361	411	439	416	338	340	
	No of employees	4080	4325	4459	4570	4700	4829	4894	4856	
	Deposit/emp.	0.57	0.62	0.67	0.71	0.76	0.78	0.86	0.91	0.116
	Loan/emp.	0.16	0.09	0.08	0.09	0.09	0.09	0.07	0.07	0.014
DBE	Deposit	49	50	48	132	135	137	183	185	

	Loan	363	300	345	301	343	330	316	156	
	No of employees	3.80	404	433	521	593	670	723	775	
	Deposit/emp.	0.13	0.12	0.11	0.25	0.23	0.24	0.25	0.24	0.031
	Loan/emp.	0.96	0.74	0.80	0.58	0.58	0.49	0.44	0.20	0.094
CBB	Deposit	213	223	236	320	376	441	469	521	
	Loan	49	39	20	36	110	74	78	48	
	No of employees	315	323	348	425	443	470	510	547	
	Deposit/emp.	0.66	0.69	0.68	0.75	0.85	0.94	0.92	0.95	0.0127
	Loan/emp.	0.16	0.12	0.06	0.08	0.25	0.16	0.15	0.09	0.020
All Banks	Total deposit	2573	2957	3262	3716	4082	4355	4854	5121	
	Total loan	1055	744	726	749	892	820	732	544	
	No of employee	4775	5052	5240	5516	5736	5969	6127	6138	
	Deposit/emp.	0.54	0.59	0.62	0.67	0.71	0.73	0.79	0.83	0.108
	Loan/emp.	0.22	0.15	0.14	0.14	0.16	0.14	0.12	0.09	0.024

Table 19b: Total Deposits and Loans per Employee (Post-reform)

		1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	1998/99	Ave. (real)
CBE	Deposit	5022	6228	7436	9596	11194	12702	15518	15017	
	Loan	364	1271	1455	2887	3437	3005	2586	2501	
	No of employees	4691	4771	4660	4538	4733	4899	5159	5718	
	Deposit/emp.	1.07	1.31	1.60	2.12	2.37	2.59	3.01	2.63	0.339
	Loan/emp.	0.08	0.27	0.31	0.64	0.73	0.61	0.50	0.44	0.073
DBE	Deposit	165	163	170	86	10	38	632	776	
	Loan	158	165	185	336	448	595	1138	840	
	No of employees	781	803	761	805	840	875	842	803	
	Deposit/emp.	0.21	0.20	0.22	0.12	0.01	0.04	0.75	0.97	0.052
	Loan/emp.	0.20	0.21	0.24	0.42	0.53	0.68	0.35	1.05	0.096
CBB	Deposit	485	359	386	393	409	557	568	554	
	Loan	28	40	110	115	209	179	63	34	
	No of employees	539	559	570	571	617	668	667	-	
	Deposit/emp.	0.90	0.64	0.68	0.69	0.66	0.83	0.85	-	0.122
	Loan/emp.	0.05	0.07	0.19	0.20	0.34	0.27	0.09		0.028
All	Total	5672	6750	7992	10075	11613	13297	16718	16347	

Banks	deposit									
	Total loan	551	1476	1750	3338	4094	3779	3787	3375	
	No of employee	6011	6133	5991	5914	6190	6442	6668	-	
	Deposit/employee	0.94	1.10	1.33	1.70	1.88	2.06	2.51	-	0.234
	Loan/emp.	0.09	0.24	0.29	0.56	0.66	0.59	0.57		0.070

Source NBE, CBE, DBE, CBB, and table 1.

The improvement in the productivity of workers in the banking industry has shown increasing trend regarding deposit mobilization. This was mainly attributed to deposit mobilize per worker in the CBE with average annual amount of Birr 0.116 million during the pre-reform period increased to Birr 0.339 million during the post reform period. There was also an improvement in the productivity of employees regarding deposit mobilization in the DBE with annual average amount of Birr 0.031 million per worker before the reform to Birr 0.052 million per worker after the reform.

Total loan disbursed by each employee which was Birr 0.024 million on average per year during the pre-reform rose to Birr 0.070 million during the post reform period ending 1997/98. This was mostly reflected in the increase of loan per worker in the CBE from annual average amount of Birr 0.014 million before the reform to Birr 0.073

million after the reform ending 1998/99. Loans disbursed by each employee also increased in both the CBB and DBE.

Thus, there was increase in the productivity of workers in the banking industry regarding deposit mobilization and credit disbursement. Hence, there was an improvement in the operational efficiency of banking sector. The main factors that contributed for the improvement of productivity were:

1. The increasing use of computer technology that improves the efficiency of workers with a small increase in the number of employees.
2. Increased training programs, mainly arranged by the Ethiopian Institute of Banking and Insurance with emphasis on commercial banking operations, and
3. The positive real rate of interest encouraged savings to be mobilized and hence credits to be disbursed.

4.5.4 Loan collection

Following the reform program, the government found that the collection of loans that had remained unpaid during the previous regime as important issue. Loan recovery recognized as the most important factor affecting the profitability of banks. In terms of institutional disaggregation, the most important sector in repaying its loans was the private sector that accounted for about 66% of the total after the reform ending 1994/95 Jumped from 44% before the reform beginning 1987/88 in the CBE. However, the most important borrowers in repaying their loans in the DBE were cooperatives before the reform and public enterprises after the reform. The share of loan repayment mainly depends on the volume of loan disbursement to each borrower. The majority of credit disbursed was to public enterprises for which its repayment was not that much higher in the CBE and even lower than cooperatives in the DBE before the reform.

Table 20a: Loan collection by sector and Beneficiaries (Pre-reform)

(Million Birr)

CBE	1987/88	1988/89	1989/90	1990/91	Ave. growth
Agriculture	62.2	39.5	20.8	5.0	7.7
Industry	43.9	43.1	66.5	59.3	13.9
Domestic trade	85.6	147	106.2	132.3	30.5
Export	49.1	53.5	56.7	27.9	13.2
Import	100.3	71.4	31.1	39.6	15.3
Hotels & Tourism	8.9	8.6	11.8	12.6	2.8
Transport & communication	20.2	45.9	37	26.5	8.3

Building & construction	18.3	12.7	11.8	5.9	3.1
Private(personal)	12	7.2	14.4	18.1	3.4
Other services	4.2	5.6	6.9	7.7	1.6
Total	404.8	435.4	384.2	335.8	100%
growth rate %		7.6%	-11.8%	-12.6%	-
Private	152.9	162.7	182.9	170.6	43.5
Public	185.0	216.8	163.5	124.5	43.9
Cooperatives	66.8	55.0	36.5	39.8	12.6
DBE					
Agriculture	147.47	111.52	119.24	82.62	72.6
Industry	35.35	16.34	23.23	45.75	19.0
Others	5.35	9.79	15.08	21.35	8.4
Total	188.17	137.65	157.55	149.72	100%
Growth rate %		-26.8	14.5	-5.0	-
* public	68.9	35.2	56.2	40.2	43.8
*cooperatives	53.4	63.95	66.4	54.7	53.4
*private	2.1	2.4	3.7	4.0	2.8
Total	124.4	101.55	126.3	98.9	100%

Table 20b: Loan collection by sector and Beneficiaries (post-reform)

(Million Birr)

CBE	1991/92	1992/93	1993/94	1994/95	1995/96	1996/97	1997/98	Ave. Growth
Agriculture	4.8	3.5	31.94	214.14	295.38	258.3	282.0	7.1
Industry	43.4	133.2	355.8	254.8	220.9	184.7	152.3	14.3
Domestic trade	131.6	217	522.85	974.12	999.03	1132.8	810.9	41.0
Export	36.4	46.8	127.47	90.93	204.93	229.43	198.1	8.4
Import	14.2	33.8	67.77	166.11	230.52	275.3	246.5	7.8
Hotels & Tourism	17.3	30.9	64.6	101.4	166.8	101.9	83.9	5.1
Transport & communication	25.8	24.4	68.15	98.4	201.7	258.5	253.2	7.3
Building & construction	27.4	8.33	19.15	13.9	14.35	22.14	27.29	2.1
Private(personal)	11.6	18.2	28.7	32.5	32.75	32.46	31.57	2.1
Other services	15.3	19.3	48.97	93.66	116.69	164.29	127.1	4.7
Total	329.9	537.1	1335.4	2039.96	2483.05	2659.82	2212.86	100%
Growth rate %	-1.8%	62.8%	148.6%	52.8%	21.7%	7.1%	-16.8%	-
Private	207.4	326.9	858.4	1517.0	-	-	-	65.9
Public	109.7	160.1	422.2	282.6				27.3
Cooperatives	12.1	49.2	36.0	239.4	-	-	-	6.8

DBE								
Agriculture	53.25	61.72	32.8	139.6	174.2	296.8	330.9	52.2
Industry	11.91	42.02	63.2	73.8	108.35	110.5	121.1	30.1
Others	18.83	25.68	35.0	15.5	31.91	31.4	45.8	14.7
Total	83.99	129.4	131.6	228.9	314.6	438.7	497.8	100%
Growth rate %	-40.6	45.4	1.7	73.9	37.4	39.4	13.5	-
* public	50.95	82.1	96.8	55.2	88.7	59.3		46.1
*cooperatives	14.5	25.0	27.0	128.8	156.0	238.2		36.4
*private	3.6	22.3	7.8	44.9	69.9	141.2		17.1
Total	69.1							100%

Source: Alemayehu (1999) and DBE: Annual Report

Note: for lack data, 1987/88 – 1991/92 institutional disaggregation is based on principal repayment only.

The CBE disbursed the majority of loans mostly to the private sector and also collected the highest proportion from this sector after the reform. This reflects the increase in the efficiency of loan collection by the banks as well as repayment readiness of private individuals and businesses.

Before the reform, the CBE disbursed the majority of its loans to the import sector but collected only half the share of loan collection from the domestic trade. However, the CBE disbursed the largest portion of its loans to the domestic trade and collected the highest share from the same sector (41%) after the reform. The annual average rate of loan collection was declined by 5.6% in the CBE and 5.8% in the DBE before the reform. However, the loan collection grew at 39.2% in the CBE and 24.5% in the DBE after the reform. This also shows an improvement in loan collection by the banks and increasing tendency of repayment by the borrowers.

CHAPTER FIVE

CONCLUSION AND RECOMMENDATION

5.1. Conclusion

The miserable underdevelopment of Ethiopian economy is mainly attributed to policy failure in the last decades. In addition to very poor performance of the overall economy observed in the last decades, there has been no change in the structure of the economy. The real GDP grew at an annual average rate of only 1% substantially behind the population growth rate of 3%, leading to the net decline in per capital income of about 2% in the last eight years of the previous government. However, an improvement in the economic performance has been registered after the economic reform in 1992/93. The annual average growth rate of real GDP was 5.8% in the last eight years (1992/93-1998/99).

The performance of the financial sector is one of the special phenomenon that accounted for a large part in the overall economic development. Thus, the main purpose of this study is to compare and contrast the performance of the financial sector before and after the economic reform.

The share of bank claims on the central government reduced from 67% in 1990/91 to 45% in 1998/99 indicating the reduction of the crowding out effect of government borrowing from banking system. The foreign assets of the banking sector have increasingly become the important determinant of the expansion of M_2 which accounted for 0.7% of M_2 in 1989/90 rose to 33% in 1994/95.

The growth in the M_2 did not consistent with the growth in the nominal GDP before the reform. This growth was mainly attributed to the growth in M_1 as the result of faster growth in the currency in circulation. The growth in the Quasi money is associated with the faster growth in saving deposit (20%) and time deposit (30%) after the reform for which the saving deposit was growing at the rate of 13% and time deposit was declining at 5% before the reform. The faster growth in saving and time deposits during the post-reform period was primarily characterized by the interest rate reform. Thus, financial liberalization encourages people to hold their financial assets in the form of saving and time deposits rather than cash.

With regard to mobilizing bank, especially for non-government deposits, the annual average growth rate of total deposit was 10.4% mainly associated with the growth in saving deposit (12%) in which the demand deposit and time deposit were growing at slower rate of 9.6% and 6% respectively before the reform. Deposit mobilization had gained greater momentum in CBE and DBE after the reform mostly due to the growth in the CBE from 9.8% during pre-reform period to 16.9% during the post-reform period. The CBE, Ethiopia's dominant banking institution particularly in terms of deposit mobilization and credit operation, accounted for about 88% of total deposit on average before the reform and about 91% after the reform. However, it has shown declining trend in the very recent years after the emergence of private banks since 1994/95. The pre-reform period witnessed higher growth in the annual flow of funds to the specialized banks (DBE& CBB), owing to the forced saving by some institutions at deposit rate far below the market cleaning to provide credit to socialized sectors at subsidized interest rate.

As far as sectroral disaggregation is concerned, the share of total deposits of private business enterprises and individuals in the total deposits of CBE was 52.8% in 1990/91 and 55.9% in 1996/97. This indicates that the private sector is he biggest source of funds in the CBE.

In general, the major factor that seem to have contributed to the growth of deposits after the reform in the absence of other alternative high-yielding monetary instruments, was keeping the real deposit rate positive which encouraged savers to gain real return on their deposits. Thus, there is no doubt that financial liberalization has increased savings in the financial assets of Ethiopia.

However, the financial liberalization contributed very small amount on the national saving. The national saving as a percent of GDP was 10.2% per year on average before the reform rose to 13.1% during post-reform period predominantly as the result of the growing transfer from other countries to support the reform program. Although the financial liberalization contributed negligible amount to the national savings, it has shown an in improvement in the allocative efficiency of the financial sector.

Keeping the nominal lending rate artificially lower than the market clearing was invited the diversion of credit from the most efficient investment by the private sector to the inefficient public enterprises and state farms. The reform measures have been successful in shifting the flow of credit to the more efficient sectors, which is evidenced by the change in the structure of the credit disbursement after the reform. The annual average share of credit for the private sector rose from 28% before the reform to 70.4% after the reform while that of public enterprises reduced from 57.7% during pre-reform period to 17% during the post reform period. The main reason for this change was the removal of restriction on the private sector coupled with the on going privatization of public enterprises and limited new investment in these enterprises.

The annual average growth of total credit has shown increasing trend at the rate of 38.4% after the reform, from 7.7% declining rate during the pre-reform period. Owing to the elimination of discriminatory credit to public enterprises and state farms through the specialized banks, a significant portion of loans came from the CBE; accounting for 75% per annum after the reform rose from 54% before reform. The share of private banks in their three years of credit operation has reached 22% in 1998/99 for which it was 6% and 17% respectively in the previous years, much higher than their deposit mobilization.

The majority of credit was channeled to the domestic trade (31%) followed by the industrial sector (16%) after the reform, which was directed to the agricultural sector (33%) through interest rate subsidy before the reform. This reflects the diversion of financial resources to the most efficient investment activity in the domestic trade and industrial sector after the reform from the inefficient investment in the agricultural sector, essentially the state farm that absorbed the majority of credit disbursed before the reform. The reform did not only improve the quality of investment but also it increased the quantity of investment explained by a significant increase in the volume of credit disbursed. The amount of credit disbursed rose from Birr 0.6 billion in 1991/92 to Birr 4.2 billion in 1998/99(seven fold in eight years). It is safe to conclude that much of the increased credit came from the funds that was revolving in the informal market due to low real deposit rate in the formal financial sector before the reform. Thus, the financial liberalization improved the allocative efficiency in Ethiopia.

Regarding the operational efficiency of banking system, the net profit of banks grew by an annual average rate of 178% for the last five years after the loss made for four years since 1989/90. This growth is predominantly associated with a significant profit made by the CBE, which grew at annual average rate of 161% during 1989/90 to

1997/98, mainly due to interest rate reform. There was also an improvement in the productivity of workers in the banking industry. The annual average loan disbursed by each employee rose from Birr 0.024 million before the reform to Birr 0.070 million after the reform. The deposit mobilized per employee also increased from Birr 0.108 million to Birr 0.234 million during the same period.

However, there was no improvement in the operational efficiency with regard to interest rate margin. Since interest rate was not fully liberalized, the cost of financial intermediation was fluctuating in the last few years.

Although the interest rate was much higher than the formal financial institutions, the informal financial sector was the only source of funds for the restricted sector before the reform. Even after the reform the rural people have been using the informal sector. It was estimated that 'iqqub' funds accounted for 8-10% of GDP in 1995. The informal financial transaction was about Birr 7.2 billion in 1998, which was 41% of the deposit mobilized and 157% of the credit disbursed in the formal institutions in the same year. Thus, the role of informal financial sector should not be neglected in the financial system of Ethiopia. The Saving and Credit Associations and NGOs are semi-formal` institutions that were increasing in the last periods.

5.2. Recommendation

It is widely accepted that financial liberalization is the most efficient way for the overall development of an economy. However, this is a long-run target to be persued and depends on the existing situation of a country. Although there was significant improvement in the financial intermediation after the reform the financial system is still underdeveloped in Ethiopia. The main problems are: -

1) The commercial Bank of Ethiopia extremely dominates the banking system,
2) The financial system is highly undiversified with regard to financial institutions and financial instruments. The country has no financial institutions such as investment and trust companies and postal savings system. There is also underdevelopment of money and capital market instruments,
3) The capital bases of recently introduced micro-financial institutions and private banks are low,
4) Low competition among financial institutions

5) Still low operational efficiency in the banking industry due to shortage of technical skills for financial operation as well as lack of appropriate technology,

6) There is still low repayment performance by the borrowers and financial resource mis-match for Development Bank of Ethiopia (DBE) and Construction and Business Bank (CBB). Therefore, there is shortage of fund to extend long-term loans. The DBE and CBB are supposed to accept short-term deposits and extend loans for long-terms.

How to find the most suitable policy is a difficult task. However, in order to achieve financial efficiency and financial stability simultaneously, the government should make further effort to search for optimum policy. Thus,

1) To improve efficiency in the financial sector, it needs further deregulation of interest rate so that the cost of financial intermediation can be narrower than the existing interest rate margin. Further more, the financial resource revolving in the informal financial market can further be flow into the formal financial market if the deposit rate is deregulated. Competition among financial institutions is also enhanced for the successful completion of the liberalization.

2) Strengthening the supervisory capacity of the National Bank of Ethiopia is required to avoid financial instability. A sound supervisory system and prudential regulation combined with well-designed sequence of financial liberalization are essential in the financial sector to prevent bank panic.

Diversification of financial institutions and financial instruments are very important for financial deepening and economic development of Ethiopia.

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