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The Structure And Performance Of Ethiopia's Financial Sector In The Pre And Post Reform Period: With Special Focus On Banking

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Abstract

Since 1992 Ethiopia has been engaged in liberalizing its financial sector. The hallmark of the strategy is gradualism. The approach is not without problems especially from Bretton Woods Institutions that saw the reform as a sluggish process. This study examines this liberalization program by analyzing the performance of the sector before and after the reform. The study notes that given the recent nascent development the financial sector in the country, the relatively good shape in which the existing financial institutions find themselves, and given that supervision and regulation capacity of the regulating agency is weak, the government's strategy of gradualism and its over all reform direction is encouraging. However, we argue for charting out clearly defined time frame for liberalization and exploring the possibility of engaging with foreign banks to acquire new technology that enhance the efficiency of the financial sector in general and the banking sector in particular.

1. Introduction

One of the main objectives of financial institutions is mobilizing resources (in particular domestic saving) and channeling them to the would-be investors. This intermediation role of financial institutions takes different forms in different economic systems. Ethiopia's history of the last three decades clearly shows the validity of this statement.

Under 'State Socialism' (1974 to 1991), popularly referred in Ethiopia as the '*Derge*[2] Regime', financial institutions were basically executing the economic plans outlined by the central planning organ. In that periodp regulation and supervision were not critical since the national plan was believed to regulate and direct the activities of the financial institutions. Moreover, financial institutions were directed to finance some public projects that may not pass proper financial appraisal simply based on either ideological ground or 'merit wants' argument.

Following the demise of the *Derg* regime in 1991, post-1991 economic policy witnessed a marked departure from the previous "Socialist' System",. Its main difference lies on openly adopting a

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[2] An Amharic term meaning "the committee" (of solders).

market-oriented economic policy. In fact much of the policies adopted by the new government in Addis in 1991 had been already proposed by the defunct *Derge* regime virtually at the end of its reign.

This new change in policy brought about a significant change in the functioning of the financial sector. Not only is the financial sector is going to serve the private sector, which hitherto had been demonized, but also new private financial institutions were emerging. Equally the role of the Ethiopia's central bank (named National Bank of Ethiopia, NBE henceforth) was also reformulated. Thus, financial sector reconstruction was the top item in the government's agenda.

In undertaking this task the Ethiopian government adopted a strategy of (a) gradualism: gradual opening up of private banks and insurance companies alongside the public ones, gradual liberalization of the foreign exchange market etc and (b) strengthening domestic competitive capacity before full liberalization (ie., restrict the sector to domestic investors, strengthening the regulatory and supervision capacity of the NBE, providing autonomy to banks as well as opening up inter-bank money market etc). In line with this strategy various proclamations and regulations were passed since 1992 (See Alemayehu and Seife 2001).

The rest of the paper is organized as follows. In section two a brief overview of banking history in Ethiopia is made. This will be followed by section three where the analysis of the financial sector in the pre and post reform periods is made. Section four concludes the chapter.

2 Brief Banking History

One can trace the history of using modern money in Ethiopia to more than 2000 years (Pankhrust in Belay, 1990). This had flourished in what is called the Axumite era which can stretch from 1000BC to around 975 AD. Leaving that long history aside, modern banking in Ethiopia started in 1905 with the establishment of *Abysinian Bank* based on a 50 years agreement with the Anglo-Egyptian National Bank. In 1908 a new development bank (named *Societe Nationale d'Ethiope Pour le Development de l' Agriculture et du Commerce*) and two other foreign banks (*Banque de l'Indochine and the Compagnie de l' Afrique Oreintale*) were also established (Pankhrust (1968) cited in Befekadu, 1995). These banks were criticized for being wholly foreign owned. In 1931 the Ethiopian government purchased the *Abysinian Bank,* which was the dominant bank, and renamed it the 'Bank of Ethiopia' – the first nationally owned bank on African continent (Belay, 1990: 83; Befekadu, 1995: 234).

During the five-years of Italian occupation there was an expansion of banking activity. In particular the Italian banks were active. Table 2(a) shows banks that were in operation during this period. After independence from Italy's brief occupation (of 1933-1941) where the role of British was paramount owing to its strategic consideration in World War II, Barclay's bank had established and was in business in Ethiopia from 1941 to 1943 (See Belay 1990; Befekadu, 1995). Following this, in 1943, the Ethiopian government established the 'State Bank of Ethiopia'. The establishment of this Bank by Ethiopia was a painful process since Britain was against it (See Befekadu (1995) for an interesting neo-colonial story). This bank was operating both as commercial and central bank until 1963 when it was dissolved into today's National Bank of Ethiopia (the central bank, re established in 1976) and 'The Commercial Bank of Ethiopia', CBE henceforth. After this period many other banks were established; and just before the 1974 revolution the following banks were in operation (See Table 2b).

{Insert Tables 2a and 2b here}

All privately owned financial institutions including three commercial banks, thirteen insurance companies and two non-bank financial intermediaries were nationalized on 1 January 1975[3]. The nationalized banks were reorganized and one commercial bank (the Commercial Bank of Ethiopia), a National Bank (recreated in 1976), two specialized banks (the Agricultural and Industrial Bank – renamed recently as the Development Bank of Ethiopia; and a Housing and Saving Bank – renamed recently as the Construction and Business Bank) as well as one insurance company – Ethiopian Insurance Company were formed. Following the regime change in 1991 and the liberalization policy in 1992, these financial institutions were reorganized to work on market-oriented policy framework. Besides, new privately owned financial institutions were also allowed to work along the publicly owned ones. The discussion about these financial institutions is the subject of the rest of this chapter.

3. The Structure and Performance of the Financial System in the Pre and Post Reform Period

Following the Mckinnon (1973) and Shaw's (1973) paradigm, financial liberalization has been high on the agenda of developing countries. The financial repression school - as it is sometimes referred to - argues that government intervention in the sector (in particular through subsidized interest rate and (favored) credit allocation) not only distorts the financial market but also depresses saving and leads to inefficient investment. The policy prescription that follows is liberalization. This has been endorsed by international financial and development institutions (such as the World Bank and IMF) and had been high on the agenda of reform packages that came with name 'Structural Adjustment Programs'/SAPs.

Many developing countries, except a few in Asia, that went through this agonizing reform process are unable to enjoy what is promised in this package in general and the financials sector prosperity in particular. Vos (1993) noted that the major factors that could explain the failure of

[3] The commercial banks were Addis Ababa Bank, *Banco di Napoli and Banco di Roma*. The insurance companies were African Solidarity, Ethio-American life, Blue Nile, Ethiopian General, Imperial, Afro-Continental, Pan-African, Union, Ras, and Ethiopian Life and Rasi. The non-bank financial intermediaries were the Imperial Saving and Home Ownership Public Association and the Mortgage Corporation (Befekadu, 1995: 273).

financial liberalization in Latin America and its success in Asian developing countries (such as Korea and Taiwan) lies in the control and intervention by state to address structural problems without disregarding market-oriented performance criteria. Thus, for Vos gradualism and addressing some of the setbacks in the financial sector reform, such as lack of sensible prudential and supervisory capacity in place before the on set of the financial sector reform, are crucial.

3.1 The Pre-Reform Financial Sector

The pre-reform period here refers to the period 1974 to 1991, which I noted as the *Derge* regime before. During this period all private banks were nationalized. The National Bank of Ethiopia (NBE) was at the apex of the banking structure and was engaged in all the functions of a central bank. As noted earlier, CBE, AIDB (DBE), HSB (CBB) were in operation. In addition to these banks, there were also two other financial institutions: Ethiopian Insurance Corporation (EIC) and the Pension and Social Security Authority (PSSA).

The CBE, followed by the DBE, was/is the most important banks in the country both before and after reform. On the average the CBE alone comprises more than 90% of total deposit (while DBE's share is 1.3%), and 71% of the total loans advanced (DBE's share being 16%). Owing to the dominant position of these two banks, the major activities and performance of these two banks is outlined below. This will provide us with a good picture of banking activity in the country both before and after the 1992 reform.

3.1.1 The Commercial Bank of Ethiopia (CBE)

The Commercial Bank is established in its present form by a merger of one of the nationalized private bank (Addis Bank) with that of the publicly owned commercial bank by proclamation No. 184, 1980. It is directed by a board and managed by three mangers (one General and two Deputies) appointed by the government. The management is supported by detailed monthly and quarterly reports of the various branch banks.

Mobilization of Deposit

Table 3(a) shows the mobilization of deposit by CBE in the pre and post reform period. The Table shows that the CBE is the dominant bank that accounts more than 90% of the total deposit mobilized in the country in the pre-reform period. This share is the highest for demand deposit (100%) followed by saving (96%) and time (45%) deposits. Thus, to study the CBE is basically to study the banking sector in Ethiopia.

CBE share in total deposit has dropped to an average of to 87% in the post-reform period, the actual figure for 2002/03 being 75.5%. The sharp decline in CBE's share in total deposit (as percent of national total) observed in 2002/03 is primarily due to the performance of the new private banks, in particular Awash and Dashen Banks. The share of the CBB and DBE has also increased (see Table 3a and below).

Clearly there is evolving structural shift when deposit is observed by institutions. In general the trend is to move away form a dominant public sector towards a financial structure where the role of the private sector is becoming increasingly important. In general, during the two periods (before and after the reform), demand deposit by the private sector and individuals increased ; the share of cooperatives declined; and the share of the public enterprises and agencies declined Financial agencies share has also declined while the central government's share has increased. In terms of saving and time deposits the private sector has the lion share in both periods. This is attributed to the government's rule that restricts public enterprise and agencies form holding such deposit (see Alemayehu 1999b).

{Insert Tables 3a }

Loans and Advances

Tables 3b and 3c show the outstanding loans of the CBE by 'institutional' and sectoral disaggregation. In the immediate years before the reform (1985-91) the average outstanding loans of the CBE was the highest in the international trade sector (15% in 1989) followed by housing & construction and domestic trade (about 6%) and industry (5.5). In the post-reform period the outstanding loans with domestic trade sector grew enormously (reaching on the average. 1992-2003, 19.3%). This is followed by domestic trade (12.6%), industry (7.2 %) and transport and construction (5.4%) sectors. Loan to the central government which was about 62 % in pre-reform period has declined nearly by half (to 32%) in the post-reform period. This perhaps shows the discipline the government is exercising in its fiscal and monetary polices.

When the outstanding loans by institutional break down is examined (see 3c) outstanding loan to the public enterprises which was about 27% in last five years of the pre-reform period has declined to an average of 15% in the post-reform period, the figure for 2002/03 being 5%. The share of the private sector, however, has increased from 14 % to 47% in the two periods. This is attributed to the liberalization program which resulted in the increasing exposure of the CBE to the private sector. As to the government, as noted above, CBE's outstanding loan with government has dropped nearly by half.

{Insert Tables 3b and 3c here}

Loan Collection

In the pre-reform period the highest loan collection is made from are domestic trade, followed by import and exports, and the industry (in the order of importance). In terms of institutional disaggregation, loan collection from the private sector was significant which constitutes nearly 47 % in the pre-reform period and jumped to an average figure of nearly 75% in the post-reform period. Loan collection from the public sector had been falling steadily in the pre-reform period. This trend has also continued in the post-reform period (dropped from 44% to 115 in the two periods. This shows the bad financial shape in which the public sector found itself. Details of this are given in Tables 3d and 3e.

In general total collection has shown a marked improvement in the post-reform period. The growth figure, which was generally negative in the pre-reform period, changed to a positive one in the post-reform period. Thus, the performance of the CBE in this regard is quite commendable. This pinpoints to the important point that existing public banks, with proper regulation and policy environment, can enormously improve their performance. Hence, privatization, as argued by IMF, is not a panacea to bring about efficiency in the banking sector.

{Insert Tables 3d and 3e here}

Asset Quality

Table 3(f) shows the quality of assets at CBE. The liquidity ratio in both periods is quite impressive - being well above the statutory requirement of 20% in all periods. These figures show an improved performance in the post-reform period. This good quality asset of the bank can also be inferred form the 'loan to deposit ratio' that is increasingly showing a declining percentage (notwithstanding the increase in credit) which in turn shows that the bank has strong resource base. By 1997 the loan to deposit ratio has the lowest figure of 60%. Moreover, the post-reform period witnessed a positive development both in the ratio of non-performing assets to total assets as well as provisions to bad debt. It should be noted however that this analysis is based on officially given figures. My observation and discussion with some researchers is that non-performing loan figures need to be cautiously taken[4]. However, the main conclusion that can be made from the analysis of the bank's asset quality (as reported in the books) is that the CBE has quite impressive record in this regard. One may contrast this finding with the IMF's and Bank's recommendation of either privatizing or dividing the CBE. On asset quality ground there is no (official) justification for such policy proposal. The IMF's and Bank's argument could be on competition ground. I will comeback on this issue at the end of the paper.

As can be read form Table 3(f), total assets of the CBE had a modest growth rate before the reform. In the post-reform period the assets of the bank has grown annually by double digit figures. In particular the unprecedented growth of nearly 50% in 1992/93 is clearly associated with the reform process. According to the CBE's Annual Report, this highest growth is attributed to growth in net loans and advances, customers' liability for Letter of Credit (LC), cash with foreign banks and deposit with NBE (in their order of importance). In particular loans and advance in 1992/93 increased by nearly 125 percentage points (constituting nearly 25% of the

[4] There are unconfirmed reports that put this figure as high as 40% in the last four to five years and now (currently) dropping close to 15%.

total assets of the bank, for the first time in two decades). This is attributed to the growing demand for credit (and hence to satisfy that demand) owing to liberalization. The availability of foreign exchange and the devaluation that took place at this period (devaluation by 240%) has also contributed to the growth. Throughout the subsequent years loans and advances to the private sector has shown sustained increment.

In sum, the CBE is the dominant bank in the country. Both the quality and structure of assets and various performance indicators of the bank show that the bank is by and large in a good shape. There are certain areas such as non-performing loans, and adopting new technology to improve the efficiency of its services where we found the CBE to be weak. The relevant policy prescription seems to intensify the on going restructuring and accompany that by prudential regulations. It seems extremely difficult, unlike that of the World Bank and IMF, to extract a policy prescription of privatization from an examination of the existing data.

{Insert Tables 3(f) here}

3.1.2. The Development Bank of Ethiopia (DBE)

The mobilization of deposit by DBE was fairly stagnant in the five years before the reform. However, it dropped sharply just before the reform period and the first two years of the post-reform period. Currently its level is picking up and reaching the level registered in the pre-reform period (see Alemayehu 1999b).

Table 3(g) shows DBE's loan disbursement by sector. Both in post and pre-reform period the highest share of loan disbursed has gone to the agricultural sector. This is followed by the loans disbursed to the industrial sector. In terms of the magnitude of the loan advanced, the recent years has show a marked decline (the total loans advanced by DBE declining from 155 million in 1992/93 to about 57 million in 2002/03, see Table 3(g)). In terms of loan by social sectors, the bias against the private sector that was witnessed in the pre-reform period is reversed in the post-reform period. This reversal shows the success of redirecting the emphasis from public to private sector (see Alemayehu 1999b).

Outstanding loan was a serious problem in the pre-reform period. This problem has eased in the post-reform period although currently its value is to 4.4 billion Birr in 2001/02 Birr (see Tables 3(h) and 3(i)). In terms of sector the agricultural sector was the most indebted on in the pre-reform period. The industrial sector took over the agricultural sector in the post-reform period, however. In terms of institutional Disaggregation outstanding loan was mainly with the public sector in the pre-reform period. Again the private sector took over the public sector in this respect in the post-reform period. The rather recent phenomenon of high level of outstanding loan with private sector needs closer attention. Although I couldn't find complete data on arrears, the level of arrears in the pre-reform period (in particular in the agricultural sectors – where the role of state farms was crucial) had reached an alarming level. The arrears which were on the average above 75% of total principal outstanding in the pre-reform period has declined sharply to nearly 40% in the first two years of the post-reform period owing to the rescue effort by the government (see Alemayehu 1999b).

{Insert Tables 3(h), 3(i), here..

In terms of loan collection, the performance of DBE is not impressive (see Table 3(j)). However, in the post-reform period the DBE has made a good effort to collect its outstanding loans, in particular, from the cooperative and private sectors.

Other performance indicators of the DBE were not impressive. For a good part of the period under analysis the DBE is operating at loss and had a bad financial shape, as can be read from the change in working capital. Its total asset was by and large stagnant in the pre-reform period and declined thereafter. In general since the DBE was operating under the auspices of central planning and relatively exposed to loss making sectors (such as state farms) its performance epitomized the inefficiency in the public sector (see Alemayehu 1999b). This should be contrasted with CBE, which is a public sector, yet relatively performed good even on financial ground. Thus, it makes sense to make the interesting conclusion that probably what matters most is not ownership but exposure/or not to loss making clients or not.

{Insert Table 3(j) here..

3.1.3 The Policy Regime in the Pre-Reform Period: Financial Sector and Ideology

The Derg can be characterized as a controlled regime where all economic activities were to be based on the directives that came from the central (national) planning organ. To facilitate this, the NBE is reorganized by the 1976 reorganization proclamation where the role of NBE as a developmental organ is clearly emphasized by the infamous article 6 in the proclamation, which expressed the objective of NBE to be 'to foster balanced and accelerated development …'.

In this period, the NBE was actively involved in direct controlling of all financial institutions by (a) fixing both deposit and lending interest rates, (b) directly controlling the foreign exchange and credit allocation which was done in a discriminatory manner, by favoring the public sector, and (c) by directly financing government deficit (NBE, 1998). Bank supervision/regulation has been largely limited to on and off inspection on a few branches.

The Derg regime is also characterized by an economic policy largely informed by the ideology of 'socialism'. The *sin qua non* of such set-up is the prominent role accorded to the socialized (public sector included) sectors by discriminating against the private sector. During this time indirect ways of regulating the financial sector was not important since it can be controlled directly. The most important financial instruments used to directly control the sector were (1) interest rate and (2) discriminatory allocation of foreign exchange and (3) credit.

The interest rate is deliberately set at a very low level (repressed). Depending on the degree of socialization, different sectors did face different interest rates. The ruling interest rates for each sector in both (pre and post reform) periods are given in Tables 3(k).

{Insert Tables 3(k)}

The socialized sectors were also accorded priority in credit as well as foreign exchange allocation. All foreign exchange earning were surrendered to the NBE. The latter will ration this limited supply of foreign exchange to sectors that were accorded priority in the national plan. In general the priority is for the socialized sectors - the private sector being the least preferred.

Similarly, credit allocation was informed by the same ideological considerations. In consultation with the Ministry of Finance and the Planning Ministry, the NBE projects the financial planning of the economy. It identifies the financial needs of different sectors through surveys and data obtained form credit institutions. Based on such information it determines the distribution of credit favoring priority investments and aiming at keeping internal and external purchasing power of the national currency unaltered. In credit allocation financial institutions used credit policy as a factor of strengthening and expanding the socialized sector and encouraging the socialization of others (See Antonio, 1988: 71-72). This favoring of the socialized sector is shown by the fact that a good part of the banks resources were directed to the socialized sector (for instance 68% of ADB resources were allocated to State farms) and that the state farms and cooperatives were not required collateral when granted loans (Ibid.,: 74). As noted by Antonio (1988), this restrictive policy has resulted in excess liquidity in the banking sectors in the 1980 chiefly because of (a) the biased credit policy, (b) the collateral requirement on the private sector, (c) seasonal trends and the (then) existing economic condition as well as (d) the CBE's inefficiency. The latter two factors are identified by a 'Liquidity Appraisal Committee' set by CBE to understand the excess liquidity problem (See Antonio, 1988: 80).

4. The Structure of The Financial System in the Post-reform Period

Proclamation No. 84/1994 that allows the private sector (owners have to be Ethiopian nationals, however) to engage in the banking and insurance businesses marks the beginning of a new era in Ethiopia's financial sector. Following this proclamation the country witnessed a proliferation of private banking and insurance companies. Currently, there are 6 new private banks (with 115 branches) and 8 insurance companies (with 79 branches) in operation. These banks in particular account for about a quarter of the total banking capital in the country. This took place in a matter of 10 years. Table 4(a) shows the list of these financial institutions.

{Insert Tables 4(a) here}

4.1. Performance of the New Private Banks

Despite the proliferation of such privately owned companies, their relative share is still extremely small. This can be read from the Tables given in this section. Tables 4(b), (and Annex 1a and 1b) show a summary picture of the share of banks in mobilization of deposit in pre and post reform period. (The actual values of the deposit and loans in a rather disaggregated form are given on Tables 1a and 1b in Annex 1). It can be read from these tables that the dominant position in terms of saving mobilization is held by the public sector in general and the CBE in particular. The public sectors share has, however, declined from 95% in 1996/97 to 67% in 2002/03 – thus, the share of the private banks rising from 4.2% to 19.6% in the two periods. This private sector share is the highest for time deposit followed by saving and demand deposit.

{Insert Tables 4(b) here}

Similar pattern is observed in terms of disbursement of loans, loan outstanding and loan collection. In general, in terms of loan disbursement the share of the public sector (the CBE being the dominant bank, accounting from more than 95% of the public banking sector in the figures analyzed in this section, followed by DBE) has declined from 93% in 1996/97 to 44% in 2002/03 – resulting in the share of the private banking sector successful rise from 7% to 56 %. In terms of loan collection the public banks share declined from 94% to 60% in the two periods; again resulting in the share of the private sector to increase from 6 to 40%. Outstanding loan is the highest in the public sector, being 96% in 1996/97 and declining a little to 82% in 2002/03 (the corresponding figure for the private bank increased from 4 to 18%). In sum, the private banks are catching up relatively faster with the public banks in almost all activities of banking. The disaggregation of the disbursed credit by institutional category also shows the increasing role of the private sector that can chiefly be attributed to the on going liberalization.

{Insert Tables 4(c) here}

The general trend is that private banks are catching up quickly with the public ones. A detailed account of each bank reveals that, using the data for the year 2002/03, the most important private banks in terms of deposit mobilization, loan disbursement, and loan outstanding are found to be Dashen Bank, followed by Awash International Bank in the second plac3e and Abyssinia Bank in the third place (the only exception here being that. Wegagan bank is in the second place, hence Abyssinia third, in terms of loan collection and loan disbursement). Clearly the trend of the existing data shows that the share of the private banks both in deposit mobilization and lending could increase significantly in the years ahead. It is also worth noting that the share of credit extended to the private sector has jumped from in the recent past the public sector's share declining (the share of cooperatives remaining fairly stable) (see Alemayehu 1999b). This is a clear demonstration of the impact of the liberalization scheme pursued by the government.

{Insert Tables 4.c) here}

4.2 Other Financial Liberalization Schemes Carried

Two other important liberalization schemes pursued by the Ethiopian government in the post-reform period are (a) the exchange rate policy and (b) the inter-bank money market. As discussed in section three above, the pre-reform period was characterized by discriminatory interest rate, foreign exchange as well as credit allocation policies. Currently the interest rate is fairly liberalized and the NBE has set only a floor for deposit rate, leaving all other rates to be determined by market forces. Banks are now allowed to set any rate within that range. Moreover, pursuant to the strategy of gradualism, the NBE has implemented this policy step-by step. The latest interest rate policy and actual rates as well as its evolution are given in Table 3(k) in section three.

The Exchange Rate Policy

A related policy of liberalization carried by the government is the introduction of the 'auction-based exchange rate' determination scheme and the introduction the inter-bank money market. Again the principle of gradualism (in liberalization) is at the heart of this policy development.

The exchange rate reform is commenced by devaluing the currency that was fixed nearly for two decades at Birr 2.07 per 1 USD by 140%, to 5 Birr per US$ in October 1992. Such massive devaluation was partly justified by the premium on the parallel market that was close to 238%. In 1993 the NBE introduced the auction-based exchange rate system. This was used to be conducted on fortnight basis and takes the form of the 'Dutch Auction' system (discriminatory price), where the marginal rate, which clears the market, is taken as the ruling rate for the coming two weeks. The supply of funds for this market comes from export earnings and loans & grants. The auction-based exchange rate system was initially working side by side with the official exchange rate. The system has been overseen by committee composed of the NBE, Ministry of Finance, Ministry of Economic Development and External Cooperation (MEDaC) and two representatives of the private sector.

In the course of its implementation an intensification of the liberalization effort (such as reducing the bid cover requirement, abolishing of negative import list, reducing the ceiling on demand for foreign exchange etc) was made. Moreover, after the 86th auction (in July 1996), the NBE introduced a weekly auction replacing the previous auction which used to be held on fortnight basis. By August 1995 the official or fixed exchange rate (that was used for importation of fertilizer, petroleum and pharmaceutical products as well as Ethiopia's contribution to international organization and external debt-service payments) is also unified with the auction rate. The NBE has also replaced the retail auction system by a wholesale auction system where banks are taken as wholesale bidders - this is issue is discussed below (Table 4(d) below shows the evolution of the official, the parallel and the auction rates)..

[Table 4(d): The Different Exchange Rates]

The Inter-Bank Foreign Exchange and Money Markets

The NBE has issued directives aimed at establishing inter-bank foreign exchange and money markets in 1998 (Directives No. IBM/01/1998 and IBM/02/1998, and other related documents). The establishment of this market is primarily motivated by the recognition that the foreign exchange supply by NBE through the auction system is not sufficient to satisfy the demand of banks. The 'inter-bank foreign exchange market' (IBFEM) is a wholesale market, where the amount traded is large and the spread between buying and selling rates is narrower than the norms for commercial transaction. It is an exclusive market for banks to trade foreign exchange with each other (NBE Directive No. IBM/01/1998).

The directive sets various specificity of the market. For instance the minimum amount to be traded is USD 50,000, banks shall not charge each other any fees, all transaction should be conducted in strictest confidentiality etc. Banks are also required to report to the NBE about their foreign exchange operation. Thus, the NBE uses this as one instrument of regulation. It is also gradually liberalizing the market because all these functions were used to be handled by the NBE itself. This market is currently very active with a volumes daily inter-bank foreign exchange transaction of 160 million USD in 2002/03.

A related liberalization policy pursued is the establishment of the 'inter-bank money market' (IBMM). The IBMM describes the borrowing and lending of funds between banks, micro financing institutions, and non-bank financial institutions at the interest rate that are freely determined by borrowers and lenders themselves (NBE Directive No. IBM/02/98). The directive specifies how this market should function. For instance, transaction should be for a minimum of Birr 300,000, there are specific times at which deals and request for deal should be made, the nature of collateral required etc. The directive also requires banks to report all their activities in this market on a daily basis to NBE. The NBE uses this information to regulate and monitor the banking activity. Moreover, the NBE has also issued a code of conduct, which has an extensive regulatory content (see NBE Code of conduct for IBMM). Since its establishment in 1998 only 11 transaction involving 142 million Birr were traded in this market. During this period the average inter bank rate stood at 7.8%. According to the NBE Annual Report (2002/03), persistent excess liquidity, lack of collateral and weak economics activity are outlined as reason for poor performance of this market.

5. Some Concluding Remarks

Since 1992 Ethiopia has been gradually liberalizing its financial sector as discussed in this chapter. The hallmark of the strategy is gradualism. The approach is not without problems, however. International institutions, which sponsor and financially support the liberalization scheme, especially the IMF, are not satisfied with the pace at which the liberalization is being carried. This has, at times, reached at a point where the IMF has temporarily suspended its support.

The various policy framework papers jointly authored by the Ethiopian government and the staffs of the two Bretton Wood institutions are quite comprehensive embracing almost all major polices. Thus, it is difficult to relate any disagreement between Ethiopia and the IMF/WB solely to the financial sector.

Examination of such policy framework papers reveals that (a) first since the on-set of the structural adjustment program in Ethiopia, the performance is by and large in line with the target set in document. There are occasional years where the performance is both above and below the target. The latter is highly correlated with the weather condition. Second (b), when we compare the time schedule set in the policy framework papers and the actual implementation of policies, the Ethiopian government is behind the schedule in many instances. However, it is interesting to note that this by and large had not led to disagreement between IMF and Ethiopia.

There are occasions when the IMF suspended its help. However, an examination of the time schedule set in the policy matrix of various policy framework papers and the performance of Ethiopia reveals that if this is the sole cause of disagreement, the IMF should have suspended the program long a go. This obviously points to possibility of having other explanations that are not apparent in the financial data. An informed guess points to at least the following areas of disagreement. First, the World Bank and IMF might have disagreement with the Ethiopian government's strategy of gradualism. Second, the Ethiopian government's implicit belief in pragmatic mix between the public and private sector might have been unacceptable to IMF and World Bank and, third the IMF's and Bank's insistences on the need for competition by doing something about the alleged monopoly position of the CBE is cautiously seen by Ethiopia. The last point is quite sensitive because Ethiopia may not be in a good shape to compete in the face of advance foreign banks if it does something about the supposed monopoly power of CBE (such as breaking it up or privatize it) and allow foreign banks to come at the same time. Moreover, the performance of the CBE doesn't warrant its privatization even unrealistically assuming that privatization is a panacea for such problems.

In general, it is my opinion that given the recent nascent level of development in using market mechanisms in the country, the transition from the pre-reform periods to the post-reform period outlined in this chapter, given the relatively good shape in which the existing financial institutions find themselves, given the weak supervision and regulation department of the NBE (which is new and lack skilled human resource), the government's strategy of gradualism and its over all reform direction need to be appreciated and be supported by World Bank, IMF and relevant institutions. The only concession that the government has to make is to clearly chart out a time schedule for its liberalization program and explore and joint venture scheme with foreign banks – obviously it can not rationally protect the sector for ever.

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