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Development of Financial Sector in Ethiopia: Literature Review

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Abstract
This article presents comprehensive review of annual reports and articles on development of financial sector in Ethiopia and for open discussion.
Keywords: development, financial sector, Ethiopia

1. Introduction

This article provides an overview of development of financial sector in Ethiopia, including Background and Structure of the Financial Sector in Ethiopia, Rural Financial systems in Ethiopia, Financial Developments in Ethiopia, Major Financial Product Services, Supplies-Demand Gaps in the Financial Sector, The Legal and Policy Environment and The Role of the Government in the Financial Sector.

The chapter is organized as follows: Section 2 focuses on Background and Structure of the Financial Sector in Ethiopia, section 3 focuses on Rural Financial systems in Ethiopia and provides a review of the formal rural financial system as well as informal rural financial systems in Ethiopia. Section 4 discusses Financial Developments in Ethiopia; Section 5 discusses Major Financial Product Services in Ethiopia; the gap between credit supply and credit demand in rural Ethiopia is discussed in Section 6; Section 7 discusses the Legal and Policy Environment in financial sector; and Section 8 discusses the Role of the Government in the Financial Sector.

2. BACKGROUND AND STRUCTURE OF THE FINANCIAL SECTOR IN ETHIOPIA

Banking in Ethiopia started in 1905, with the establishment of the Bank of Abyssinia that was owned by the Ethiopian government in partnership with the National Bank of Egypt then under British rule. But a well structure banking system started to evolve starting the 1940_s-after the Italian departure. A government owned bank-the State Bank of Ethiopia-was established in 1942, and a number of foreign bank branches and a private bank were operating in competition with the government owned commercial bank until they were nationalized and merged into one government owned mono-bank in 1976. The competitive banking situation that started to flourish during the 1960s and 1974s was nipped in the bud by the command system that reign over the 1974-1991 periods.

Following the change of government in 1991, and the subsequent measures taken to liberalize and reorient the economy towards a system of economy based on commercial considerations, the financial market was deregulated. A proclamation number 84/94 was issued out to effect the deregulation and liberalization of the financial sector, and a number of private banks and insurance companies were established following the proclamation. Directives issued in subsequent years further deepen the liberalization mainly including the gradual liberalizations of the interest rate, foreign exchange determination, money market operation, etc. In the year 2013/14, there were 16 private banks operating along with three public banks, namely the Commercial Bank of Ethiopia, the Construction and Business Bank, and the Development Bank of Ethiopia. Other financial institutions operating in the economy includes 17 insurance companies, one pension fund and about 31 Micro Finance Institutions with a business focus mainly in the rural areas but in reality concentrated in urban area. The Development Bank of Ethiopia (DBE) is a specialized bank in project financing and is not a deposit taking institution (NBE, 2013/14).

Generally, public banks dominate the financial industry in Ethiopia. The Commercial Bank of Ethiopia (CBE), the largest bank in the industry, accounts 38.8% of the branch networks, over 53.3% of the outstanding loans and mobilizes about 66.4% of the deposits of the commercial banks (NBE, 2014). However, the progress observed by the private banks in the last ten years appears commendable. In terms of the fresh loans annually disbursed, the share of the private bank is at par with the public commercial banks. In addition, private banks also managed to capture more than half of the private sector commercial banks' loan customers (CBE, 2013/14).

3. RURAL FINANCIAL SYSTEMS IN ETHIOPIA

Rural finance in Ethiopia, as in other developing countries, has dualistic features. There exist both formal and informal credit institutions in the country.

3.1 Formal financial institutions in Ethiopia: The formal sources are financial institutions that are set up legally and engaged in the provision of credit and mobilization of savings. These institutions are regulated and controlled by the National Bank of Ethiopia (NBE). In the Ethiopian context formal financial sector includes National Bank of Ethiopia (NBE), commercial banks (owned by private and public), Development Bank of Ethiopia (DBE), credit and savings cooperative, insurance companies (both public and private) and microfinance institutions (owned by regional governments, NGOs, associations and individuals)(NBE, 2013/14). According to the proclamation number 84/94, foreign entry in to the financial sector is not allowed until domestic banks attain a certain degree of desired competitiveness and the National Bank's supervisory and regulatory capacity is adequately strengthened.

The numbers of bank branches reached 2208, of which 1003 or about 45 percent belong to the Commercial Bank of Ethiopia. Despite modest branch expansion, Ethiopia remains as one of the under-banked countries even at sub-Saharan African countries standard. The bank branch to population ratio was 1:43912 in 2013/14 during 20013/14. Similarly, total capital of the banking system reached Birr 37.3 billion, of which about 44.7 percent was hold by government owned 3 banks. Commercial Bank of Ethiopia accounted for more than 34 percent of total capital of the banking system (excluding NBE). Yet geographical distribution of bank branches was highly skewed to major towns and cities. Nearly 34 percent of bank branches were located in Addis Ababa (NBE, 2013/2014).

Total branches of insurance companies reached 332 at the end of the fiscal year (2013/14). The number of insurance companies operating in Ethiopia reached to 17 at the end of the fiscal year (2013/14) and the branch network reached 332 following the opening of 59 additional branches. Major branch expansion was undertaken by the state owned Ethiopian Insurance Corporation (EIC) (13 branches) followed by Abay Insurance (7 branches), Oromia Insurance and Nile Insurance Company (5 branches) each. Yet geographical distribution of insurance branches was highly skewed to major towns and cities. Nearly 55 percent of insurance branches were located in Addis Ababa (NBE, 2013/2014). The share of private insurance companies in total branches stood at 81.3 percent, slightly down from 82.1 percent a year ago. On the other hand, total capital of insurance companies increased by 36.6 percent reaching Birr 2.0 billion from Birr 1.5 billion last year. Private insurance companies accounted for 78.6 percent of the total capital of insurance sector while the share of EIC was 21.4 percent.

Microfinance institutions in Ethiopia: Microfinance can be defined as provision of a broad range of client-responsive financial services to poor people through a wide variety of institutions. Microcredit activities in rural and urban Ethiopia were initiated by local and international NGOs (Wolday, 2004). According to Pischke (1996), there were 30 NGOs in Ethiopia who were delivering microcredit services but concentrated in urban areas. Although the NGOs had contributed to testing innovative methodologies and products, they had the problem of combining the humanitarian objectives of the NGOs with the financial objectives of the microcredit program. In Ethiopia integration of the credit schemes initiated by local NGOs like the Relief Society of Tigray (REST) and Organization for Rehabilitation and Development in Amhara (ORDA) into the formal financial system contributed to the formulation of a regulatory and supervision framework for efficient delivery of services to the urban and rural poor and the issuance of a new proclamation for Licensing and Supervision of Micro-Financing Institutions in 1996 (Proclamation No.40/1996)

According to Getaneh (2005a), to further stimulate economic activities and provide opportunities for the majority of poor to escape poverty through availing more and appropriate financial services, the Government has been refining the regulatory framework for the microfinance operations. The regulation that put a ceiling on the interest rate that micro financial institutions could charge from their credit clients no longer exists and a new liberal system is in operation (Directive No. MFI/92/98) whereby MFIs could decide the level of 14 interest rate they charge as long as they can remain in the competitive market, thus opening up a new opportunity in the effort to ensure both operational and financial sustainability for MFIs. Although most MFIs in developing countries aim to reach poor people, it has become increasingly apparent that they rarely serve very poor people. Most MFIs reach the "upper poor" in much greater numbers than the "very poor." The extent to which microfinance programs are able to reach the poorest of the poor remains an open debate (SEEP network, 2006). On the other hand, according to Wolday (2004), the Ethiopian microfinance industry has been growing in terms of its outreach as well as its asset and capital base.

By the end of 2013/14, the number of micro-finance institutions (MFIs) operating in the country reached 31. Their overall performance was encouraging as their total capital and total asset increased by 24.6 and 38.6 percent and reached Birr 5.6 billion and Birr 24.5 billion, respectively. At the same time, their deposit mobilization and credit provision have expanded remarkably. Compared to the previous year (20112/13), deposit mobilization of MFIs went up by 54.8 percent and reached Birr 11.8 billion while their outstanding credit rose by 31.9 percent indicating their expanded outreach. The four largest MFIs, namely Amhara credit and saving institution(found in the study site), Dedebit, Oromiya and Omo Credit and Savings institutions accounted for 74.9 percent of the total capital, 84.0 percent of the savings, 80.6 percent of the credit and 81.6 percent of the total assets of MFIs at the end of 2013/14(NBE,2013/14).

Amhara credit and saving institution (ACSI): As indicated by Getaneh (2005b), the Amhara Credit and Saving Institution (ACSI) were established in the Amhara region, and aims to fill the gap of formal institutions by meeting the needs of small scale borrowers in income generation schemes. It was initiated by the Organization for the Rehabilitation and Development in Amhara (ORDA), an indigenous NGO engaged in development activities in the Amhara region. In a move to depart from the more usual direct provision of relief, the NGO created a department to supply small credit to rural people on a pilot basis. That department grew into a separate institution, and ACSI was licensed as a microfinance share company in April 1997, with the primary mission of improving the economic situation of low income, productive poor people in the Amhara region through increased access to lending and saving services. According to Mix market (2014), in terms of Outreach, currently, in ACSI there are about 975,104 active credit clients (about 62.5*%* women), with an active credit balance. But, given the number of economically active people outside of the reach of the conventional financial service, estimated at about 3 Million, the outreach is clearly minimal. It is only 12-15% of demand taking only the number of the very poor. Presently, ACSI is operating in all Woredas of the Region, and has covered about some 75% of total Kebeles. There are many economically active poor people still un-reached.

Cooperatives: According to Wolday (2004), the cooperative movement in Ethiopia took birth in 1950s. Actually the first saving and credit cooperative in Ethiopia was established by the employees of Ethiopian Road Authority in 1957. This was followed by the SACCO of Ethiopian Airlines (1964). During the period between 1960 and 1978, 140 cooperatives with a total membership of about 44,000 were established in the country. Derg, after issuing Proclamation No. 138/78 established agricultural producers' cooperatives and service cooperatives, organized 13,546 cooperatives with a membership of about 10 million by 1990. International donors, NGOs, and the government of Ethiopia have supported the expansion of credit services to the rural poor since 1970s. The delivery of rural credit in Ethiopia through formal banks such as agricultural and Industrial Development Bank (AIDB) using the cooperatives was one of the interventions to provide input loans to farmers. The CBE started providing input credit in 1994. The CBE provides input loans to importers and wholesale traders and regional governments. The bank was providing input credit mainly for chemical fertilizer and improved seeds through intermediaries like Service Cooperatives, Peasant Associations and farmers groups. According to information obtained from the Federal cooperative agency of Ethiopia (2014), there were a total of **56,044** primary cooperatives and **311** unions, with approximately **9,165,267** members and Birr **8.8** billion share capital, in the country. Of the primary cooperatives, 10648 were multi-purpose cooperatives operating in the agricultural sector. The numbers of other types of cooperates were: housing 11208, SACCOs **14,453**, handicraft 79, consumer 15, mining 9, and others 82. The unions are specialized by function and cover marketing of inputs and grain (41), coffee (4), fruits and vegetables (2), milk (1); sugar cane (1), and saving and credit (1). At present (2014), there are no cooperative federations. The Ethiopian cooperative agency(2014) indicated that in Amhara national regional state (ANRS) there were a total of 2,520 farmers' multipurpose service cooperatives (FMSCs) with a combined capital of Birr 96,176,921. Among these, around 622 (60.68%) FMSCs were actively engaged in agricultural input credit extension activity. They administered most of the fund borrowed by the regional government from commercial banks. They administered more than 80% of the input credit in 2014 in the region.

3.2. Informal credit institutions in Ethiopia: The inability of the formal financial sector to provide adequate financial services to small farmers and the poor in general continued even after the reform (Assefa 2004). A study by the National Bank of Ethiopia (1996) concluded that "CBE and DBE have only catered for insignificant demand for credit of small farmers. The bulk of financial services provided to small and micro-enterprises in rural and urban areas, therefore, mostly originated from the informal sector such as Eqqub, moneylenders and friends" (NBE, 1996). On the other hand, as Dejene (2003) stated the non-formal sources in Ethiopia include relatives and friends, moneylenders, neighbors, Iddir, Eqqub and Mahaber are the major sources of loans include friends and relatives (66 percent), moneylenders (14 percent), and Iddir (7 percent). In other words the bulk of the rural credit comes from informal sources. Every year, the informal sector mobilizes resources equivalent to about 10 percent of deposits mobilized by all banks in Ethiopia. Rural Iddirs mobilized through informal loans alone an amount 3.5 times the total capital of all micro finance institutions in Ethiopia. The socio-economic base line survey in the Amhara region review that the most widely used financial institutions in rural areas were informal, which provided very small loan size, for short period and especially for daily consumption. The survey result of Dejene (2004) indicates that from the total respondents about 65 per cent of the households were accessing credits from informal institutions. Ethiopian cooperative agency (2014) also identifies the percentage share of the number of borrowers by institution as ACSI caters to 22%, co-operatives 9 %, NGOs 3%, Arata Abedari 20% relatives/friends 44% and others 2%. It is argued that informal sources, however, do not generate enough and affordable finance for business to stimulate economic development. In particular, the individual moneylender (the Arata Abedari) is extremely expensive, and is only resorted to in the absence of any alternative. In this case borrowers are required to provide guarantors and the interest rate is excessively high. Until recently the annual interest rates that the money lenders charged was estimated to range from 60% to 120% (Getaneh, 2005a).

3.2.1 Types and Roles of informal Finance in Ethiopia

The term informal refers to the provision of service which is not generally or partly regulated by law but which relies on self-regulating mechanisms. Moneylenders and pawnbrokers may be required to register, and in that case, they operate to some extent under formal legislatures. Informal operators are a worldwide phenomenon: this demonstrates the universal need of the population, particularly the rural, of finical services and the ability of the professional operators to provide some of these services under different circumstances as a financially viable occupation. The variety of financial transactions reflects the variety of circumstances, and additional conditions such as the delivery of products the provision of labor or the exchange of pledges such as gold and jewelers may be part of the transaction. Despite the variety of operators and transactions, the informal professional operators have various main features in common which justify their classification in one group. The informal sector accounts for most of the rural financial services provided to the rural areas in Ethiopia .In his study of micro- finance development in Ethiopia, Worku (2000)describes the different informal professional financial services operated in Ethiopia.

There are various types of informal organizations in Ethiopia (Worku, 2000). These include private sector rotating saving and credit groups such as lddir and lqqub that are initiated and organized by the people themselves, under the premise of financial relations based on reciprocity. In Ethiopia lddir, Mahebers, Eqqqub, Debo, elders' group, women's association, money lenders, friends and relatives, pawnbrokers, money keepers and tradesman are the most important informal organizations and explained below in detail:

Iddir: is one of the informal local institutions in Ethiopia established voluntarily by the community and involved in self-help and other social activities. Iddir is established primarily to provide mutual aid in burial matters but also to address other community concerns (Pankhurst & Mariam, 2000). It is an association established by a group of persons united by ties in families, friendship, neighborhood, or belonging to the same job (Teshome, 2008). Furthermore, Iddir is a local association with long history, most widespread, commonly known in rural and urban settings of Ethiopia such as: Addis Ababa, South Wello, Wag Hemra, Sothern Gonder, Sothern Tigray, Siltie, and others. It organizes people according to gender, generation, wealth, education, religion, kinship, ethnicity and some other special relations. To mention some of the associations the Iddir formed: *Iddirs* based on professions like the teachers' *Iddirs,* on gender such as women's *Iddirs,* or on ethnicity or clanship such as those formed by migrants from specific areas. However, with regard to membership structure, iddirs are the most democratic and egalitarian social organizations which people are free to join and become a member regardless of their differences in religion, sex, and ethnic affiliation (Pankhurst & Mariam, 2000).

As noted by Dejene (1993), iddir as an informal financial and social institution that is almost ubiquitous throughout Ethiopia. Iddir is also defined by Mauri (1987) as an association made up by a group of persons united by ties of family and friendship, by living in the same district, by jobs, or by belonging to the same ethnic group, and as an object of providing mutual aid and financial assistance in certain circumstances. In practice, the Iddir is a sort of insurance program run by a community or a group to meet emergencies. According to Salole (1986), the original purpose of Iddir was the burial of the dead. Today, the Iddir provides a much wider range of services including financial and material assistance and consolation to a member in the event of difficulties as well as entertainment as the case may be. The expansion of Iddir to urban areas is perhaps associated with growing social insecurity. Salole (1986) for example, noted recourse to iddirs and lqqubs as one of the most significant survival strategies or coping mechanisms adopted by the Ethiopia urban populations.

Iddir is considered as an excellent vehicle for the state to gain direct access to the urban population (Salole, 1986) . However, attempts to effectively mobilize through Iddir for community development have not yet succeeded (Hamer, 1976: Cohen and Koehn,1980) , although such attempts were initiates as early as in 1972 when the first seminar was convened for this purpose by the then Ministry of community Development and social Affairs (Mekuria, 1973). Similar attempts by the Ethiopia insurance corporation to integrate both Iddir and 'Eqqub' with the formal sector have not yet succeeded. It has been observed that despite the abundance and vitality of these institutions, the development agencies appear to have overlooked them as partners or tools in their work (salole 1986). Dejene (1993) suggests that the Iddir, unlike the insurance system, is very popular among the people .It is attractive because it is culturally appropriate flexible easily accessible, and cost- effective. Unlike the insurance system, it is basically a nonprofit making institution based upon solidarity, friendship, and mutual assistance among members. People from all types of socio- economic backgrounds participate in the Iddir.

The insurance system, on the other hand, is limited to high income households seeking insurance policies for a definite purpose .On the other hand; Iddir is invariably have a strong linkage with the banking system. Iddir is keep the bulk of their financial assets in banks. Only small amount of cash is kept at hand to meet emergency requirements.

Mahbers: are voluntary and mutual aid community (religious) associations peculiar to Orthodox religion followers. The members gather together at church or in one of the member's house so as to pray together to get blessing from God and saint and discuss their problems and further share information. In doing so, the members bring food and drinks to church to feed the poor and themselves and discuss matters of common interest (Moges, 2006). Mahbers are also very crucial informal institutions involved in various community activities such as risk coping, provision of information, addressing manpower and traction force and conflict resolution.

Eqqub:is an informal institutions established voluntarily to collect a specific amount of money from the members on a specific date to be paid on round and lottery basis to the members. The members know each other and thus trust each other to make the Eqqub function smoothly (Dessalegn and Aklilu, 1999; Desta, 1995). Interestingly enough, Eqqub also lends a hand to the members in many aspects such as provision of credit and sharing important information.

In the literature ,'Eqqub' is conceived as traditional social organization in which members come together for the purpose of savings in cash or in kind. The normal practice is that members contribute money or materials on a regular period of time and lots are drawn so that the one who wins the chance gets the total sum. This process continues at a regular period until the last member receives his/ her share , or what he/ she has been saving through the months and the whole process starts again. As noted by Dejne (1993), Eqqub has perhaps evolved over centuries out of ancient customary institutions (e.g. community level labor exchange arrangements) although some writers (e.g Pankhurst and Endreas, 1958: Comhaire, 1966) attempted to trace its origins to the period of Italian occupation, i.e. 1936-41. Moreover, it is possible that the 'Eqqub' pre-dates the emergence of the modern banking system in the country. The Eqqub consists of homogenous groups: people from the same work place, ethnic background trade schooling background or neighborhood. The 'Eqqub' is not limited in urban areas: it is also common in rural areas though perhaps practiced to a lesser degree.

According to Mauri (1987) , people prefer 'Eqqub' to the formal financial sector because of the following reasons: the intimate integration between the financial service offered by the 'Eqqub' and the strengthening of the solidarity and friendship in the group, the forced savings of a contractual nature , the provision of credit services particularly suited to the needs of the participants and the flexibility and adaptability of 'Eqqub' to various situations and needs , low risks of default the low or practically non- existent costs of administration and transactions, the absence of minimum investment threshold, probable tendency to gamble on the part of members and the consequent attraction which the lottery holds for them, and secrecy which surrounds the 'Eqqub' and the member's involvement in it.

Further, to the importance of 'Eqqub' in the Ethiopia society, Mauri (1987) indicates that the annual contribution of Eqqubs amounted to Birr 139 million, which is 15.2 percent of total household savings deposited in the commercial Bank of Ethiopia in 1986. Following his estimate, Dejene (2004) has estimated for the rural areas of three major regional states that the size of savings generated through 'Eqqub' to be approximately Birr 396.5 million per year. Saving through rural lqqub amounted to an equivalent of 30 percent of outstanding loans to the agricultural sector by the banking system. There are distinct types of lqqub in Ethiopia each has its own specific features. The big "traders lqqub", for example is different from other types of lqqub in that the big "traders" 'Eqqub' has a stronger linkage with banks: it is business – oriented. It has developed sophisticated mechanisms for compensating those members with longer waiting time for collecting the pool its transaction costs are considerable and its operations are quite complex, participation in the 'Eqqub' is affected by household characteristics . For example, poorer households have access to 'Eqqub' and not to banks. The Better off households use the banking system more than poorer ones. People from different age groups and levels of education participate in 'Eqqub's.

Debo/Webera /Jigie/Wonfel/oxen or labor sharing- are arrangement of agricultural work groups in rural Ethiopia that create structures for "pooling the labor of a number of people from an area to assist one or more individuals with building a house, cultivating a large piece of land, or ploughing, harvesting crops, clearing forests for ploughing and similar tasks through promises of future reciprocity among member participants (Getachew, 1998; Daniel, 2003). But in Debo or Wobera, a form of festive labor, where a person will provide food and drink for a large work party in order to carry out a time-sensitive agricultural task, there is no reciprocity. These informal institutions contribute a lot to the group like manpower mobilizing to the community.

Elder's group/Senbete: It is commonly called "Shimagelay in Amharic language" is a traditional association of Elders people who are elected by the local community in order to serve the society in times of disagreements and coordinate them in common resource management like water and forest and disseminate information (Frankenberger et al., 2007; Spielman et al., 2008).

Women's Association- is a voluntary association of women group who have explicit agreement to help each other in a specified way when well-defined events occur. These associations help the members in cash or in kind, in capacity building and by sharing of information (Dercon et al., 2005).

Moneylenders: Loans from moneylenders are typically short-term and are extended to clients of long standing business relationships usually exploit the poor through interest and unfair seizure of collateral.

The money lender (known as arata- abadari) has been active in Ethiopia for centuries and until the beginning of the twentieth century represented the only source of loan (Mauri, 1987). He also notes that in towns, reduced lending by the financial institutions has created a potential for the development of informal lending because even persons who in the past were familiar with bank credit turned to moneylenders to replace bank loans. Before 1974 , moneylenders were often rich landowners, but following the nationalization of land, landlords disappeared as a social class and their roles as moneylenders were replaced by rich traders (Dejene, 19993). The financial operations of moneylenders are simple, cost effective, and flexible compared to that of the banking system. Interest rates, which are never stated in the agreement made with the borrower are influenced by the extent of personal relations, degree of risk involved , availability of funds in the community, length of the maturity period and extent of competition from the formal financial market (Mauri ,1987). When a potential borrower approaches a moneylender for a loan it is impossible to determine the risk involved in offering him/ her loan contract.

The lender would not sign a loan contract for every one that comes along, because this could easily increase the risky ness of the loan portfolio that the lender would find unacceptable. Higher interest rates that moneylenders charge are in part due to the higher costs and risks associated with informal loans. The risks of long-term lending are also greater, because informal lenders and their customers are small and isolated groups. There is no adequate information on the size of the interest rate. According to a survey undertaken some years back, it ranged from 24-900 percent per year (Mauri ,1987). The bank's lending interest rate varied from 4.5 -9.5 percent per year depending upon the type of project and the borrower . Market vendors and other small business often turn to moneylenders for short- term credit needs. The so- called profit – sharing arrangements prevail in some parts of the country under which the borrower receives say Birr 100 and repays the principal and half of the profit earned, in the business to the lender. The more the profit is earned, the more the lender gets and this seems to be extremely usurious.

In some cases, the credit market is interlinked with product market. According to widespread custom in certain agricultural districts of Ethiopia for example, in the coffee producing districts around Jimma and Gore, the merchant – lenders pay the cultivators a sum of money, which represents both a loan and an advance payment for the purchase of a given quantity of coffee to be produced after the next harvest. The unit price is established by the merchant – lender in the advance payment based on the price of the previous harvest or of the estimated price of the next one duly discounted (Mauri 1987). This also happened in other crop producing areas of the country.

Friends and relatives : In Ethiopia where there is a strong tradition of mutual assistance and reciprocity , individuals who need funds call on the friends and relatives for help , however, obligates the borrower to reciprocate by providing non financial services or by supplying funds in turn when the lender needs to borrow. Lending between friends and relatives often carries low interest rates or no explicit interest charge. An oral promise, confidence, trust and mutuality are frequently all that is needed as collateral or security.

Pawnbrokers: since they are involved in many kinds of pawning or exchanging cash with something like gold or land or anything of value, which is the quickest way for people with a problem to get funds. Pawnbrokers are found everywhere. The lender has to know a lot about the item pledged, but does not have to know anything about the borrower. However, some pawnbrokers do want to know something about the borrower to avoid lending against stolen goods. A farmer in need of cash will allow the lender to occupy and make use of his land until at least a stipulated minimum of two or three years has elapsed. Although damaging for the farmer, this is considered as one of the few sources of credit for persons not having access to formal credit due to lack of other forms or acceptable collateral. Leasing contracts are not confined to land but extended to other productive assets such as milking cows. Borrowers who won marketable assets turn to pawnbrokers for short- term credit. Pawnbrokers take possession of assets for a fixed term and lend against them at an agreed rate of interest. If the term expires, the pawnbroker can sell the asset and keep the proceeds. Because the loan has collateral, the pawnbroker needs no further information about risk. The risk involved is also lower as the loan size is smaller than the estimated value of the collateral.

Money – keepers: Generally, money keepers are parents, elders, or religious leaders. They are persons generally acknowledged to be trustworthy in a locality with which individuals and groups feel comfortable entrusting them to safely keep their cash. Money – keepers are known to fulfill a strong demand for safekeeping and depository services. They are also recognized as lenders, able to lend short- term loans at their own risk but sharing the interest earned with depositors.

Tradesmen: Credit is an important component of marketing transaction between traders and farmers. Contractual linkage is prevalent in many forms. This includes pledging of standing crops as collateral, committing all or part of a crop or crops at harvest time, the forward sale of future crops etc. This kind of credit is mostly extended as a short- term loan for consumption goods and farm inputs. Loan repayments are made at the end of the cropping season. A local market vendor obtains fresh produce such as potato, fruits etc. from a wholesaler in the same market. If the consignment is valued say at Birr 50.00 and repayment of birr 70.00 is expected after a week, the simple interest rate is 20 percent per week. There is another class of transactions involving transfer of right to use a standing crop or to land for varying length of time, which is a different form transaction in which land is leased out. The transactions involve the borrower transferring the asset (standing crop) to the lender, who leases it. The transfer of a standing crop in return for cash is a forward sale of produce. A very common example is in coffee growing areas, where about a third of the anticipated value during harvest is advanced. In this case, loan collection is in kind, and those who make advance are often coffee traders. There are cases where a merchant might provide a farmer with one sack of wheat in return for two sacks at harvest time two or three months later. Apparently, the monthly rate can be 20 percent or more.

4. FINANCIAL DEVELOPMENTS IN ETHIOPIA

Financial development in Ethiopia is generally low. The degree of monetization is obviously low in a country where the economy itself is dominated by a subsistent oriented agriculture. Broad money as a proportion of the GDP, which is broadly taken as a measure of the extent of financial development, is in the range of 24% to 28%. While this statistic is comparable to many low-income African countries **(Table 4.1)**, it nonetheless suggests that financial deepening in Ethiopia is far lower than those upper and high-income countries. Other indicator such as claims to the non- government as a proportion of the GDP, which stands at about 22%, also points to the same conclusion. Bank credit to the non-government and deposit of the banking sector as a proportion of GDP normally rises as the economy grows.

Table 4.1: Indicators of Financial Deepening in Ethiopia

Items	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
M2 GDP Ratio	24.89	27.54	28.22	25.34	27.21	28.42
Deposit to GDP Ratio	0.16	0.16	0.16	0.16	0.16	0.16
Total Credit to GDP Ratio	0.18	0.13	0.10	0.09	0.06	0.03
Credit to Private and public enterprise Sector –GDP ratio	0.19	0.19	0.17	0.19	0.21	0.22

Table 4.2 below provides some comparative financial deepening statistics for some low-income African countries, and mid to high-income African and Asian countries. Broadly speaking, both credit and deposit to GDP ratio for Ethiopia are fairly comparable to many low-income African countries. However, compared to middle and high-income countries, both ratios are significantly low, suggesting the undeveloped nature of the financial sector in Ethiopia.

Another indicator of banking development is the number of banks and bank branches in relation to total population of the country. As of 2013/14 fiscal year, there are only nineteen commercial banks for the 96.9 million population of the country, suggesting the per capita commercial bank is very low about 5.7 million populations per one commercial bank. This rather crude measure also indicates that access of the population to financial services is limited. This is also confirmed by financial access survey conducted by IMF as indicated in tables 4.3a&b and 4.4

Table 4.2: Comparative Financial Indicators for Some African countries

Countries	Credit to private and NFPEs to GDP/2014	M2 to GDP/2014	Credit to Private and NFPE to Deposits/2007
Low income SSA countries			
Ethiopia	18.53	28.42	52.4
Ghana	NA	28.78	72.0
Kenya	34.42	42.93	59.1
Mozambique	33.12	51.48	50.4
Namibia	47.54	51.02	88.4
Nigeria	14.61	20.23	44.5
Tanzania	13.83	23.43	51.5
Uganda	14.39	22.35	38.4
Zambia	17.14	20.99	135.3
Mid and high Income Countries			
India	51.12	76.76	129.6
Malaysia	124.68	141.77	139.4
Thailand	158.92	137.98	60.5
Tunisia	75.74	66.66	95.4
South Africa	151.56	71.04	106.8

Source: IMF financial access survey (2014)

Table 4.3a:Access to and use of financial services in Ethiopia

		Year						
No	key Indicators	2006	2007	2008	2009	2010	2011	2012
1	Commercial bank branches per 1,000 km^2	0.4	0.47	0.54	0.62	0.68	0.96	1.53
2	ATM per 1,000 km^2	0.01	0.02	0.03	0.05	0.15	0.16	0.24
3	Outstanding deposits with commercial banks(% of GDP)	32.41	30.1	24.96	22.68	25.2	27.18	24.4
4	Commercial bank branches to per 100,000 adults	0.94	1.08	1.2	1.32	1.37	1.91	2.96
5	ATM per 100,000 adults	0.03	0.04	0.07	0.1	0.3	0.32	0.46
6	Outstanding loans from commercial banks(% of GDP)	16.63	15.03	14.44	12.1	12.44	12.61	13.46

Source: IMF financial access survey (2014)

Table 4.3b:Access to and use of financial services in Ethiopia compared to selected countries in the world

		Country					
No	key Indicators	Ghana	Kenya	India	South Africa	Malaysia	Ethiopia
1	Commercial bank branches per 1,000 km^2	3.89	2.31	33.17	3.05	7.23	1.53
2	ATM per 1,000 km^2	3.74	4.18	32.67	17.52	34.56	0.24
3	Outstanding deposits with commercial banks(% of GDP)	26.78	39.40	60.66	41.26	115.70	24.40
4	Deposit accounts with commercial Banks per 1,000 adults	479.47	637.40	1,034.96	1,350.31	2,305.31	NA
5	Commercial bank branches to per 100,000 adults	5.68	5.28	11.30	10.24	11.08	2.96
6	ATM per 100,000 adults	5.47	9.57	11.13	58.92	52.94	0.46
7	Outstanding loans from commercial banks(% of GDP)	17.49	33.75	47.93	68.94	110.77	13.46

Source: IMF financial access survey (2014)

Countries like Kenya; with over 43 commercial banks for a population slightly above 44.8 million has a far better per capita. Nigeria has 23 commercial banks for a population of 177 million, which suggests about 7.72 million per bank. Ghana has about 27 banks including commercial banks, merchant banks, and development banks for a population of about 26.7 million. Uganda, Zambia and Tanzania have also a better bank per capita.

Table 4.4: Population to Bank Ratio in some African countries and India

Countries	Population per Bank(mn)
Ethiopia	5.70
Ghana	0.99
Kenya	1.04
Mozambique	2.47
South Africa	2.84
Tanzania	1.06
Uganda	1.51
Zambia	1.31
Nigeria	7.72
Namibia	0.48
Rwanda	0.95
India	14.89

Source: IMF financial access survey (2014)

On the other hand, the population to bank branch in Ethiopia, that was about 166,745.84 in 2005/06, has been reduced to about 43,912 by 2013/14. The rapid branch expansion of the private commercial banks has contributed to the fall in the population to branch ratio over the last ten years. The private banks opened about 1020(57%) branches since 2005/06, while public banks managed to open only about 767(43%) branches. In such a short span of time, private banks have indeed contributed to the increased monetization of the economy, although many of their branches are located in the city and major regional towns of the country.

Despite the good progress over the last ten years, this level of population to branch ratio, nonetheless, is far higher than the situation in many African countries. Anecdotal evidence from the African continent suggest that the population to branch ratio in Ghana is about 23,726 and 33,783 respectively, which is much better than the situation in Ethiopia. In the Southern sub-continent, such as South Africa and Namibia, the population to branch ratio is 11,136 and 20,074, respectively. In the Southern Asia sub-continent, India, the population to branch ratio is 14,061. By the standards of these countries, and indeed by the standard of many African countries, Ethiopia is a highly under-banked country.

Table 4.5: Trends in Bank Branches to Population Ratio in Ethiopia

Year	Population (million)	No of Bank Branches	Population-Branch Ratio
2005/07	70.2	421	166,745.84 :1
2006/07	72.4	487	148,665.3:1
2007/09	74.9	562	133,274:1
2008/09	76.8	636	120,754.7:1
2009/10	78.8	681	115,712.2:1
2010/11	80.7	970	83,195.9:1
2011/12	82.7	1289	64,158.3:1
2012/13	84.8	1724	49,674.8:1
2013/14	96	2208	43,912.59 :1

The low level of banking development in Ethiopia can also be looked from the loans and deposit customers of the formal banking sector. To date, the loans and deposit customers are unlikely to exceed 40,000 and 2,000,000, respectively. Evidence from the largest bank suggests that its loans customers are about 30,000 while its deposit facility holders are less than 1,500,000. If we roughly put the number of customers belonging to the private banks at about 500,000 because they constitute about 34% of the deposit stock, the number of formal banks' customers is likely to be less than 2% of the total population, suggesting that over 98% of the population is outside the formal banking sector. Moreover, a good number of the accounts may not be active as far as the feeling goes. Some individuals and companies may have multiple bank accounts, and the actual number of bank users may be far lower than what is indicated above. In addition, the per capita concepts hide the uneven distribution of banks and their branches. Almost in all cases, formal bank operate in towns with a population above 20 thousand, indicating that they are inaccessible to the rural population and to many small towns. Evidence suggests that only less than 1% of the rural population have bank accounts (Gobezie 2002). The fact that the Addis Ababa city alone claims for one-third of the total bank branches itself is a good indicator that access to formal banking services is limited.

5. MAJOR FINANCIAL PRODUCT SERVICES

Broadly speaking, the banking industry in Ethiopia provides products mainly deposit facilities, loans and advances, local transfers, foreign letter of credit facilities, etc. These are traditional commercial banking businesses.

Credit business is of course the key income generating activities for many of the banks operating in the country. Over 60% of the income of banks is generally derived from credit businesses, although fee based income are also growing to a sizeable level *(Annual Reports of the commercial banks, various issues)*. Short-term loans, mainly trade and working capital finance dominates the commercial banking businesses, but some of the public banks are also involved in medium to long-term loans. Sectorally, many of the commercial banks focus on domestic and international trade. Over the last fifteen years, the Commercial Bank of Ethiopia has extended large amount of loans to farmers to finance fertilizer and improved seed purchase, largely on the basis of guarantees from regional governments, which in effect take the responsibility of collecting the loans and repaying the bank (SDPRP 2002). However, extending loans to the sparsely settled and with limited viable collateral farmers has not been done on their own by any of the commercial banks, and their business, by and large, remained urban based. Even in the urban economy, good business entities and project ideas may be under-financed unless they are well backed up by collaterals. The information base on which credit decision is based is too weak to be relied on to manage risks, and good projects with viable collateral would most likely be excluded from the formal bank financing.

On the deposit side, three types of facilities are provided-ie savings, fixed time deposit and checking accounts. Savings and fixed time deposits are generally regarded as interest bearing accounts. The rates on these facilities vary from bank to bank, depending on their liquidity needs and branch networks, but currently are in the range of 5 to 8%. Given average lending rates in the range of 8 to 10.5%, the average spread is in the range of 4.5% to 7%. The current account is mainly extensively used by organizations and companies, and is run mostly by checks. Some banks pay interest rate on demand deposits ranging from 0.5% to 1%, while others including the large public bank-the CBE, does not pay interest on current accounts. Along with these services, a variety of domestic and international payment services are also provided, and the banks are the pillars of the payment system.

Technology based payment systems and products, however, have not yet been developed to a visible extent. Many are yet to network their service channels, although a couple of the private banks have succeeded in networking their branches. Some have also introduced Automatic Teller Machines (ATM) in some sites in the city. Efforts to introduce card businesses are also underway. Nonetheless, the recent encouraging trends in the telecommunication sector, mainly the fiber and broadband technology, suggest that the long-term prospect for the introduction of electronic based banking products is promising. Low level of socio-economic developments and other infrastructure may meanwhile be limiting factors.

6. SUPPLIES-DEMAND GAPS IN THE FINANCIAL SECTOR

As shown above, Ethiopia remains one of the highly under-banked countries in the world, with possible effects of constraining economic growth and business development as access to financial services to the wider public remained rather limited. The bank per capita in Ethiopia, which is about 5.7 million populations for one bank, is one of the lowest in Africa. This suggests that even by the standard of Sub-Saharan Africa, access to financial services has not yet been developed. The population per bank branch, which is around 43,912.00, also points to the same conclusion.

Generally, banking is the dominant sources of funding business activities in the country. Other sources of financing are yet to be emerged. Trends for the last ten to fifteen years suggest that supply of the banking sector services is growing from year to year, albeit from a modest base. Private commercial banks in particular are growing at faster pace than the public banks so as to comfortably place themselves in the industry. In terms of deposits, loans, assets, and capital, private banks have grown at a rate in the range of 45 to 55% in contrast to the less than 35% of the public banks. However, it cannot be concluded that the emergence of private banks has led to an increased outreach of the banking system at large. When compared to the public banks, which have a relatively fair distribution of branches throughout the country, private banks tend to be highly metropolitan oriented. In 2013/14, of the 1205 total branches network of the private banks, 549 were located in Addis Ababa city (45%). In contrast, of the 1003 total branches public banks had during this year, only about 204 were in Addis Ababa (20%).

Data on the extent of demand for financial services is not quite handy, but is generally thought to be vast. One of the sources of demand for banking services would come from population size and growth. Currently, the Ethiopian population is estimated at over 96.9 million, and is expected to reach about 100 million by 2017. This suggests that the number of commercial banks must grow to over 19 to maintain the existing 5.7 million populations per bank, and the number of bank branches must increase to over 2278 to maintain the current bank branch–population ratio of 43,912 from around 2208 in 2014/15. These are, however, meant to maintain the current undesirably low state of banking development from further sliding into a worse situation. Ethiopia needs to double the existing commercial banks to reduce the population bank ratio from about 5.7 million to about 2.85 million, which is still very high compared to Ghana which has less than 1 million populations per one bank, for example. It also needs to have over 2007 bank branches to reduce its population per bank branch to about 23,726.00(Ghana) populations, which is still very high by the standard of many African countries. The projection of the CSA also suggest that Ethiopia’s population will reach 100 million by 2017, and nearly 130 million by 2030, indicating that the long term demand prospect for banking services would continue to grow.

Whether finance should precede economic growth or growth leads to financial services expansion has been a debatable issue for long (Levine 1997). In any case, better economic growth prospects could also be a source of demand for financial services. The macroeconomic forecast of the government for the next five years indicates GDP will grow by about 11% per annum, the investment rate will increase to about 41.3% from about 36.3% in 2014/15, and the Millennium Development Goals will be scaled up suggesting large public investment programs in the area of economic and social infrastructures will be carried out. These trends would generally mean that demand for banking services such as for credit; transfer services and deposit mobilization across the country would continue to expand so as to accommodate the expected increased economic expansion.

There is also vast unattended demand for financial services. The rural households constituting about 85% of the total and small-scale urban-based operators are generally outside the radar of the formal banking system. Their market is largely concentrated on the corporate part of the market. The MFIs, largely focusing on the rural households have so far succeeded to cover about 10% of the rural households. The few urban oriented MFIs have not yet been effective in generating visible impacts on the small operators in the urban area. Studies suggest that capital shortage and credit access are among the three top constraints for the expansion of Micro and small-scale enterprises (MSE) operators in the urban areas(Gebrehiwot Ageba and Wolday Amaha 2006), which are generally the most important enterprises from the employment and poverty reduction perspective. A study by IFAD (2012) also indicates that the number of MFIs clients, entirely rural households, can easily be raised to about 5.5 million, and the annual credit intake to 4.4 billion birr or USD 515 million. Compared to the current level of 1.2 million households so far covered by the MFIs, the unmet gap is wide.

7. THE LEGAL AND POLICY ENVIRONMENT

A sound legal and policy environment is generally taken as a key prerequisite for the smooth operation and development of a banking system. In Ethiopia, the bedrock for the development of the banking sector was laid down in 1994 during which banking business proclamation No.84/94 was issued out. This proclamation ended the mono-bank system that reined for a decade and half, and gave a new lease of life to the financial sector in the country. Proclamation No.84/94 stipulates, among others, that a company should be licensed to carry out banking activities, defines the conditions for bank licensing. It also defines that banks are to be established as Share Company, wholly owned by Ethiopian nationals, and the NBE should approve any share ownership transfers.

Proclamation 84/94 also defines the business activities that a banking company should carry out in the country, and stipulates the amount of capital, both paid up and subscribed, its adequacy in relation to assets, the computation of legal reserves, the minimum liquidity and reserves requirements banks are required to hold, etc. This Proclamation and subsequently issued out directives of the National Bank of Ethiopia defines the main functions and responsibilities of the commercial banks and other financial institutions. There are various directives (www.nbe.gov.et) that govern the operation of the banking industry. However, proclamation No.97/1998 is also worth mentioning at this juncture as it empowered the banks to foreclose collaterals and retrieve their loans without resorting to the court system and further discipline borrowers to respect contracts.

A legal framework for the establishment and operation of Micro finance institutions has also been provided by proclamation No. 40/1996. The proclamation stipulates that MFIs are to be established as share companies wholly owned by Ethiopians and should be licensed by the NBE. Following this proclamation, about 31 MFIs have been established, and the fragmented provisions of micro credits by various NGOs and government departments have now been better streamlined.

8. THE ROLE OF THE ETHIOPIAN GOVERNMENT IN THE FINANCIAL SECTOR

The government pursues a two-pronged policy as far as the financial sector is concerned. On the one hand, maintaining a stable macroeconomic environment and a sound financial system are the key monetary policy objectives of the government. Improving the operational quality and efficiency of the financial sector are its stated objectives. Three strategies have been reflected in the SDPRP document, namely (a) creating a favorable environment for the banking sector (b) building internal dynamics of the banks (c) promoting contestability of the market in the banking sector.

On the other hand, the government has encouraged the development of micro financial services, largely to the rural people. The agricultural development strategy (2001) of the government takes rural finance as one of the key factors for enhancing agricultural production and ensuring food security. Over the last ten years, an arrangement has also been made for the formal banks to provide input loans to the farmers as part of the agricultural extension program to boost cereal production, largely on the basis of interest spread sharing and guarantee from the regional governments. The collection and monitoring of the loans has been generally left to the regional governments, and as such, were the most secured one. However, this arrangement, which has been working for the last ten to twelve years, is reported to be institutionally unsustainable, as the tasks of disbursing and collecting the loans proved to be too demanding on the human and budgetary resources of the regional governments (IFAD 2012). The SDPRP (2002) document clearly states the strategies for developing viable rural financial institutions, namely: replace the large rural loans so far provided via the intermediary of the regional governments by a viable and reliable institutions, Strengthen the rural financial system by forging a strong working relationship between the formal banks and the rural financial institutions, Promote group lending system, Strengthen rural banks and expand their operational scope, Directly extend credit to cooperatives with strong institutional and managerial capacity via forging a strong link between rural banks and cooperatives.

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