Banking Sector Reform in Ethiopia: An Abstract

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The fragile and inefficient state-dominated banking sector that existed in Ethiopia during the military government (1974-1991) was a major hindrance to economic growth. Since it took power in 1991, the current government has implemented a number of reforms. For instance, in 1994, the government legalized domestic private investment in the banking industry. In addition, it restructured the two development banks as commercial banks, and introduced a new Banking and Monetary Proclamation that gave more autonomy and further clarified the National Bank of Ethiopia’s activities as the regulator and supervisor of the banking sector.

Although the process has taken two decades, the banking sector remains repressed since the reform process has been painstakingly slow and the policy measures implemented so far are not fully adequate. To date, these measures fall short of significantly improving the banking sector. It is not yet competitive and efficient, nor is it capable of accelerating the economic growth of the country which remains marginal. The government’s concern that financial liberalization may lead to a banking crisis that may culminate into an economic crisis is also misplaced. Empirical studies provide evidence that as regulatory and supervisory tools are upgraded and as supervision becomes increasingly vigorous, the probability of a banking crisis significantly diminishes. It is time to recognize this contradiction and it would be wise to begin the process of vigorous reform to achieve financial strength. 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.
Therefore, the policy implications drawn from the study suggest that the Ethiopian banking sector needs to be tuned to the following additional market-oriented reforms in order to benefit positively from the harmonization of financial intermediation with economic growth. These measures include 1) the privatization of the dominant state-owned Commercial Bank of Ethiopia; 2) permitting entry of foreign banks; 3) allowing market forces to determine interest rates and the exchange rate of the ETB, and 4) upgrade the regulatory and supervisory ability of the National Bank of Ethiopia to restore the public’s trust in the banking sector.

1: Privatization of State-owned Banks to Level the Competing Field

Despite the government’s decision to allow private domestic banks to be reestablished, reversing the nationalizing policy of the socialist military government, a lion’s share of banking business remains dominated by three state-owned banks, the Commercial Bank of Ethiopia, Development Bank of Ethiopia, and the Construction and Business Bank. In the Ethiopian banking sector, loans are not priced competitively by taking into consideration the risk of the borrower and the return of the loan to the lending bank. Instead Ethiopian banks in general follow the loan pricing policy adopted by the Commercial Bank of Ethiopia. In the absence of market forces in the credit market, credit is inevitably directed to inefficient borrowers outside the productive sector of the economy. This practice inevitably denies capital to efficient firms and contributes to the build-up of non-performing loans in the state owned bank’s portfolio.

Several studies such as La Porta et al (2002) indicate that the performance of privately owned banks is better than state-owned banks. According to the survey conducted by Access Capita, in Ethiopia bank concentration defined as the asset share of the three largest banks was 100 percent in 1994 and down to 93.6 percent in 1998. It progressed further downward to 69.6 percent in 2006. This implies that the share of government owned banks also declined. According to Kiyatta et al., in seven out of nine years private banks had a higher ROA than state-owned banks. This is due to several factors: the spread has increased for both public and private banks and private banks have higher spreads than publicly owned banks. Therefore, since privately owned banks are superior in terms of efficiency and profitability, publicly owned banks need to be privatized.

2: Opening the Ethiopian Banking Sector to Foreign Participation
Despite heavy pressure from the United States Government, as evidenced from Wikileaks messages, the Ethiopian government continues by law to prohibit the entry of foreign banks to the country. Barriers to entry in the banking sector reinforce inefficient state-owned enterprises by shielding them from competition. The government’s concern is that if foreign banks were to be allowed to operate in Ethiopia, it may lose of control over the economy. This position is based on the infant industry argument. Prohibiting foreign bank entry at this time would prevent the domestic banks from being weakened because of unfair competition from foreign banks.

Two important questions must be answered when examining the issue of foreign bank entry to Ethiopia. First, will foreign banks invest in Ethiopia if the government reverses its stand and permits their entry? Second, once foreign banks start operations in Ethiopia will they be assets or liabilities to the country? The answer to the first question is an unqualified “yes” since Ethiopia presents a huge potential for bank profits for a number of reasons.

To begin with, foreign banks have a number of advantages compared to domestic banks. By servicing client’s active in more than one country, they can achieve benefits from spreading best-practice policies and procedures. Second, they may be able to diversify risk better, allowing them to undertake higher risk, but also with potentially higher returns on investments. Third, foreign banks have advantages in the form of more diversified funding sources, including having access to external liquidity from their parent banks, which may lower their funding costs. Finally, by being larger they may achieve other scale advantages such as utilizing more advanced and sophisticated risk assessment models to give them a competitive edge over fragile Ethiopian banks.

At the same time, foreign banks are likely to incur additional costs and face more obstacles when compared to domestic banks. They may have less information compared to local banks on how to do business in Ethiopia, putting them at a disadvantage, at least until they have been in the country for some time. Moreover, foreign banks might be exposed to discrimination by individual customers. Additionally, diseconomies might arise because of an institutional environment that is culturally different. However, these costs remain a small fraction of the huge revenue benefits they are likely to generate by operating in
Ethiopia. As Aghion and Howitt (1998) pointed out, successful foreign banks that have learned to work in a competitive environment with demanding customers in their home countries have learned to innovate, pursue new business segments, and adjust to changing circumstances. Greater competition in their home countries can lead to more efficient operations in Ethiopia. Gregorian and Manole (2006) and Berger, Hansen and Zhou (2009) after examining the role of foreign banks in developing countries have found that foreign banks outperform domestic banks.

The current state of development of the financial sector in Ethiopia is also a factor that could have a favorable impact on the profitability of foreign banks. In Ethiopia, where a large part of the population does not yet have access to banking services, it is easier for foreign banks to gain market share and therefore likely easier to make a higher profit. Finally, according to Berger and Humphrey (1997), size has been found to be an important factor for explaining performance of any bank. By being comparatively larger, foreign banks may achieve other scale advantages; for example they may afford more advanced and sophisticated risk assessment models giving them superior risk management skills.

When studying foreign banks in developing countries, Claessens, Demirgüç-Kunt and Huizinga (2001) point out that in a country like Ethiopia where the banking sector is inefficient, banking practices are outmoded, and credit is not allocated on commercial criteria, foreign banks may be able to reap higher profits than domestic banks. Similarly Mico, Panizza and Yanez (2007) find that foreign banks do tend to have higher profits than domestic banks in developing countries. Also, Gregorian and Manole (2006) have found that foreign banks outperform domestic banks. The answer to the first question of whether or not foreign banks will be willing to invest in Ethiopia is an affirmative “yes” because it will be profitable for them to do so and globally competitive banks will seek to exploit the profit potential to their advantages.

The answer to the second question, whether or not the participation of foreign banks would be an asset or a liability to Ethiopia, is also clear and unambiguous. Foreign banks will be an asset since they will promote competitiveness and efficiency in the banking sector. However, as far as the current government of Ethiopia is concerned, foreign banks are viewed as a
liability to the country. As a consequence, entry of foreign banks is prohibited. The government’s rationale is based on the infant industry argument as follows: First, since the banking sector in Ethiopia is young it will not be able to compete with more mature foreign banks that have more capital, professionally qualified and seasoned managers and employees, and better reputations.

Second, there is evidence in the literature about the association between financial liberalization and banking crises. Such studies include Williamson and Mahar (1998), Kaminsky and Reinhart (1999), Demirguc-Kunt and Detragiache (2001), Weller (2001), Eichengreen and Arteta (2002) and Noy (2004). Demirguc-Kunt and Detragiache (2001) find that financial liberalization is strongly and positively correlated with the probability of a subsequent banking crisis. This is especially true in a country like Ethiopia where the institutional environment is weak. Weller (2001) finds that a banking crisis becomes more likely after domestic financial liberalization. Noy (2004) considers interactions between domestic liberalization and supervision and concludes that banking crises occur as a result of weak supervision after liberalization.

Third, since foreign banks, if allowed to operate in Ethiopia, are likely to engage in cream skimming behavior, preferring large scale operators for clients, such as commercial agriculture, big industrial, real estate and service establishments. They inevitably will skew credit allocation in favor of these very large and established enterprises. Fourth, foreign banks may concentrate on lending rather than mobilizing of savings.

Finally, the government believes that at present Ethiopia is poorly endowed with the financial experts to design and operate the regulatory and institutional structures needed to supervise the banking sector. Although assistance from IMF/World Bank can help redress the shortage, the ultimate success of banking reform ambitions will stand or fall by Ethiopia itself. Ethiopia continues to experience a significant brain drain begun in 1974 and does not have the capability to effectively oversee the operations of foreign banks at this time.

The infant industry argument seems to be an excuse for a concern held by some Ethiopian government officials. According to them, since foreign banks
serve as conduits for inward and outward flows they would facilitate the outflow of capital whenever they felt that a banking crisis was about to emerge. An outflow of capital could develop into full-blown economic crises leading to political instability. The government does not want to take chances and lose control. According to Demirguc-Kunt and Detragiache (1998) banking crises tend to erupt when the macroeconomic environment is weak, particularly when growth is low and inflation is high. Since Ethiopia’s economy is characterized by low growth and high inflation, the danger of political instability remains real.

Contrary to the government’s view, the potential benefits that can result from opening the sector for foreign direct investment remain substantial. First, foreign bank participation may have the potential for a positive impact on the efficiency of the Ethiopian banking sector. Competition demands that domestic banks continuously upgrade their skill and technology levels to stay in business. Second, entry of foreign banks may improve bank regulation and supervision. According to Goldberg (2007) the entry of foreign banks in emerging markets that are healthier than domestic banks implicitly allows the introduction of stronger and more prudent regulation, increasing the soundness of the local banking sector. Third, the entry of foreign banks to Ethiopia will strengthen the financial sector and may have a positive impact on economic growth. Demirguc-Kunt, Levine and Min (1998) and Mattoo, Rathindran, and Subramanian (2006) have found a positive correlation between financial sector openness and economic growth. Also, Beck et al. (2004), Levine, Loayza and Beck (2000) and La Porta (2002), Lopez-Silanes, and Shlefer (2002) concluded that an increase in bank concentration was an obstacle in obtaining financing for growth.

3: Allowing Market Forces to Determine Interest Rates as well as the Value of the Ethiopian Birr (ETB)
Eliminating government interference in the banking business is critical for the efficient mobilization of savings and allocation of deposits to profitable enterprises. Examples of government interferences that have disrupted the banking sector include the following: first, the deposit rate on savings is set by the National Bank of Ethiopia. Until December 2, 2010 the deposit rate was 4 percent. Since the inflation rate averaged 19 percent during the last 5 years, the real negative savings rate amounted to 15 percent. Although the National Bank of
Ethiopia increased the deposit rate from 4 percent to 5 percent effective December 2, 2010, this move did not lead to a higher level of savings. This would be avoided if all interest rates were allowed to be determined by the market. As a consequence, Ethiopia’s savings rate in 2009, according to the World Bank, was 2.3 percent of Gross Domestic Product, which compares poorly to the 25.7 percent rate achieved by Sudan.

Second, the government imposed credit ceilings on private banks, which reduced the volume of credit. This measure contributed significantly to a reduction of the inflation rate, from 64 percent to 2.7 percent. It was removed on April 1, 2011. Third, private banks are now required to offer 27 percent of their loans to the government and do so at an interest rate of 3 percent. This directive is estimated to divert about ETB 11 billion from the private to the public sector. This sum is equivalent to a 2.4 preferment of GDP and is estimated to cover the government budget deficit this year. As a consequence, credit will be tight and expensive.

To enhance the banking sector’s ability to mobilize deposits and efficiently allocate savings, all interest rates should be market determined. Currently, the National Bank sets the deposit rate. Although recently NBE has announced its decision to increase the deposit rate from 4 percent to 5 percent, this is still below the level that can allow financial institutions to mobilize deposits and extend credit to support the growth of business and the economy at large. This requires higher interest rates above the inflation rate to make saving a profitable endeavor.

In regard to determining the value of the Ethiopian Birr (ETB), the gradual devaluation policy followed by the government did not prove to be useful. Although it drove down the value of the ETB from US$ 0.4831 in 1992 to $0.0592 in 2011, Ethiopia continues to experience widening current account deficits and rapidly declining foreign exchange reserves. At times the level of the reserve has reached a precariously low level, equivalent to 2 to 3 weeks of imports.

In order to free the exchange rate from the political calculations of the government, and to enhance its flexibility, defining ETB in terms of a basket of floating currencies would lead to a better outcome. In this regard, a basket of four key currencies -- the British Pound, Euro Dollar, Japanese Yen, and the US dollar -- would lead to a better outcome. This approach will indirectly determine the value
of ETB based on market forces. The basket composition can be reviewed as needed to insure the relative importance of currencies in the world’s trading and financial systems. The weights of the currencies in the ETB basket would be revised based on the value of exports of goods and services and the amount of reserves denominated in the respective currencies which were held by the member countries of the International Monetary Fund.

4: Upgrade the Regulatory and Supervisory Capacity of the National Bank of Ethiopia (NBE)

According to several studies, financial liberalization remains a contributing factor to financial crises. However, according to empirical results, this relationship is found to be true only in countries where regulation and supervision are weak. The determining factor for banking crises is not financial liberalization but the quality of the regulatory and supervisory apparatus. The relationship between liberalization and a banking crisis depends strongly on the strength of capital regulation and supervision. The probability of a banking crisis is high in a country with very weak regulation and lethargic supervision. By contrast, the probability of a banking crisis decreases with liberalization in a country with stricter regulation and vigorous supervision.

Despite the government’s initiative to upgrade the regulatory and supervisory capacity of the National Bank of Ethiopia (NBE), and gains achieved in improving the quality of NBE’s staff, the progress achieved to date remains unsatisfactory. As a consequence, the National Bank’s supervisory capacity remains weak. In its recent country report on Ethiopia dated November 2010, the International Monetary Fund “urged the Ethiopian Government to enhance the ability of the NBE to recruit and retain qualified staff to ensure the institutional absorption of the technical assistance provided by the Fund and other partners in this area.” With a continuing brain drain significant progress in this area is unlikely to take place in the near term. However, the threat of a banking crisis may embolden the government to continue with its policy of prohibiting foreign bank entry.

On the other hand, the government may give in to pressures exerted by friendly governments and the IMF and the World Bank. Ethiopia’s heavy dependence on foreign aid coupled with its desire to join the World Trade
Organization (WTO) may prove to be significant motivation for changes in government policies in this regard. Progress in this area will enhance public trust in the banking system and may lessen the possibility of a banking crisis.