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Financial Liberalization Policy at Micro Perspective, The Case of Banking Sector in Ethiopia: Literature Review

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1. Introduction

International institutions like World Bank (WB) and international monetary fund (IMF) are preached countries to adopt structural adjustment program around 1990. Financial liberalization is one of among the key pillars of structural adjustment program with its own principles. Even though liberalization is with some costs due to IMF and WB followed conditionality approach for every nations especially for developing countries, all nations are adopting it. The basic themes behind the liberalization program are openness, privatization of government owned enterprises / properties, deregulation, reducing or eliminating tariffs and tax for international trade within and outside the domestic country, increasing interest rate, reducing government expenditure and eliminating government intervention in the economy (free market there by the two market forces efficiently manage marketing system), among others. The financial sector is the one that needs the adoption of liberalization strategy. This review gives more emphasis for the liberalization of the banking sector due to banks play the key role in the development arena of a given country.

With the aim of facilitating economic growth the government of Ethiopia currently made different reforms to enhance and improve the capacity as well as efficiency of the banking sector.

The government of Ethiopia had implemented major reform tools in the banking sector like optimizing interest rate, providing license for domestic private investors, increasing the number of government owned banks and private banks, addressing the wide-spread problem of nonperforming loans experienced by state owned banks, reconstituting both the Development Bank of Ethiopia and the Construction and Business Bank as commercial banks. The major outcomes of these measures were increasing access by customers, enhancing competition, increasing efficiency and increasing the reserve ratio and smoothing loan- credit base, among others.

After implementing the above-mentioned reform measures in the banking sector (since 1990) the banking sector has been grown, yet still the banking sector is monopolized by government, inefficient in stabilizing the financial sector, and inefficient in accommodating the private sector saving as compared to other nations of the world. Hence the contribution of the banking sector for economic growth of the country remains insignificant.

This review presents rough sketch of historical perspective of the banking sector in Ethiopia, current status of the banking sector in Ethiopia, financial sector reforms, summary and policy recommendations in their respective sequence.

2. Banking Sector Reform Experience from Kenya

Kenya adopted financial sector reforms in 1989, supported by a $170 million World Bank adjustment credit. The main feature of the program was full interest rate liberalization which was achieved in July 1991 after a gradual increase in nominal rates in the 1980s. In the first half of the 1980s for example, nominal deposit rates were increased by about 100 percent and lending rates by about 50 percent, from relatively low levels. Before this period, the government followed a low-interest-rate policy whose main objective was to promote investment. From the time the Central Bank was established in 1966 until 1980 interest rates were only adjusted upwards once in 1974 by 1 to 2 percentage points (Wanyama S. etal,2014).

Other reforms included (i) liberalization of the treasury bills market in November 1990; (ii) setting up a Capital Markets Authority in 1989 to oversee the development of the equities market with a view to enhancing availability of long-term resources for investment; (iii) abolition of credit guidelines in December 1993 (which were in existence since 1975 in favor of agriculture); and (iv) improving and rationalizing the operations and finances of the DFIs, though against the wishes of some donors who urged for their dissolution or privatization. In 1988 and 1994, the two parastatal banks were partially privatized, selling 30% of their shares to the public. A component of reforms has been the restructuring of financial institutions. The country experienced a bank crisis in 1986 when a number of 'specified' NBFIs and a small commercial bank collapsed. To avoid a repeat, eight financial institutions were taken over and merged into a state bank in 1989 — Consolidated Bank of Kenya Ltd. The central bank has also strengthened the supervision and the inspection of financial institutions and introduced a Deposit Protection Fund which guarantees deposits up to Kenyan Shilling 100,000. The initial capital for setting up financial institutions has been increased both for commercial banks and "specified" NBFIs (ibd).

3. Historical Perspective of the Banking Sector in Ethiopia

Modern banking system was started in Ethiopia around 1905 when Menelik II signed an agreement with the representative of the national bank of Egypt, Mr. D. Mac Gilliuray, and the bank immediately started its operation in February 1905 by opening branches in some urban areas of the country like Dire Dawa, Gore and Dessie. The activities of these foreign banks are limited only on managing government account and export financing. Later on 1908 another foreign development bank, namely Ociete Nacionale d'Ethiope Pourle Development l'Agriculture et du Commerce, started operation in Ethiopia. After seven years addition two banks from Italy started engagement in the ethiopian banking sector, which were Banque de l' Indochine and the Compagniede l' Afrique Oreintale. During Italian occupation period from 1914 to 1939 the number Italian banks were increased to six in number (Alemayehu 1999 in Jonse 2002).

After the Italian occupation of 1941, British was the major player of the banking sector in Ethiopia due to political reasons and Barclay's bank had established in 1941 and operated for three consecutive years after establishment (Alemayehu, 1999 in Jonse, 2002).

Monetary and Banking Proclamation No. 206 was introduced in 1963, which specifies the percentage share of foreign ownership in the financial sector. The basic idea of this proclamation is that a license to carry on banking business in Ethiopia was granted only to partnerships with Ethiopian nationality with at least the Ethiopian nationals have owned 51% of the capital. Accordingly, foreign banks, which had already started their operations in the country re-applied for license (NBE, 1999).

After the emergence of military regime in 1974, yet, all foreign banks are nationalized and re-organized and yielded the creation of the following banks (Berhenu and Befakedu (1999/2000) in Jonse 2002).

- ✓ one national bank (reinstitutionalized in 1976)
- ✓ two specialized banks (the Agricultural and Industrial Bank and Housing and Saving Bank), which currently re-named as the Development Bank of Ethiopia (DBE) and
- ✓ the commercial bank of Ethiopia (CBE),

After the new government of 1992, these financial institutions have been re-organized so as to operate based on market orientated policy framework. In addition, monetary and banking proclamation No.83/1994 and the Licensing and Supervision of Banking Business No.84/1994 laid down the legal basis for investment in the banking sector. The proclamation provides the involvement of the private investor in the banking sector. After this proclamation the licensing and the number of private bank were increased relative to the past two regimes.

4. Current Status of the Banking Sector in Ethiopia

Currently banks, insurance companies and microfinance institutions (MFIs) constitute the main financial institutions in Ethiopia. The number of operating banks reached 19 as of June 2015 of which 16 are owned privately. The bank branches reached 2,693, with the private sector accounting for 58.1%. Consequently, the ratio of bank branches to population was reduced to 33,448.2, reflecting an improvement in financial services outreach. Total banking system capitalization reached ETB 31.5 billion, of which private banks accounted for 56.5%. The state-owned Commercial Bank of Ethiopia accounted for 34% of banking system capitalization. Meanwhile, total banking system loan disbursements reached ETB 18.9 billion, of which 55.6% was by public banks and the remainder by private banks. About 99.6% of the private banks' new loans and 54.5% of public banks loans went to the private sector. About 99.8% of outstanding private banks loans were claims on private enterprises. While 58.1% of public banks outstanding loans (excluding credit to government and interbank lending) were claims on public enterprises, 41.9% were on private enterprises.

But surprisingly what we are observing from the above paragraph is that the role of government owned bank and his playing field are by far different from private owned banks. From the total capital invested in the banking sector the share CBE is 34percent but the share of 16 private banks where only 56.5 percent. Similarly, from the total of ETB 18.9 Billion loan disbursements, the share of government owned bank accounts for 55.6 percent while the private banks being many in number accounted only for 44.4 percent of the loan disbursement. In addition, in terms of service provision many of the services which are provided by government bank, commercial bank of Ethiopia, is not provided by private banks.

Accordingly, one can judge that the banking industry in Ethiopia indicates an intensive competition between government and the private investors. This in turn raises the spillover effect of government banks and the efficiency issue of government owned banks. In addition, it discourages other new entrants in the banking sector.

Table 1: The Existing Banks in Ethiopia with their Respective Branch Numbers

R.No.	Name of the Bank	Year of Establishment	No. of Branches	Ownership
1	Awash International Bank	2002	180	private
2	Commercial Bank of Ethiopia	1971	644	Gov't
3	Development Bank of Ethiopia	1909	32	Gov't
4	Construction and Business Bank	1983	32	Gov't
5	Dashen Bank	1983	55	private
6	Wegagen Bank	1965	50	private
7	Bank of Abyssinia	2004	47	private
8	United Bank	2005	41	private
9	Nib International Bank	2006	45	private
10	Cooperative Bank of Oromia	2004	38	private
11	Lion International Bank	2006	20	private
12	Zemen Bank	2008	NA	private
13	Oromia International Bank	2008	25	private
14	Bunna International Bank	2009	NA	private
15	Addis International Bank S.C	2011	49	private
16	Debub Global Bank S.C	2012	28	private
17	Enat Bank S.C	2012	19	private
18	Abay Bank S.C	2010	NA	private

Source: NBE, 2015

Yet the naming of the above banks under Table 1 is indicative of the concentration of much of branches in some specific regions. When we observe the political structure of Ethiopia it's composed of nine diverse regional states and two town administrations. Each region as well as town had its own unique cultures, norms, and institutional set-ups, which makes a great difference among them. The above brands for banking sector are indicative of the concentration of banks in some regions with their respective naming as well as shifting the preference of clients to services provided at their birth place regions. For instant, Debub Global bank's shareholders are individuals from Debub regions and the bank branches are highly concentrated around Southern region. Same is true for Abay, Oromia international bank, Cooperative Bank of Oromia, and Awash International Bank, and others. This tendency has it has its own negative consequences on the deterioration of the financial sector due to unfair share holding behavior and the distribution of banks in some specific regions by some group of people.

In the above statements, the intense competition between investors and government, as well as ethnicity-based bank branding, ownership and expansion may raise the question of sustenance of the sector in Ethiopia. To the extreme case these arrangements might be the causes for the long-run risk attachments and failure of the financial sector in Ethiopia.

According to national bank of Ethiopia (2011), the minimum paid up capital required to obtain a banking business license shall be Birr 500 million which shall be fully paid in cash and deposited in a bank in the name and to the account of the bank under establishment. This increment in the initial minimum capital requirement is had the objective of enhancing the capacity of newly emerging banks to compete efficiently with the existing banks. However, it acted as a discouraging factor for private domestic investment in participating on banking sector investment; this might be the main cause for the current limited number of banks in Ethiopia as compared to neighbor countries of Africa.

According to IMF 2016, the banking system of Ethiopia has been dominated by the Commercial Bank of Ethiopia (CBE), which controls 70% of the total assets in the country. The other 30% is controlled by private banks. The reason for this success of the CBE is that it is a fairly well-run and efficient bank, and provides an element of security in that it is run by the government.

The government continuously implemented different discouraging measures that negatively affects the performance of capital, foreign exchange markets and weakens the involvement of private owners in the banking sector. In addition to controlling interest rates on deposits, the government interferes with the credit allocation decisions of private banks. Credit is often rationed in favor of larger and more established businesses. In fact, the World Bank's assessment demonstrates that state-owned enterprises have much better access to credit than private businesses (World Bank, June 2009). The state-owned Development Bank of Ethiopia only lends to support the government's industrial development initiatives, selectively providing capital to firms in sectors the government wants to promote. Moreover, the National Bank issued a directive on April 6, 2011 ordering private commercial banks to buy government bonds worth 27 percent of the loan disbursements they have made since July, 2010. This measure was set to earn 3 percent interest while the deposit rates set by the National Bank stand at 5 percent (Ethiopian Bank, July, 2010).

Now a day the financial sector specially the banking sector in Ethiopia is highly regulated by the government and intensively closed from foreign ownership, it is only licensed by private domestic investors. This reduced the competition of the Ethiopian banking sector in the international market and there by reduced the efficiency of banks.

In addition, acquisition of loan requires higher collateral, giving lower opportunities for new and small-scale operating businesses. Hence businesses are constrained from engaging in large investment activities.

Furthermore, securing a loan requires high collateral, putting younger and smaller businesses at a disadvantage. Without access to capital they cannot afford the investments necessary to grow. This development ends up protecting underperforming large and medium-sized firms. Furthermore, the extent of financial control has contributed to negative effects on savings, capital formation, financial development and economic growth.

4.1 Financial Sector Reforms in Ethiopia

The EFDR government introduced a market-oriented economy from the early beginning of power transition. Among these reforms were measures to decontrol prices and markets were taken in the financial sector. The following principal reforms in the financial sector were gradually introduced:

- ✓ The National Bank issued a directive, no. NBE/INT/7/98 to decontrol commercial banks' deposit and lending rates in January 1998 (NBE,1998a).
- ✓ The National Bank directive no IBM/02/98 set a framework for the conduct of inter-bank money market operations (NBE,1998 b).
- ✓ The National Bank issued a directive no. SBB/24/99 that set a higher capital standard: a minimum capital requirement for new banks of birr 75million (NBE,1999).
- ✓ The establishment of discount window facilities for commercial banks through directive no. ERD/01/2001 (NBE, 2001).
- ✓ The government issued Proclamation No. 591/2008 dated August 11, 2008, in order to increase the autonomy of the National Bank of Ethiopia, which among other things clarified the role of the National Bank as the regulator and supervisor of the banking sector.
- ✓ NBE has set the minimum saving and time deposit rates at 5%. But banks may pay higher than this rate
- ✓ The lending rate is fully liberalized, and hence there is no lower/upper lending limit rate in the country. Each bank determines the lending rates.
- ✓ Anyone can participate on the auction of Treasury bill with a minimum of birr five thousand (birr 5000.00).
- ✓ In January, 1994, the Ethiopian government, reversing the nationalization decision of the Socialist Military Government, issued Proclamation No. 84/1994, to legalize domestic private investment in the banking industry.
- ✓ All eligible individuals can get foreign currency from commercial banks of Ethiopia yet not as such implemented.
- ✓ A significant part of the micro management and operations function of foreign exchange transactions have been transferred from National Bank of Ethiopia to commercial banks via directive No. FXD/07/1998 issued on August 31, 1998.

5. Summary and Policy Recommendations

Although the current government exerted different efforts to enhance the performance of the banking sector for about twenty-five years, it remains at infant level and incompatible with the international world experiences. The implementation process also had taken lots of years and is not fully adequate to run the economy of the country. Compared to neighbor countries like Kenya the banking sector of Ethiopia is not as such competitive and efficient. The role of banking sector remains marginal in accelerating economic growth.

Global experience suggests that greater competition among domestic and foreign banks can bring greater benefits in the form of improving efficiency. Fundamental market-oriented measures are therefore needed to further strengthen the financial sector in order to accelerate Ethiopia's economic growth.

The policy implications suggest that the Ethiopian banking sector needs to be adjusted to the following additional market-oriented reforms in order to benefit positively from smoothing of the financial sector with economic growth. These measures include

- ✓ The privatization of the dominant government-owned Commercial Bank of Ethiopia and Development Bank of Ethiopia;
- ✓ According to NBE Only Ethiopians can own and operate financial institutions. Hence it's better to Opening up the banking sector for foreign investors and allowing the participation of foreign banks in Ethiopia with some management control system and with some conditions.
- ✓ Government should critically consider the risk factors related with the current ethnicity-based ownership and expansion of banks in some specific regions.

- ✓ The government of Ethiopia and other concerned bodies should consider the existence of competition in the banking industry among government and the private investors to curb problems related with sustenance and efficiency.
- ✓ Allowing market forces of demand and supply to determine interest rates and the exchange rate of the ETB, and
- ✓ Reducing the intervention of government in the banking sector
- ✓ Upgrade the regulatory and supervisory ability of the National Bank of Ethiopia to restore the public's trust in the banking sector.
- ✓ Allowing free acquisition of foreign currency by formal individuals of the nation from all banks (either it's government or private).
- ✓ Since all Ethiopian nationals living and working abroad and non-resident foreign nationals of Ethiopian origin can open fixed (time deposit), current and non-reparable Birr account only in commercial bank of Ethiopia, yet it's better to enlarge the system to some or all private banks of Ethiopia.
- ✓ It's not as such worthwhile of adopting all principles of liberalization strategy. For me adopting all the principles might provide a significant comparative advantage for these policy, strategy or international law pinpointing developed countries. We are expected to challenge the proposed strategies or if possible to contextualize the strategies developed by IMF and WB.

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