

ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES

**EFFECTS OF THE ETHIOPIAN FINANCIAL SECTOR
REFORM ON THE PERFORMANCE OF BANKS AND
THE MARKET SHARE DYNAMICS**

By

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Acronyms

AAB: Addis Ababa Bank

AB: Agricultural Bank

AIB: Awash International Bank

AIDB: Agricultural and Industrial Development Bank

ATM: Automatic Teller Machine

BOE: Bank of Ethiopia

BIS: Bank for International Settlement

BOA: Bank of Abyssinia

BPR: Business Process Re-Engineering

Br: Birr

CAR: Capital Adequacy Ratio

CBB: Construction and Business Bank

CBE: Commercial Bank of Ethiopia

CBO: Cooperative Bank of Oromiya

CS: Capital Share

DB: Dashen Bank

DBE: Development Bank of Ethiopia

DEA: Data Envelopment Analysis

DS: Deposit Share

ECEA: Ethiopian Commodity Exchange Authority

ECX: Ethiopian Commodity Exchange

EM: Efficiency Measure

EPRDF: Ethiopian People's Revolutionary Democratic Front

ERRP: Emergency Recovery and Reconstruction Project

GDP: Gross Domestic Product

HB: Hibret Bank

HSB: Housing and Saving Bank

IBE: Investment Bank of Ethiopia

IBFEM: Interbank Foreign Exchange Market

IBM: Interbank Market

IBMM: Interbank Money Market

ISHOPA: Imperial Savings and Home Ownership Public Association

IFAD: International Fund for Agricultural Development

IIC: Imperial Insurance Company

LDCs: Least Developed Countries

LIB: Lion International Bank

LRR: Liquidity Requirement Ratio

M/I: Market/ Investment

M/P: Money/Price

MDGs: Millennium Development Goals

MOFED: Ministry of Finance and Economic Development

MS: Market Share

NBE: National Bank of Ethiopia

NIB: Nib International Bank

OLS: Ordinary Least Square

ROA: Return on Asset

ROE: Return on Equity

RRR: Reserve Requirement Ratio

SAP: Structural Adjustment Program

SBE: State Bank of Ethiopia

SMCE: Saving and Mortgage Corporation of Ethiopia

WB: World Bank

Abstract

This paper examined the effects of the 1994 financial sector reform on the performance of banks using descriptive analyses. It also estimated the determinants of market share in the Ethiopian banking industry by employing the standard fixed effect panel data model. The model allows explanatory variables to vary over two dimensions (firms and time), which helps to have accurate estimators in cases where there are only few firms and the time period is short. As the banking business dominates the Ethiopian financial sector, the paper is focused on studying the banking sector performance while gleaning through rather briefly the financial sector performance as a whole. The descriptive part of the study analyzed the pre- and post-reform data of public and private banks by applying standard financial ratio and comparative trend analyses.

The results of the study suggest that the sector has gained progress in terms of profitability, asset quality and efficiency after the reform, as expected. However, considering the intermediation effect to the larger economy, contribution of the financial sector is not substantial. The major problems include confining banking service to trade and service financing, weak fiscal stance and ineffective economic policy of the government and lack of strategic planning and program development by the central bank. Resource reallocation of banks towards production and manufacturing sector of the economy does not show significant improvement following the financial sector reform. The government's redundant involvement in the economy is crowding out the private sector, which would have been the efficient sector. The recently tightening financial regulation and absence of long term financial development program of the central bank has also endangered the prospects for effective intermediation role of banks in Ethiopia.

Regarding the dynamics of market share (average of loan share and asset share), two factors are found significant, outside the hypothesis of the study. a) Individual banks fixed effect (which are bank specific characteristics that include managerial efficiency, particular line of business, good will, etc); and b) banks deposit share (individual banks deposit/total banking deposit) are found major determinants of the market share.

The policy implications include the need for favorable economic and fiscal policy to foster the private sector business (the major client of the financial sector and the principal actor in the larger economy). In addition, further liberalization of the financial sector and improvement in the performance of the regulatory body are found essential.

Chapter One

Introduction

1.1 Background

Financial sector reform takes several levels, types and concentrations. It can range from simple, very limited in scope and highly regulated type to fully liberalized form that incorporates every type of financial activities. Full liberalization implies no limitation with only least required prudential regulation system. According to the arguments of Liberalization-Theorists made in the 1960s and 1970s (e.g. by Patrick (1966), McKinnon (1973) and Shaw (1973))¹; there is a strong relationship between financial development and economic growth. In their view, the key is to alter the incentives between consumption and saving. McKinnon (1973) indicated that large and fast-growing real cash balances, nominal money/price (M/P), contribute to rapid growth in investment and output. These arguments support deregulation and liberalization of financial system, to enhance economic development. As also noted in Dixon (1997); the regulation of the financial markets, which imply among other measures interest ceilings, high reserve ratios and implicit credit programs – will lead to lower investment ratios and have a negative impact on growth.

In the light of the foregoing, over the last thirty years, many developing countries liberalized their financial markets by abolishing ceilings on bank interest rates, abandoning credit rationing through administrative decision, eliminating foreign exchange controls and removing restrictions on capital flows.

¹ All these and more are cited in Phillip Arestis, Machiko Nissanke, and Howard Stein (2003)

On the other hand, critics on liberalization assert that government intervention is necessary to remedy market failure by referring to different scenarios in the 1980s and 1990s where many countries, which have followed the advice of liberalization theorists and have deregulated their financial markets, faced heavy financial crisis followed by deceleration of growth rate, rising inflation and increasing unemployment. Examples often mentioned in this context are the banking crisis of Japan, Argentina and Mexico in the 1990s. Many European countries also faced increasing banking instability in this period, although they did not have to deal with such high costs of an economic breakdown like emerging markets had to deal with (Demirguc-Kunt, 1998). In general, different positions of financial reform advocacy were made during the 1980s and 1990s: Rejection of liberalization, support for planned financial systems, and advocacy for different degrees of financial market regulation were advanced by fiscal experts or policy advisors during the decades.

Financial reform was implemented much earlier in most Asian countries than in Africa; for example Malaysia liberalized interest rates in 1978. In contrast, even the earliest African liberalizers (The Gambia and Ghana) began to introduce reform only in the late 1980s (Huw Pill and Mohamood Pradhan, 1997). Ethiopia, though in the more liberal financial traditions during the Imperial period has opted for collectivist system of economic management in the years 1974 to 1991, which destroyed its market economy. However, very lately, the country restarted its financial sector reform in 1994 with so much trepidation—by restricting the involvement of foreign banking and insurance business and pursuing strong financial regulation and government participation approach in the financial industry.

In the period between 1960 and 1974 (in the Imperial era), privately owned banks were operating alongside the Commercial Bank of Ethiopia (CBE), which was state-owned. Branches of foreign banks (Banco di Roma, Banco di Napoli) and domestically established bank—Addis Ababa Bank (with foreign equity participation), were in operation. The 1963 banking proclamation was an important benchmark in the development of banking industry during the period. It brought about the end of public monopoly for about twenty years of all banking services and divided the dual functions of the then State Bank of Ethiopia between two institutions (a central bank and a commercial bank) (Assefa Mehretu, 1974). As briefly indicated in its preamble, the decree was required to provide a sound basis for the continued expansion of the economy of the empire at the time.

However, during the Derg rule there was a marked reversal of policy. As a direct outcome of government policy, the private sector and the market system had diminished roles and a condition of heavy reliance on the state for economic growth and development prevailed. The increase in the rate of government capital expenditure (growing structural deficit) had a significant ‘crowding out effect’ on private investment—private entry into specific investment lines were barred (by law), credit rationing practices gave priority to government investment projects, licensing and permit procedures were cumbersome and frequent changes in investment laws and administrative red-tapes were discouraging to prospective private investors (Teshome Mulat, 1992, p. 16 and 1993, p. 80).

In the post 1991 period, after 17 years of command economy that resulted in high degree of financial repression with highly overvalued exchange rate, the Ethiopian People’s Revolutionary

Democratic Front (EPRDF) adopted Structural Adjustment Program (SAP) of the International Monetary Fund (IMF) and the World Bank (WB). The policy prescriptions in SAP include removal of price controls, devaluation of the Ethiopian Birr (Br) and subsequent determination of the exchange rate through the auction system, gradual liberalization of interest rates, opening up of the financial sector for private participation, privatization of state-owned enterprises and provision of foreign currency through the auction system (Menilik , 2006).

Being part of the SAP's policy prescription, the 1994 financial sector reform (which will be elaborated later) was a major step forward in opening up the financial sector for private participation though domestically bounded and has several limitations. The current situation of financial sector in the economy is characterized by a high degree of government regulation, limited to few financial services and dominated by the banking business. For instance, the LRR (Liquidity Requirement Ratio) is as high as twenty five percent and the RRR (Reserve Requirement Ratio) becomes fifteen percent of deposits—both are high relative to the previous fifteen and five percents, respectively. There are no foreign banks or insurance companies operating in the Ethiopian financial sector, no secondary market exists and international capital flow is strictly regulated by government.

Thus, the main focus of this paper is to examine the effects of the 1994 financial sector reform on the performance of banks and to estimate the determinants of market share dynamics. Beside, the economic and financial sector status of the country will be broadly examined. The paper addresses major issues in the financial industry including the performance of credit, deposit mobilization, profitability, etc.

1.2 Statement of the Problem

Financial sector is expected to play a key role in the development endeavor of any country through stimulating the economy. Moreover, it serves as a major mechanism for efficient and effective allocation of scarce resources, especially in developing countries. However, the Ethiopian financial sector has been suffering from various difficulties over the last three decades and is still dominated by traditional services. Especially, the Derg regime had limited the private sector's role in both financial and non-financial businesses, which finally led the economy to collapse. Presently too, the sector has been subject to a number of government interventions, limited to few financial services, lack technology and modernization, etc though important measures were taken at the outset.

Hence examining the status of the Ethiopian financial sector, finding problems and challenges that impede financial development, and evaluating the changes after the 1994 financial sector reform is essential. Consequently, since the Ethiopian financial system is dominated by the banking sector; evaluating the performance of the banking industry and identifying the challenges would fairly reflect the problems in the overall financial sector of the country. Among the worrying issues within government owned banks (following the reform), the deterioration in the market share of major banking businesses like external trade and credit happen to be the major one. That is, in most cases, a firm's performance relative to competitors can be measured by the proportion of the market that the firm is able to capture and market share often is associated with profitability. Thus, many firms seek to increase their market share. The findings of this study (which mainly focuses on evaluating the performance of banks and looks for the determinants of the market share dynamics), then, is expected to address this fundamental issue.

So far, there are some studies like the project appraisal documents from stakeholders² and other researches from scholars, which try to evaluate the performance of the financial sector in Ethiopia, after the reform. But they lack either depth of analysis or made within a short period of post-reform time. In this regard, this paper is expected to deal with both weaknesses since it uses descriptive as well as econometric analyses and rely on relatively longer (post-reform period) data set.

1.3 Objective of the Study

The basic motive behind conducting this study is to examine whether the performance of the banking sector has improved in the post reform vis-à-vis the pre reform period and to estimate the determinants of the market share in the banking business. The general objective of the study is thus: to evaluate the effects of the 1994 Ethiopian financial sector reform on the performance of banks and to estimate factors that affect the market share dynamics in the banking industry. The specific objectives are to:

- (a) Review the post-1991 financial sector reform;
- (b) Evaluate the performance of banks after the 1994 financial sector reform vis-à-vis the pre-reform period;
- (c) Estimate factors that affect the dynamics of market shares in the banking sector;
- (d) Examine problems and constraints affecting the financial sector development in Ethiopia;
- (e) And make policy recommendations.

² The major stakeholders in the Ethiopia's financial sector reform are the WB and the IMF because of their financial support in implementing the reform.

1.4 Research Hypothesis

The study will evaluate the following hypothesis:

- i. Successful financial reform would enhance the performance of financial institutions and cause for the creation of an efficient financial system which contribute to the overall economic development in the country;
- ii. Market share of individual banks depends mainly on efficiency and investment capital of banks.

1.5 Data Source and Methodology

The study will use both descriptive and econometric data analysis.

The descriptive one will make use of financial ratio analysis, comparative analysis and time series analysis of audited financial data. Also, macro financial and other macroeconomic data on the Ethiopian economy will be utilized for the descriptive analyses. To estimate the major determinants of the market share dynamics, the econometrics system of analysis will be employed. The analysis will be based on fixed effect panel data model. This model is used to estimate the determinants of market share in the banking industry of Ethiopia. When using econometric system; selecting appropriate econometric model and formulating the model with proper variable is fundamental. Thus, utmost effort is made to decide on the model to be used for the issue at hand.

The panel data model is preferred as a result of the existence of only few firms and the short time in the post-reform period of the Ethiopian banking industry. Panel model is prioritized for the purpose of having relatively large number of observations and to have more accurate estimators since explanatory variables vary over two dimensions (firms and time). Panel model also helps to reduce identification problems like identification in the presence of endogenous regressors or measurement error, robustness to omitted variables and the identification of individual dynamics. In this regard, the basic panel data model discussed in Verbeek (2000) is used with own specification of variables as discussed in section 3.4.2.

The left-hand-side or the dependent variable is the MS_{it} (Average market share of firm i at time t) and the right hand side or the explanatory variables are CS_{it} , DS_{it} and EM_{it} which are acronyms for capital share, deposit share and efficiency measure, respectively. The expectation is that as one or two or all of the three explanatory variables of one bank increases, the market share of that bank will improve and vice versa. The net effect depends on the magnitude of the coefficients.

The specific market share function or the regression equation to be used for empirical testing will be specified as follows:

$$MS_{it} = \alpha_i + CS_{it} + DS_{it} + EM_{it} + \varepsilon_{it}, \quad \varepsilon_{it} \sim IID(0, \sigma^2_{\varepsilon}) \quad (1)$$

Where, it is assumed that all explanatory variables are independent of all ε_{it} .

Description of Variables

MS_{it} : The average market share of total asset and total loans and advances at the end of each period for each bank that are included in the analysis.

CS_{it} : The capital share at the end of each period for each bank.

DS_{it} : The deposit share at the end of each period for each bank.

EM_{it} : The Efficiency Measure at the end of each period for each bank (Gross Profit to Total Expense ratio will be used as a proxy measure).

α_i : The unobservable effect for each bank which is assumed to be constant over time.

Regarding the source of data, the study relies on secondary data for the systematic evaluation of the hypothesis. Accordingly, aggregate and firm level time series data over the last 35 years (1974 – 2008) are collected from individual banks—to be utilized for econometric analysis. Also pre- and post- reform data of individual banks, data from the National bank of Ethiopia, and other macro data of the country are collected for the purpose of descriptive analyses.

1.6 Scope and Limitation

The study is limited only to formal financial business and focuses on institutions that are currently engaged in providing banking services in Ethiopia regardless of the fact that there are other formal and informal financial activities. In addition, lack of diversified data and information as well as difficulties in own gathering of data have placed limitations on the kinds of issues and problems to be probed in the banking sector.

1.7 Organization of the Paper

The paper is organized as follows:

Chapter 2 presents literature review and deals with the nature and content of financial reform of the post-Derg period. Chapter 3 makes an analysis of assembled data and also carryout performance evaluation tests of banking service in Ethiopia. Chapter 4 give focus on the analyses of issues and problems constraining the development of banking services; and chapter 5 presents the conclusion and policy recommendations of the study. All time periods in the study are in Gregorian calendar, unless otherwise expressed.

Chapter Two

Literature Review

The nature of financial system and its structure is complex; involving different types of financial institutions and markets. Banks, insurance companies, mutual funds, stock and bond markets, exchange rate markets, hedge funds, etc are all included in the financial system of a country. When considering less developed countries, banks are the most important financial intermediaries; where, even, the average person can interact with more frequently. Due to various asymmetric information problems, the smaller role played by security markets leave a greater role for banks in these countries. Banks engage in processing information where the information they produce avoid the free-rider problem by primarily making private loans rather than purchasing securities that are traded in the open market. Thus, as the banking industry dominates the financial business in Ethiopia, literature review of this study focuses on theoretical and empirical literatures that predominantly discuss financial system of banking business.

2.1 Theoretical literature

The broad financial system theories in addition to those who discuss about the developing countries issue will be widely reviewed in this part. In addition, some concepts on the issue of market share will be covered.

2.1.1 Financial System Theories

Financial liberalization means that domestic interest rates get aligned to international ones, the credit constraints become looser in the case of a deficit of expenditures over receipts and that the menu of portfolio allocation become richer. From the point of view of international economy, financial liberalization profits from the international specialization of savings and investment. A “young” country which is usually a deficit country with a higher investment than saving ratio is able to borrow from “mature” countries being in surplus. Domestic stabilization policies become by far less autonomous under an open capital account. A monetary-fiscal policy mix which is divergent from that of the outside world may have immediate repercussion on the balance of payments (for fixed exchange rates), on the foreign exchange rates (under floating exchange rates) or on both (managed float) (Emil-Maria Claassen, 1991).

Since the days of Mckinnon and Shaw (1973), financial liberalization theory has advanced from focusing merely on credit markets and the public sector to include the private sector (Tswanuno, David T., Scott Pardee, and Phanindra V. Wunnova, 2006). As discussed in the paper, advocates for liberalization argues that unlimited international capital flows resulting from liberalization lower the costs of capital, allow for risk diversification, and encourage investment in projects with higher returns. As further indicated in the paper, according to the prediction of the international asset pricing model, liberalization will lead to a drop in the cost of equity and debt capital through integration of segmented markets. Integration is said to be achieved when global assets of identical risk command the same expected return regardless of where they are traded. Also, according to advocates, liberalization results in an increase in stock market liquidity. Increased liquidity leads to further development of the underlying market as investors are assured

of getting in and out of a position without much difficulty. Moreover, foreign investors pressure local institutions to adhere to international standards, which improves local corporate governance and reduce the division between internal and external finance.

On the other hand, opponents of liberalization argue that it increases the risk of speculative attacks and increases a country's exposure to international shocks and capital flight. In addition, information asymmetries, which are especially endemic to financial markets and transaction in developing countries, can be detrimental to liberalization. Compared to their developed counterparts, emerging markets do not have the capacity to assemble information relevant to financial transactions and thus cannot guarantee that capital will flow where its marginal productivity exceeds opportunity cost.

The third group (Guarded supporters) according to Tswanuno, et al, consists of conservative advocates for liberalization, who suggest that there are several conditions, not yet met by most developing countries, which are necessary to ensure the success of liberalization. Economies at an intermediate level of financial development are more susceptible to macroeconomic shocks. Full liberalization in such economies may lead to destabilization, characterized by chronic phases of growth and capital flight. Openness to international capital flows can harm a country if appropriate controls, bundled with a strong macroeconomic and regulatory environment, are not in place.

Another study made by, Florian Bersier (2007) discusses the internal or domestic model designed by McKinnon and Shaw and the external characteristics of the liberalization's with some links to

Mathieson and Shaw arguments. According to the internal model, growth in the economy is influenced by real interest rates through their effects on Savings (S) and Investment (I). Investment is a negative function of the real interest rate (r) [$I=I(r)$, $I_r < 0$]. Savings are influenced not only by the rate of interest but also by the rate of growth of national income (g) [$S=S(r,g)$, $S_r>0$; $S_g>0$]. McKinnon and Shaw argued the case for financial liberalization by showing that financial repression affects, on the one hand, the efficiency of how savings are allocated to investment and on the other hand, that such repression, through its effect on the return to savings, also has an impact on the equilibrium level of savings and investment.

The external characteristics concentrate on the effects of liberalization during stabilization programs. This is interesting because developing countries often implement financial liberalization and try to stabilize their economies (reduce inflation and eliminate balance of payment deficits) at the same time and do this process while they are open economies. External liberalization leads to free capital flows and indeed liberalization drives to an increase of inflows of foreign capital which improves their investment rate. Then, it seems evident that the question of exchange-rate policy becomes crucial in the external theory of financial liberalization. According to Mathieson, the optimal policy is to over depreciate the exchange rate, reduce the rate of monetary growth and increase loan and deposit rates. But Kapur (1983), cited in Florian discussion, thinks that the choice of exchange-rate policy is rather difficult and depends on where initial inflation is relative to its target level. What is important for him is that the decisions concerning exchange-rates are set in coordination with the deposit interest rate in order to avoid potentially damaging capital flows.

2.1.2 Market Share Theory

Based on the information found from www.wikipedia.com and www.quickmba.com, some concepts about market share, the reasons to increase market share, ways to increase market share and reasons not to increase market share are discussed below:

Market Share is the proportion of total sales of a product or type of product by a company in a given market. Market share can be calculated in terms of value or in terms of units sold. Markets may be defined geographically—for example, by city, region, country, continent, or the world—or markets may be calculated according to some other distinguishing characteristic, such as age group, social class, or ethnicity. However, the more specific the market segment, the more difficult it is to get accurate data. The products also may be defined narrowly or broadly.

Market share is an indicator of the success of a company's marketing policy. The company that has the largest market share for a given geographical market is said to be the market leader in that market. The importance companies attach to market share varies according to business culture. In the United States, Canada, and many European countries, companies tend to focus on profit, although market share is a key determinant of profit. In Japan, on the other hand, market share can be more important than profit. It is common for Japanese companies to invest hugely in order to gain market share and to place a greater emphasis on long-term success rather than on profits in the short term.

Reasons that a firm may seek to increase its market share include economies of scale in which higher volume can be instrumental in developing a cost advantage, sales growth in a stagnant

industry (when the industry is not growing, the firm still can grow its sales by increasing its market share), reputation that a market leaders benefit from clout which they can use to their advantage, and increased bargaining power where a large player has an advantage in negotiations with suppliers and channel members.

On the other hand, an increase in market share is not always desirable. For example: First, if the firm is near its production capacity, an increase in market share might necessitate investment in additional capacity. If the capacity is underutilized higher costs will result. Second, overall profits may decline – that is, if market share is gained by increasing promotional expenditures or by decreasing prices. Third, Antitrust issues may arise if a firm dominates the market. Market share can be increased by changing the variables of the marketing mix such as product, price, distribution and promotion. The product attribute can be changed to provide more value to the customer, for example, by improving product quality. The price variable can be used if the price elasticity of demand is elastic (that is, > 1). Then, a decrease in price will increase sales revenue. This tactic may not succeed if competitors are willing and able to meet any price cuts. The distribution variable works by adding new distribution channels (branches) or increase the intensity of distribution in each channel. The promotion variable refers to increasing advertising expenditure in a way to increase market share, unless competitors respond with similar increase.

2.2 Empirical literature

In this part, practical phenomenon relevant to the study will be reviewed. Literatures those helps to look at different features of the financial system and those which focuses on the developing country issue will be included. So, beginning with the review of the advanced and developing

countries experience in the financial system, this part of the paper subsequently discusses the Ethiopian financial sector development.

2.2.1 Advanced and Developing Countries Experience

2.2.1.1 Advanced countries case

A paper written by Timothy A. Canova (2000) analyzes how the global monetary system has been transformed over the past two generations, examines the relationship between neo-liberal discourse and central bank autonomy, and considers alternative paths of globalization. As Timothy noted in his paper:

“The United States dollar was the linchpin of the Bretton Woods System of fixed exchange rates; however, by the early 1970’s, the United States economy fell into balance-of-payment deficit while foreign holders of dollars increasingly demanded convertibility of the dollar into gold. The Nixon administration had few choices at the time. It could have swallowed the IMF’s model for adjustment for deficit countries — namely, fiscal and monetary austerity — but with global commitments to contain the real and imagined spread of Soviet Communism, the IMF’s model was not an appealing option. Nixon refused to deflate those commitments and instead ended the dollar’s convertibility to gold. The Bretton Woods System had effectively passed into history.”

The paper, strongly critical of the new world system of highly liberalized financial environment, has indicated other paths that would permit the benefits of globalization. Achieving globalization

(increased trade, travel, communication) would be possible by throwing out the worst aspects of the neo-liberal model, including unrestricted and speculative “hot money” capital flows, asymmetrical adjustment burdens and central bank irresponsibility, instead of the only alternative of the entire neo-liberal model claimed by Western countries.

Financial liberalization has been a popular topic since the 1980s and 1990s and it has actively been advocated by such organizations as the IMF and WB and has been pursued by many governments since 1980s (Willi Semmler and Brigitte Young, 2008). The Willi et al paper notifies that, even under Clinton government, the Fed Governor Alan Greenspan was strongly promoting globalization, in particular globalization of capital markets. After the fall and breaking up of the Soviet Union; he thought, according to the paper, there will be a long period of expansion of the world economy due to the establishment of global markets for products and financial services.

On the other hand, as the paper indicated, other scholars like Stiglith et al (2006) maintained that the rapid enlargement of the financial market has led to more financial instability, which in turn, can be devastating. Examples cited are the Mexican (1994), Asian (1997/8), and Russian (1998) financial crisis that demonstrated the degree to which a too-rapid market liberalization could lead to a currency crisis wherein a sudden reversal of capital flows was followed by financial instability and consequent decline in economic activity.

Willi et al also discusses the different capital market regulatory regime in the US and Europe. “While the US and EU plays the dominant role in global financial markets as both the largest and

most liquid financial markets world wide, they operate under quite different regulatory regimes. According to the study, despite these continuing regulatory differences, the degree of market integration between the two transatlantic markets has increased over the last two decades, as formal barriers to trade and investment have been reduced and financial markets have been increasingly liberalized on both sides of the Atlantic. The study points to the recent subprime crisis and the subsequent joint transatlantic policy response as an illustration to how quickly the effects of the leveraged loan market failures were transmitted to Europe and elsewhere, which indicate the increasing transatlantic interdependence of financial markets.

The study, however, noted that, despite the fact that formal barriers to free flows of capital have been removed, differences in licensing rules for financial services providers and products, conduct of business, investor protection, and reporting requirements continue to restrict the free market access on both sides of the Atlantic, which increases the transaction costs for market participants and investors in Europe and the US.

Historically, according to Willi et al, the US regulatory regime has relied more on market-control whereas in Europe, until the capital market reforms in the latter half of the 1990s, financial market regulation and supervision was the domain of national public authorities.

2.2.1.2 Developing countries Experience

Asian countries have generally been successful than African countries in liberalizing their financial systems (Pill, H., et al, 1997). According to Pill et al study, until the 1980s, extensive government intervention was the norm in the financial markets of developing countries. Ceilings

were imposed on bank interest rates; credit was allocated by administrative decision rather than market criteria; and inflows of foreign capital were strictly controlled.

As their article indicated, over the last twenty years, however, many developing countries—persuaded by both the theoretical arguments made in support of liberalization and the experience of many of the rapidly growing countries, have begun to liberalize their financial markets by abolishing these types of controls. According to their findings, the results of financial liberalization appear quite different for Asia and Africa. Using the ratio of broad money (cash plus deposits in commercial banking system) to national income as a measure of financial deepening and the success of reform, liberalization appears to have been much more successful in Asia.

Pill et al also explains the generally successful Asian cases. Macroeconomic stability is a prerequisite for successful financial liberalization and creates the stable context required for it to succeed. And in Asia, macroeconomic imbalances were largely eliminated before financial reforms were introduced, balance of payments and fiscal deficits were manageable, and inflation was relatively low. The Asian countries that were exceptions to this rule—the Philippines and Sri Lanka—were notably less successful in expanding their financial sectors following reforms. In the others, for example in Indonesia, where macroeconomic conditions were favorable, the ratio of broad money to GDP rose dramatically, from a pre-liberalization level of 9 percent in 1983 to well over 40 percent in 1991. “Only credible and sustained macroeconomic stabilizations produce the increased demand for money that is the counterpart to financial deepening.”

In contrast, according to the Pill et al study, the situation is markedly different in Africa, where a number of countries have attempted to implement financial liberalization in an environment of ongoing inflation—largely a consequence of excessive fiscal deficits. In Ghana, Inflation was more than 20 percent a year when interest rates were deregulated; in Zambia, inflation exceeded 100 percent at the time of reform. Attaining low but positive real interest rates is difficult when inflation is high and volatile.

Despite the extensive financial sector reforms that have taken place in terms of interest and price liberalizations, Sub-Saharan African (SSA) financial systems face severe inefficiency, illiquidity, and thinness. Moreover, despite a surge of global investor interest in the 1990s, Africa has been bypassed by massive international capital that flew to developing countries (Lemma W. Senbet and Isaac Otchere, 2005).

According to Lemma et al, there has been a massive flow of private international capital to developing countries resulting from the opening up of the world economy in 1980s (with the fast growing components being portfolio flows—equities and bonds). SSA was left out of the dramatic portfolio flows. On the other hand, although development finance flows have declined over time, SSA continues to account for the largest and growing proportion of development finance. In fact, since the mid 1980s, aggregate private capital flows to developing nations have rapidly outpaced official development assistance flows. Unfortunately, as Lemma et al pointed out, SSA is the only region (except South Africa), which continues to face development assistance flows in excess of private capital flows.

However, as Lemma et al further indicated in their paper, financial sector reforms have contributed for Africa's integration into the global financial economy. First, increasing integration of African markets with the other capital markets will encourage the flow of investments into these countries as investors seek to capitalize up on the potential diversification benefits. Second, due to the recent performance of the African stock markets, there is an encouraging element for increased prospects of Africa's financial globalization. Stock markets in Ghana, Uganda, Egypt, Kenya, Nigeria and Mauritius performed phenomenally with a return over 50%.

2.2.2 The Ethiopian financial sector development

This part of the study is mainly based on the information found from the sources of NBE, Assefa Mihiretu (1974), Consolidated Laws of Ethiopia³, and different proclamations.

2.2.2.1 Pre- reform (1905 – 1974)

Modern banking services in Ethiopia was started in 1905 with the entry of foreign owned Bank of Abyssinia (BOA); based on 50 years franchise agreement with Anglo Egyptian National Bank. The agreement was immediately signed between Menilik II and Mr. D. Mac Gilliuray, the representative of the National Bank of Egypt, and the bank was inaugurated by the Emperor in Feb 16, 1906.

³ Faculty of Law - Addis Ababa University (1975), Consolidated Laws of Ethiopia: Sep. 10, 1970-Sep. 10, 1973, Supplement No. 1.

The initiative was started in 1893 when Emperor Menilik—unhappy with the Italian misinterpretation of the Wuchale Treaty, decided to institute his own currency bearing his effigy. The currency was coined to compete with the then Maria Theresa and Talero Eritreo both of which had Italian backing. As Assefa indicated in his study; “After this important initiative, whose continued operation was guaranteed by the defeat of Italy in 1896, the Emperor was soon interested in moving ahead with another innovation, the Establishment of a bank in Addis Ababa”. Accordingly, in 1903, the Emperor requested the British to help start a bank and the British responded favorably which led to the establishment of BOA.

The major terms of the agreement include the fixed capital of the bank which was ½ million Pounds Sterling of which 20% was subscribed and the balance was collected by selling shares in the large cities like London, Paris and New York. The sole right of issuing bank notes and minting coins was given to the bank and all the governments funds were to be deposited with the bank and all payments were made by checks. BOA opened branch offices in some parts of the country like Harer, Dire Dawa, Gore and Dessie and involved in limited activities such as keeping government accounts and external trade financing.

Moreover, according to the source from NBE, the bank faced enormous pressure for being inefficient and in order to free banking from foreign control. Consequently, BOA was legally replaced by Bank of Ethiopia (BOE), a purely Ethiopian institution, shortly after Emperor Haile Selassie came to Power. The new bank, BOE, was the first indigenous bank in Africa and was established by an official decree on August 29, 1931 with capital of £750,000 and continued successfully until the Italian invasion in 1935.

During the invasion, the Italians established branches of their main Banks until they ceased operation soon after liberation except Banco di Roma and Banco di Napoli. The Italians had come in with four different banks, Banco d'Italia, Banco di Roma, Banco di Napoli and Banco Nazionale del Lavoro and had opened services in a total of 29 branches in 15 central places between 1936 and 1941.

In 1941 another foreign bank, Barclay Bank came to Ethiopia with the British troops and organized banking services in Addis Ababa until its withdrawal in 1943. Then on 15th April 1943, the State Bank of Ethiopia (SBE) commenced full banking operation in addition to its act as the central bank of Ethiopia with the power to issue bank notes and coins as the agent of the Ministry of Finance. The SBE had established 21 branches including a branch in Kartoum (Sudan) and a transit office in Djibouti until it ceased to exist by bank proclamation issued on December, 1963. After twenty years of monopoly, the arrangement of SBE came to an end and the 1963 banking proclamation, hence, was another important bench mark in the development of the banking service in Ethiopia.

Then the Ethiopian Monetary and Banking law that came in force in 1963 separated the function of commercial and central banking by forming National Bank of Ethiopia (NBE) and Commercial Bank of Ethiopia (CBE) independently. The proclamation also allowed foreign banks to operate in Ethiopia limiting their maximum ownership to be 49 percent while the remaining balance should be owned by Ethiopians.

According to the 1963 proclamation, the accelerated economic development of the Empire requires the establishment of a modern monetary and banking system which provides a sound basis for the continued expansion of the economy. Following the incorporation as a share company on December 16, 1963 as per proclamation No. 2017/1955 of October 1963, CBE took over the commercial banking activities of the former SBE. It started operation on January 1, 1964 with a capital of Br 20 million and in contrast with the former SBE, all employees were Ethiopians.

There were also two other banks in operation namely Banco di Roma S.C. and Banco di Napoli S.C. that later reapplied for license according to the new proclamation each having a paid up capital of Br 2 million. Furthermore, the first privately owned bank established on Ethiopians initiative, Addis Ababa Bank Share Company (AAB), was started operation in 1964 with a capital of 2 million in association with National and Grindlay Bank (London), which had 40% of the total share. In 1968, the original capital of the Bank rose to 5 million and until it ceased operation; it had 300 staff at 26 branches. In addition to banking services, there were also other financial institutions operating in the country like the Imperial Savings and Home Ownership Public Association (ISHOPA) which specialized in providing loans for the construction of residential houses and to individuals under the guarantee of their savings; Saving and Mortgage Corporation of Ethiopia (SMCE) whose aims and duties were to accept savings and trust deposits account and provide loans for the construction, repair and improvement of residential house, commercial and industrial buildings and carry out all activities related to mortgage operations; and a bank called Agricultural Bank (AB) that provides loan for the agricultural and other relevant projects established in 1945.

In 1951 the Investment Bank of Ethiopia (IBE) replaced AB but in 1965 the name of the bank becomes Ethiopian Investment Corporation Share Company (EIC) and the capital raised to Br 20 million, which was fully paid up. However, Decree No.55 of 1970 established the Agricultural and Industrial Development Bank Share Company (AIDB) by taking over the asset and liability of EIC.

As indicated in the Development Bank (Repeal) Decree of 1970, the purpose of the transformation was to encourage the development of industrial and agricultural production and thus raise the standard of living of the people; since the stage of economic development Ethiopia has by then calls for the mobilization and investment of all available funds in profitable development projects.

During the final year of the Imperial period (1974), there were three commercial banks doing most of the banking business in the country. Namely: 1) The CBE, 2) The Addis Ababa Bank, and 3) Banco di Roma. The CBE as indicated was an outgrowth of the SBE, which took over the commercial functions of the latter; and it was by far the most developed since it inherited the national branch infrastructure of its predecessor. The Addis Ababa Bank, which joined the commercial banking business in 1964, was the second most important and had produced 17 branches in eleven towns till 1970. Banco Di Roma was the third bank with seven branches in five central places since it resumed operation in 1967.

Regarding insurance institutions, as the source from NBE further indicate, modern form of insurance services were introduced in Ethiopia in 1905 when the BOA began to transact fire and

marine insurance as an agent for a foreign insurance company. There were 9 insurance companies that were providing insurance service in the country in 1954. However, except Imperial Insurance Company (IIC) that was established in 1951, the rest of the insurance companies were branches or agents of foreign companies. The minimum paid-up capital required to establish an insurance company was as little as Br 12500 causing the number of insurance companies to increase significantly and reached 33 in 1960.

The first proclamation issued to provide for the control and regulation of insurance business in Ethiopia was proclamation No. 281/1970 that created an Insurance Council and Insurance Controller's Office. Until then insurance business was classified as trade, like any business, and was administered by the provisions of the commercial code except the maritime code of Ethiopia which was issued to govern the operation of maritime business and the related maritime insurance.

The controller of insurance licensed 15 domestic insurance companies, 36 agents, 7 brokers, 3 actuaries and 11 assessors in accordance with the provisions of the proclamation immediately in the year after the issuance of the law.

The law required an insurer to be a domestic company (a share company having its head office in Ethiopia but non-Ethiopian nationals were not barred) whose share capital (fully subscribed) to be not less than Br 400,000 for a general insurance, Br 600,000 in the case of long term insurance and Br 1 million to do both business. In the case of a company transacting both

businesses at least 51% and in the case of a company transacting life insurance business at least 30% of the paid-up capital must be held by Ethiopian nationals or national companies.

2.2.2.2 Pre-reform (1974 –1991)

Following the declaration of socialism in 1974 the government extended its control over the whole economy and nationalized all large corporations. The Ethiopian economy was managed as a soviet-style centrally planned economy under the socialist government from 1976 to 1994. “All privately owned financial institutions including three commercial banks, thirteen insurance companies and two non-bank financial intermediaries were nationalized on 1 January 1975” (Alemayehu, 1998). The commercial banks were Addis Ababa Bank, Banco di Napoli and Banco di Roma. The nationalized insurance companies include 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) cited in Alemayehu, 1998).

All insurance companies were merged to form one insurance company named Ethiopian Insurance Company (EIC). The three privately owned banks, Addis Ababa Bank, Banco di Roma and Banco di Napoli were merged in 1976 to form the second largest bank in Ethiopia called Addis Bank with a capital of Br 20 million and had a staff of 480 and 34 branches. Then Addis Bank and CBE were merged by proclamation No. 184 of August 1980 with establishing capital of Br 65 million to form the sole CBE in the country till the 1994 financial sector reform. The SMCE and ISHOPA were also merged to form Housing and Saving Bank (HSB) with working

capital of Birr 6 million and all rights, privileges, assets and liabilities were transferred by proclamation No. 60 of 1975 to the new bank.

Proclamation No. 99 of 1976 reforms the AIDB, which was formed in 1970, as a 100% state ownership under the umbrella of the NBE. Then it was reestablished by proclamation No. 158 of 1979 as a public finance agency possessing judicial personality. It was entrusted with the financing of the economic development of the agricultural, industrial and other sectors of the national economy extending credits of medium and long-term nature as well as short-term agricultural production loans (NBE Source). According to the NBE Source, the financial sector that the socialist oriented government left behind constituted only three banks, namely NBE, CBE and AIDB, each enjoying monopoly in their respective markets.

2.2.2.3 The Post 1991 Economic and Financial Sector Reform

2.2.2.3.1 Economic Policy

After the downfall of the Derge (Military) regime, the year 1991 was an important period in terms of economic policy as the new government adopted a market oriented economic program. EPRDF led government undertakes a transition to a more market-based economic system, compared with its predecessor, and subsequently introduced important economic reforms since 1992. As discussed in the Ethiopia's Economic policy document, the state of the economy during the time was in dangerous situation. Ethiopia is classified as being among the least developed countries in the world. Its economy, already structurally deficient and backward, has been declining during the 17 years of the Derg regime and has reached a critical stage. Economic

indicators like the growth rates of the GDP and PCI, the rates of investment and saving, the BOPs (Balance of Payments) and foreign exchange reserves, government revenue and expenditure and the modes of financing and money supply and credit, were in a poor condition. According to the document, such parameters as the level of unemployment, inflation and the condition of infrastructure all point to the economic backwardness of the country.

The wrong policies that were pursued by the then military regime were among the reasons cited behind the Ethiopia's economic crisis. The regime denied individuals to own and manage economic activities and there was a wide-ranging economic mismanagement that had been deep-rooted for many years. Thus, according to the document, the old policy needs to be replaced by an appropriated new economic policy. Removing bureaucratic bottlenecks that have strangled the economy, opening up opportunities for the population and creating the necessary conditions for the protection of their rights were the major purpose of the new policy. Changing the role of the state in the economy, promoting private investment and mobilizing external resources were the major mechanisms cited in the new policy. The general direction regarding the Agricultural, Industrial, Financial and Trade policies were included in the policy. As the financial policy part indicated, major financial institutions were planned to remain under state ownership, but domestic private capital were targeted to be encouraged in order to play a part in banking and insurance activities.

Also, the International Community (spearheaded by the WB and the IMF) structured with the transitional government of Ethiopia has initiated an economic recovery project, which it financed. This project is called the Emergency Recovery and Reconstruction Project (ERRP) and its main

objective had been to provide a capacity for a transition into a sustainable economic development course.

The ERRP amounted to 672 million USD apportioned among the following major expenditure lines:

- i. 43% paid for critical input imports;
- ii. 35% for infrastructure repair; and
- iii. 22% to fund the social sector component, mainly education and health care.

The main immediate policy goals of the ERRP and that of SAP included market reform, public sector reform, privatization and correction of balance of payment problems. Public sector reform was included with the expectation that the bureaucracy enabled to carry the implementation through capacity building program. Market reform has the goal of achieving competitiveness and market determined prices; while privatization program was aimed to free the capital from the crowding out effect of-the government operation. An integral part and a principal component of the reform had been also the financial sector reform program.

2.2.2.3.2 The Financial Sector Reform

The post 1991 Ethiopian financial sector reform enveloped a number of policy measures that have been taken over the past eighteen years. The major ones are listed below and are discussed subsequently.

- i. **Monetary and Banking Proclamation No. 83/1994, presently amended by NBE Establishment Proclamation No. 591/2008;**
- ii. **Proclamation No 84/1994 which allow for the establishment and supervision of Private Banks; .**
- iii. **Proclamation No 86/1994 which allow for the establishment and supervision of Private Insurance Companies;**
- iv. **The establishment of the Inter Bank Foreign Exchange Market (IBFEM) based on the NBE directive No: IBM/01/1998;**
- v. **The establishment of the ‘Interbank Money Market’ (IBMM) based on the NBE directive No: IBM/02/98; and**
- vi. **Proclamations No 550/2007 and No 551/2007 to provide for the establishment of Commodity Exchange and Commodity Exchange Authority.**

Monetary and Banking Proclamation No. 83/1994: This proclamation was issued on 30th Jan 1994 and it redefines the legal status, purpose, powers and duties of the NBE. The proclamation highlights the supervisory and regulatory role of the NBE and empowers NBE to examine whether banks comply with the rules and regulations, assess their soundness and make short and long term refinancing facilities available to banks and other financial institutions. The legislation clearly stipulates the NBE’s relation with the government and other financial institutions.

The proclamation discusses about the need for systematic mobilization and use of financial and monetary resources and the necessity to lay the basis for a sound banking system to foster the expansion of the economy. The duties of the NBE specified in the proclamation include: coin,

print and issue legal tender currency; regulate the supply, availability of money and credit and applicable interest and other charges; implement exchange rate policy, allocate foreign exchange, manage and administer the international reserve of Ethiopia; license, supervise and regulate banks, insurances and other financial institutions; setting of limits on gold and foreign exchange assets which banks and other financial institutions authorized to deal with and can hold in deposit; setting limits on the net foreign exchange position and on the terms and the amount of external indebtedness of banks and other financial institutions and fixing of the minimum and maximum lending and borrowing rates of interest, which licensed banks adopt, as required.

This proclamation also set limit to government borrowing from the central bank under its article 25. Among the outlined sub articles, article 25(3a) says: For the purpose of overcoming budgetary deficit of the government, the bank may make direct advances to the government provided, however, that the total of the outstanding direct advances to the government shall at no time exceed 15% of the average annual ordinary revenue of the government for three fiscal year immediately preceding the year of borrowing. And, repayment of all advances made during the preceding fiscal year within the next one year period shall be a condition to the making of any advances in the following year. Also the direct advances shall bear interest at a market related rate to be determined by the bank.

Proclamation No 84/1994: This proclamation recalls the adoption of the new economic policy and emphasizes the banks role in the implementation of the policy through mobilization of funds from within and outside the country to be utilized in welfare improvement and economic development. Banking business is defined in the proclamation as any business that consists of

the following elements: Receiving funds from the public, through accepting deposits of money payable upon demand or in a fixed period or by notice or any similar operation involving the sale or placement of shares, certificates, notes or other securities; and any other means that the NBE determines or declares.

Foreign companies are excluded from the ownership of banks in Ethiopia and a share of more than 20% of a bank is not allowed by a person or jointly or severally with his spouse and or with a person who is below the age of 21 or related to him by consanguinity in the first degree relationship. Recently, the 20% share limit was reduced to 5% by the proclamation no 592/2008.

Proclamation No 86/1994: This is a proclamation aimed to allow for the establishment of insurance business in Ethiopia. A licensing proclamation stipulates, among others, the minimum capital requirement, the ownership limit of a shareholder's equity and the ruling out of foreign nationals from the ownership of insurance business in Ethiopia.

The IBFEM Directive No IBM/01/1998: This directive introduced one of the important financial sector reform schemes pursued by the NBE, which is the exchange rate policy. The interbank foreign exchange market (IBFEM) is a wholesale market, where the amount traded is relatively large and the spread between buying and selling rate is narrower than the norms for commercial transaction. It is the auction based exchange rate determination system conducted on a weekly basis and takes the form of discriminatory price where the marginal rate which clears the market is taken as the ruling rate for the coming week. The Ethiopian exchange rate system, thus, can be categorized as managed floating exchange rate regime due to this policy.

The IBMM Directive No IBM/02/98: This also is a financial policy pursued by the NBE to establish the interbank money market. It describes the borrowing and lending of funds between banks, micro-financing institutions, and non-bank financial institutions at the interest rate that is freely determined by borrowers and lenders themselves.

Establishment of Commodity Exchange (ECX) and Commodity Exchange Authority (ECEA): ECX is a national multi-commodity exchange that is expected to provide a market place where buyers and sellers can come together to trade and be assured of quality, delivery and payment. Established by proclamation no 550/2007 in June 2007, ECX is authorized to trade in both spot and future contracts, initially starting with spot contracts for immediate delivery. It is established as a self regulatory organization, thus granted rule making and enforcement responsibilities under its establishing proclamation. The exchange is a private-public undertaking with capital investment from its main promoter, the government of Ethiopia, and membership seats privately owned by trading and intermediary members. It is jointly governed by private-public Board of Directors and managed professionally by a recruited team.

On the other hand ECEA is a regulatory body (a government organ), established by proclamation no 551/2007 entrusted with the responsibility of regulating the proper functioning of a commodity exchange. The general objective of the authority, as described in the proclamation, is to ensure the development of an efficient modern trading system, and to regulate and control the secure, transparent and stable functioning of a commodity exchange and to protect the rights and benefits of sellers, buyers, intermediaries and the general public.

Chapter Three

Data Analyses

In an attempt to carry out the task, both descriptive and econometric methods are employed. The descriptive method is to examine the performance aspect while the econometric technique is to estimate the determinants of the market share. Secondary and time series data are collected from various sources and are assembled in a manner to use proficiently. Mainly, data from quarterly and annual bulletins of the NBE, annual bulletins of both government and privately owned commercial banks and data from MOFED are used. Since the number of banks in the country is small, all banks in the country that were operational during the study period are included in the analysis; except Cooperative Bank of Oromiya (CBO), who failed to provide its data though repeated effort was made.

3.1 Why Focus on Banking?

As indicated in section 1.2, the main focus of this paper is to study the performance of banks following the major financial sector reform (1994). The main reasons claimed are the following:

- a) The dominance of banking in the total capital and asset of the formal financial system in Ethiopia is one compelling justification. As the data in Table 2.1 indicates, the share of banking capital in the total financial sector capital is substantial and stood at 82.2%, on average, over the period 2004-2007; and the total banking asset has recorded about 92.9% share, for the same period.

Table 2.1: Relative Importance of Insurance, Banking and Microfinance Institutions

Particular	June 2004		June 2005		June 2006		June 2007		Average	
	millions of Br	Share, in %	millions of Br	Share, in %	millions of Br	Share, in %	millions of Br	Share, in %	millions of Br	Share, in %
Total Capital	3,967.00		4,489.00		6,714.4		10,767.39		6484.46	
Insurance	406.5	10.3	434.8	9.7	492.8	7.3	530.12	4.9	466.06	7.2
Banking	3,154.9	79.5	3,486.0	77.7	5,427	80.8	9,258	86	5331.48	82.2
Microfinance	405.6	10.2	568.2	12.6	794.6	11.9	979.27	9.1	686.92	10.6
Total Asset	41,735.4		51,460.9		59,067.36		71,223.12		55871.70	
Insurance	1,355.5	3.2	1,490.2	2.9	1,760.9	3	1,909.56	2.7	1629.04	2.9
Banking*	38,974.2	93.4	48,066.4	93.4	54,755.5	92.7	65,830.9	92.4	51906.75	92.9
Microfinance	1,405.7	3.4	1,904.3	3.7	2,550.96	4.3	3,482.66	4.9	2335.91	4.2

Source: NBE

*Excluding the Asset of Development Bank of Ethiopia because of data shortage

- b) The regulatory body, the NBE's, experience and focus is on banking sector than other financial institutions (Insurance and Microfinance). This resulted in shortage of long period data for non-banking sector and hence compels the study to concentrate in banking area.
- c) The large dependence of insurance business on banking business through credit insurance in Ethiopia. This is mainly due to the banking credit-procedure's requirement of insuring credit collaterals, at least against fire and lightning risk or against damage risk. Since the economy of the country is dominated by traditional

activities and per capita income of the population is very low, non credit insurance business is very limited.

Due to the above reasons, the study focused on the banking business performance in order to examine the effects of the major financial sector reform in the post 1991 period.

3.2 Descriptive and Qualitative Analyses

A single parameter may not be adequate to yield an accurate picture of the performance of banks given the complexity of the subject matter. Thus, in the descriptive and qualitative analysis the major indicators like profitability, asset quality and efficiency will be utilized in a bid to comprehend the nature, trend and extent of banking business in Ethiopia thereby analyzing the performance and market share of different banks.

3.2.1 Profitability Measures

Profitability ratios attempt to measure a company's ability to earn corresponding return relative to sales or resources devoted to operations. Resources devoted to operations can be defined as total assets or only those assets provided by owners, depending on the evaluation objective. Profitability might decrease as competition becomes stronger. In contrast, higher or growing profitability may indicate early stage of competition in the market. The major profitability ratios in banking business are returns on equity and return on asset, which are considered below.

A) Returns on Equity (ROE) – It is the ratio of profits to equity capital (shareholder's equity) and provides a useful measure of the profitability of equity investment in banking. It differs from return on asset as it evaluates returns in relation to equity (shareholders capital) only—which is one part of the total asset of a business firm. Mostly, owners or shareholders of business firms are interested in this ratio because it is a direct indicator of the dividend payable on their investment capital. Decreasing ROE overtime would imply an increasing competition. One measure of profitability is the ability of management to generate income from the resources owners provide.

For comparison purpose, the ROE of the three government-owned banks before and after the 1994 reform are presented in Table 3.1 and 3.2. As the data in the table indicate, the average profit to capital ratio of these banks had declined from 0.31 to 0.25. This means a capital investment of Br 1, which had a return of 0.31 cents (or 31%) in the pre-reform period, has a return of 0.25 cents (or 25%) in the post reform period. Nevertheless, in absolute terms both pre and post reform figures look big compared with investment rate of return for non-banking sectors. In the Ethiopian non-banking sector, the return to investment is usually taken as 10% in different project feasibility studies. The decrease of return may be due to decreasing monopoly power of government banks. Similar ratio for the CBE, the dominant bank in the Ethiopian banking sector, also shows a decrease to 0.35 from 0.68 of the pre-reform period, indicating the increasing competition in the banking industry.

Table 3.1: Gross Profit to Capital Ratio of Banks during the Pre-Reform period

Bank	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	Average
CBE	0.51	0.57	0.62	0.56	0.36	0.15	0.35	0.55	1.04	0.97	0.68
DBE	0.74	0.05	0.08	0.10	-0.25	-0.06	-0.41	-0.64	-0.02	1.20	-0.08
CBB	0.60	2.15	1.75	1.51	0.78	0.38	0.34	0.15	-0.19	0.08	0.29
Overall	0.58	0.31	0.35	0.34	0.02	0.03	-0.08	-0.15	0.52	0.90	0.31

Source: Annual Reports of Banks and Own Computation

Table 3.2: Gross profit to Capital Ratio of Banks during the Post-Reform period

Bank	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Average
CBE	0.23	0.48	0.16	-0.61	0.52	0.35	0.55	0.72	0.28	0.41	0.35
DBE	0.15	0.17	0.15	0.13	-0.03	-0.01	0.03	0.02	0.03	0.04	0.05
CBB	0.04	0.04	0.01	0.06	0.09	0.13	0.24	0.46	0.38	0.45	0.27
Overall	0.20	0.39	0.15	-0.33	0.36	0.25	0.26	0.34	0.21	0.31	0.25

Source: Annual Reports of Banks and Own Computation

B) Returns on Asset (ROA) – is the ratio of profits to total assets and is an indicator of how profitable a company is relative to its total assets. The ROA indicates a company's overall profitability and it expresses income as a percentage of the total assets available to generate that income. Because total assets are partially financed with debt and partially by equity funds, this is an inclusive way of measuring earning power that ignores specific sources of financing.

As depicted in Tables 3.3 and 3.4, the ROA of the three banks has recorded an average ratio of 0.0214; a return of 2.14 Br on a 100 Br worth of asset, after the 1994 reform. Compared with

0.98 of the pre-reform period, it is a notable achievement. The result indicates an improved capacity of management in utilizing non-equity asset, given the declined figure of ROE discussed in section (A) above. It implies that deposits (liability of banks) are better used and transformed to earning assets, after the reform. The average ROA ratio of CBE has also increased from 1.42 percent to 2.25 percent showing an enhanced performance in utilizing the asset of the bank, after the reform. DBE and CBB also recorded a better performance regarding their ROA.

Table 3.3: Gross Profit to Asset Ratio of Banks during the Pre-Reform period

Bank	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	Average
CBE	0.01	0.01	0.01	0.01	0.01	0.00	0.01	0.01	0.02	0.02	0.0142
DBE	0.02	0.00	0.00	0.01	-0.02	0.00	-0.02	-0.11	0.00	0.04	-0.0052
CBB	0.01	0.02	0.02	0.02	0.03	0.01	0.01	0.00	-0.01	0.01	0.0102
Overall	0.01	0.01	0.01	0.01	0.00	0.00	0.00	0.00	0.02	0.03	0.0098

Source: Annual Reports of Banks and Own Computation

Table 3.4: Gross Profit to Asset Ratio of Banks during the Post-Reform period

Bank	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Average
CBE	0.01	0.03	0.01	-0.02	0.03	0.02	0.02	0.03	0.03	0.04	0.0225
DBE	0.02	0.03	0.03	0.02	-0.01	0.00	0.01	0.01	0.01	0.01	0.0119
CBB	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.04	0.04	0.05	0.0234
Overall	0.01	0.03	0.01	-0.02	0.03	0.02	0.02	0.03	0.03	0.03	0.0214

Source: Annual Reports of Banks and Own Computation

Analyzing the performance of all banks on the basis of the above ratios, profitability of most of banks in Ethiopia is substantial (see Annex 3 and 4). The overall average ROE registered 0.2578 (or 25.78%) over the last ten years period (1998/99—2007/08). The similar figure for ROA was 0.0241 (or 2.41%), which is better relative to the result in the pre-reform period. Though the performance of government owned banks has improved after the financial sector reform, it recorded a lower performance compared with private banks. The average ROE and ROA of private banks are 0.2842 and 0.0322 while those of the government banks are 0.2464 and 0.0214, correspondingly. Such differences of performance prove the rightness of the theoretical arguments that favor the private sectors' role in the economy than the government owned business institutions.

3.2.2 Major Variables and Concentration Measure

Concentration indicators measure the change in the market structure. It is the market share of different variables held by a bank under consideration. The major variables discussed in this section are the following:

- i. **Number of Branches**
- ii. **Amount of Deposit Mobilized (Saving, Demand, and Time deposits)**
- iii. **Amount of Loan Extended /Share of Credit Channeled to Various Economic Sector**
- iv. **Asset and Capital of Banks**

As can be seen in Table 3.5 and 3.6, all the above variables showed improved results in recent times relative to their figures recorded just before the reform. Total bank capital and assets which were only about 276 million and 13 billion Br before the reform now reached 10.5 and 89.6 billion Br, respectively, which is a huge improvement in terms of nominal figures. Also deposit and loan figures showed big progress from their respective figures of 8 and 4 billion Br to 61.3 and 39.9 billion Br at the end of 2007/08 Ethiopian fiscal year. Number of bank branches too increased more than twofold and reached 530 in the same period.

Table 3.5: Selected Figures just before the Reform—end of 1993/94 fiscal year (in 000' Br)

	Outstanding Deposit	Outstanding Loan	No of Branches	Total Capital	Total Asset
CBE	7,455,264.18	2,856,062.46	155	232,621.14	11,217,413.21
CBE's Share	93.1%	70.6%	74.9%	84.2%	85.9%
DBE	169,616.60	712,768.00	31	0	1,148,370.00
CBB	386,408.42	476,964.68	21	43730.91	689,832.59
Total of Government banks	8,011,289.20	4,045,795.14	207	276,352.05	13,055,615.80

Source: Annual Reports of Banks and Own Computation

Table 3.6: Selected Figures at the end of 2007/08 fiscal year, in 000' of Br

	Outstanding Deposit	Outstanding Loan	No of Branch	Total Capital	Total Asset
CBE	36,966,600.00	17,338,500.00	205	4,560,000.00	50,347,800.00
CBE's Share	60.3%	43.5%	38.7%	43.6%	56.2%
DBE	500,589.00	5,389,249.00	30	1,910,001.00	6,969,971.00
CBB	1,488,522.66	1,207,857.61	30	259,007.43	2,393,899.52
Total of Government banks	38,955,711.66	23,935,606.61	265	6,729,008.43	59,711,670.52
Total of Private banks	22,342,741.47	15,952,504.70	265	3,728,811.85	29,846,109.15
Overall Total	61,298,453.13	39,888,111.31	530	10,457,820.28	89,557,779.67

Source: Annual Report of Banks and Own Computation

*See Detail for Private Banks in Annex 5

Nevertheless, the concentration of banking services towards the dominant bank in the pre-reform period had substantially declined in the post-reform period. The share of CBE in deposit, loan, no of branches, capital and asset has declined from 93.1%, 70.6%, 74.9%, 84.2% and 85.9% of the pre-reform period to 60.3%, 43.5%, 38.7%, 43.6% and 56.2% of the post-reform period. The implications of the above indicators to banking performance are direct. The expansion of bank branches, the increasing capital investment in the industry, the rising amount of deposit and the decreasing concentration; all indicate the growing potential capacity of banking sector to play its role in the economy. However this alone does not provide sufficient indications of performance behavior. Hence, more assessment using quality measures is necessary, which are discussed in the next section.

3.2.3 Asset Quality

Asset quality typically affects bank's profitability. It follows that profitability measures like ROE and ROA do not necessarily indicate improving performance of banking sector. Hence, some caution should be exercised in interpreting the above profitability measures by considering the quality of asset. Looking at quality of asset also helps to compare the competitive position of the available banks overtime. Indicators to be considered here include:

- (a) **Capital Adequacy Ratio-** This usually measures financial strength of a bank which is expressed as capital-to-asset ratio. It also measures risky-ness of asset.
- (b) **Loan Loss Provisions to total Asset Ratio-** Loan loss provisions serve as a proxy for non-performing loans as it is difficult to get the data on the latter.
- (c) **Liquidity Ratio-** This ratio indicates the capacity of banks to fulfill their obligation.

(a) Capital Adequacy Ratio (CAR)

CAR is a ratio that regulators in the banking system use to watch bank's health, specifically bank's capital to its risk. Regulators in the banking system track a bank's CAR to ensure that it can absorb a reasonable amount of loss. In most countries they define and monitor CAR to protect depositors, thereby maintaining confidence in the banking system. It is a ratio which determines the capacity of a bank in terms of meeting the time liabilities and other risk such as credit risk, market risk, operational risk, and others. It is a measure of how much capital is used to support the banks' risk assets.

Minimum standard set by the Bank for International Settlements (BIS) is 8% and the ratio is calculated by dividing capital by the risk weighted assets (www.maxi-pedia.com). However, due to lack of detailed data, a proxy of total capital divided by total asset is used in this study. According to the results in Table 3.7 and 3.8, average capital to asset ratio during the pre-reform period was 0.0222 (2.22%) and showed an improvement after the reform by recording 0.0933 (9.33%), on average, for all banks. CBE's performance has also improved in this regard (An average of 6.39% is achieved in the post reform against 2.07% of the pre-reform period).

(b) Provision

It is obvious that one of the main objectives of the financial sector reform is to reduce the huge duff loans that banks are saddled with in the pre-reform period. Loan loss provision is an expense set aside as an allowance for bad loans (customer defaults, or terms of a loan that have to be renegotiated, etc). High provision implies the existence of high bad loans in a bank.

The results of the study as summarized in Table 3.7 and 3.8 demonstrated that; before the reform the Ethiopian banks allocate relatively big provision compared with the post-reform period. The provision to total loan ratio was 12.61% in the pre-reform period (1993/94 fiscal year) whereas it reduced to 5.96% in the post-reform period (2007/08 fiscal year). Similarly, the figures for CBE also decreased from 15.7% to 6.16% for the same comparison periods. This indicates banks have improved their non-performing loan after the reform.

(c) Liquidity

Liquidity helps to ensure the availability of funds to meet withdrawals on demand, meet reserve requirement needs of banks and helps to meet short-term expenses of a bank. However, since cash holdings have zero interest yields, it prevents banks from increasing their earning potential. Consequently, liquidity management is essential to strike a balance between maintaining enough cash on hand to meet needs and the allocation of idle cash to earning assets. In order to measure the banking sector's liquidity management, the study examined the loan to deposit ratio of banks. This ratio is also used by the NBE, the regulatory body, to ascertain the banks liquidity requirement (the latest liquidity requirement of Ethiopian banks is 25%).

Table 3.7: Asset Quality Measures before the Reform

Name of Bank	Capital Adequacy ratio (average)	Provision/total loan ratio, 1993/94	Provision/total asset ratio, 1993/94	Liquidity ratio (average)
CBE	0.0207	0.1571	0.0386	68.11
DBE	0.0239	0.0644	0.0400	-1061.30
CBB	0.0347	0.0654	0.0452	0.86
Government banks total	0.0222	0.1261	0.0391	35.6

Source: Annual Reports of Banks and Own Computation

Table 3.8: Asset Quality Measures after the Reform

Name of Bank	Capital Adequacy ratio (average)	Provision/total loan ratio, 2007/08	Provision/total asset ratio, 2007/08	Liquidity ratio (average)
CBE	0.0639	0.0616	0.0212	61.73
DBE	0.2612	0.0279	0.0215	-320.18
CBB	0.0865	0.1505	0.0759	-2.28
Government banks total	0.0867	0.0585	0.0234	49.09
Private banks total	0.1131	0.0389	0.0208	23.69
Overall Total	0.0933	0.0506	0.0226	42.43

Source: Annual Reports of Banks and Own Computation

*See Detail for Private Banks in Annex 6

As demonstrated in Table 3.7 and 3.8, the industry level liquidity ratio depicted an increased situation during the post-reform period vis-à-vis the pre-reform period, on average. The ratio was 35.6% before the reform and improved to 42.4, on average, after the reform. The low level of liquidity before the reform was mainly attributed to the poor liquidity position of the DBE. Contrary to the industry average, the liquidity level of CBE has reduced to about 61.7%, on average, after the reform from its high level of 68.1 in the pre-reform. However, in both cases, the liquidity level of CBE can be categorized as excess liquidity and by far higher than the requirement level of the NBE.

Looking at the liquidity position of private banks, the result of the study showed that their liquidity level is lower than the government banks and below the minimum requirement level of

the regulatory body (23.69% of liquidity ratio, on average). This would be mainly due to the change of the minimum requirement level from its usual figure of 15% to 25% in recent times.

3.2.4 Efficiency

In many markets, a business needs to be at least as efficient as its main competitors in order to be able to compete and survive in the long-term. A more efficient business will produce lower cost goods than competitors; and may generate more profit possibly at lower costs. Increasing efficiency will boost the capacity of a business, assuming there is no change in the number of inputs employed. The capacity of a firm refers to how much a business can produce during a specific period of time. Where a business has efficient production, it is operating at maximum output with minimum cost per unit of output (www.tutor2u.net/).

Efficiency is, therefore, a measure of how well the production or transformation process is performing. However, this is not always easy to assess. There are several ways to measure efficiency. The major one is by using Data Envelopment Analysis Technique (DEA) that requires detailed data on income and expense of business firms. However, due to limitation of time and capacity, this study uses proxy variable of gross profit to total expense ratio of each bank, overtime. This ratio can serve as proxy for efficiency score because any businesses who can improve this ratio means it is producing better output o with lower cost per unit of output.

Table 3.9: Profit to Expense Ratio of Banks before the Reform

Bank	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	Average
CBE	0.36	0.47	0.45	0.39	0.21	0.09	0.20	0.18	0.63	0.64	0.4148
DBE	1.31	0.07	0.11	0.12	-0.23	-0.07	-0.30	-0.38	-0.05	1.07	-0.0797
CBB	0.08	0.89	0.93	0.79	0.99	0.50	0.42	0.13	-0.17	0.08	0.2564
Total	0.47	0.33	0.33	0.30	0.01	0.03	-0.06	-0.07	0.45	0.64	0.2379

Source: Annual Reports of Banks and Own Computation

Table 3.10: Profit to Expense Ratio of Banks After the Reform

Bank	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Average
CBE	0.29	0.88	0.19	-0.34	1.22	0.65	1.31	1.56	1.08	1.71	0.7417
DBE	0.43	0.45	0.39	0.30	-0.07	-0.03	0.25	0.12	0.43	0.54	0.2475
CBB	0.05	0.06	0.01	0.07	0.13	0.21	0.37	0.84	0.59	1.10	0.4398
Government banks Total	0.30	0.77	0.21	-0.25	0.82	0.50	0.97	1.12	0.96	1.52	0.6433

Source: Annual Reports of Banks and Own Computation, *See Detail for Private Banks in Annex 7

As the data in Table 3.9 and 3.10 shows, the efficiency of generating profit has considerably improved after the reform by recording profit to expense ratio of 0.64 against that of 0.24 in the pre reform period, on average. Profitability of the CBE has also improved from 0.41 to 0.74 based on the same measure and the negative profitability history of DBE changed to positive figures, in the same comparison periods.

3.3 Evaluation of Results

It is generally believed that financial sector reform accompanied by entry of new banks into the industry will create competition that will lead to a reduction in the dominance of few banks and improved performance in the industry as a whole. In view of that; as evidenced from the above assessment on profitability, concentration measures, efficiency and asset quality; the overall performance of the banking industry has improved following the financial sector reform in the country, as expected. Analyzed based on these factors, the CBE's performance has also shown a good progress after the reform.

However, evaluated against the role of the financial sector in the economy; the Ethiopian financial sector has done little in transforming the economy from its long-entrenched agriculture dependent structure to modern and diversified economic state. Banks in Ethiopia focus on the business of financing trade and services like import, export, domestic trade and financing the government deficit; instead of focusing to channel scarce resources towards the production system of the economy. Data on the recent GDP structure of the Ethiopian economy and credit allocation of banks to different economic sectors are good evidence for these conclusions (See Table 3.11, 3.12 and 3.13).

Table 3.11: Percentage Distribution of Real GDP by Major Industrial Classification

Sector	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
AGRICULTURE	51.2	49.9	50.9	49.1	44.9	47.0	47.4	47.1	46.3	44.6
INDUSTRY	12.4	12.4	12.1	12.9	14.0	14.0	13.6	13.4	13.3	13.1
SERVICES	37.2	38.7	38.0	38.6	41.7	39.7	39.7	40.4	41.4	43.4
TOTAL	100.8	101.0	100.9	100.6	100.7	100.7	100.8	101.0	101.0	101.1

Source: MOFED

The share of the industry sector in the total GDP of the country fluctuates around 13% for long time. The sector also attracts only about 16% of the total credit allocation from the banking system. Both data indicate the diminutive performance and little focus given to the industry and manufacturing sector in the economy.

Table 3.12: Percentage Share of Loans and Advances by Economic Sector (Post-Reform)

Economic sector	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Average
Government deficit financing	18.4	14.6	28.2	32.2	37.2	43.8	25.1	32.5	29.8	14.3	27.6
Agriculture	7.4	7.3	5.8	5.9	5.3	3.7	7	8.6	9.5	11.4	7.2
Industry	11.7	11.3	10.7	10.7	10.8	13.3	17.7	15.9	15.8	16.4	13.4
Domestic Trade	10.7	11.8	8.8	7.0	6.9	6.9	9.2	8.4	8.6	10.8	8.9
Import	11.5	10.8	8.5	8.1	6.0	7.8	10.8	9.4	9.4	19.1	10.1
Export	6.6	5.2	4.3	3.3	3.0	3	5	4	5.3	6.2	4.6
Hotel and Tourism	2.4	1.6	1.6	1.7	1.3	6.5	1.1	0.8	1.5	1.5	2.0
Transport and Communication	3.7	4.8	3.9	3.0	2.1	2.4	3	4	5.3	5.8	3.8
Housing and construction	8.8	8.3	7.0	6.5	6.9	1	7.6	8.1	8.6	10.1	7.3
Mines, Power and Water resource	0.1	0.1	0.1	0.1	0.1	0.0	0	0.1	0.1	0	0.1
Others	18.3	24.0	20.9	21.2	20.1	11.3	11.9	7.2	5.2	3.8	14.4
Personal	0.1	0.1	0.1	0.1	0.2	0.2	0.4	0.2	0.3	0.4	0.2
-Inter bank lending							1.2	0.7	0.5	0.4	0.7
Total	100	100	100	100	100	100	100	100	100	100	100

Source: NBE Annual Reports and Own Computation

Table 3.13: Percentage Share of Loans and Advances by Economic Sector (Pre-Reform)

Economic sector	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95	Average
Government deficit financing	55.8	55.7	53.0	33.3	36.4	40.0	37.3	32.7	38.8	43.8	42.7
Agriculture	21.0	21.4	21.9	31.1	30.6	29.5	4.4	25.1	28.4	3.7	21.7
Industry	4.6	4.4	4.6	8.4	8.4	8.5	14.6	12.3	9.7	13.3	8.9
Domestic Trade	2.3	2.7	3.3	3.1	2.6	2.1	11.2	5.4	2.7	6.9	4.2
Export	3.5	2.2	2.1	4.2	2.8	3.2	8.1	5.2	4.4	3.0	3.9
Import	2.2	3.7	4.4	5.0	4.8	2.8	7	6.8	2.9	7.8	4.7
Housing and construction	7.6	6.8	7.6	10.9	10.8	10.3	10.9	8.2	9.7	1.0	8.4
Transport and Communication	2.0	1.7	2.1	2.0	1.4	1.3	3.5	1.9	1.2	2.4	2.0
Hotel and Tourism	0.3	0.3	0.2	0.3	0.4	0.5	1.8	1	0.6	6.5	1.2
Mines, Power and Water resource	0.3	0.6	0.7	1.3	1.5	1.3	0.7	0.9	1.2	0.0	0.9
Personal	0.2	0.2	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Others	0.3	0.3	0.2	0.2	0.2	0.2	0.4	0.2	0.1	11.3	1.3
Total	100	100	100	100	100	100	100	100	100	100	100

Source: NBE Annual Reports and Own Computation

The financial sector fails to play its intermediary role of allocating resources towards the industrial and manufacturing sector, adequately. Moreover, it also not succeeded in sufficiently financing the agricultural sector—the dominant sector in the economy (less than 10% of the total credit was allocated to the agricultural sector over the last three years). In general, resource reallocation of banks towards production and manufacturing sector of the economy did not show much improvement after the 1994 financial sector reform (see Table 3.12 and 3.13).

The overall economy of the country is still in depressing condition. According to a document prepared by the International Fund for Agricultural Development (IFAD) (2008), Ethiopia is one of the poorest countries in the world, with an annual per capita income of US \$ 170. Infant and maternal mortality and child malnutrition rates are among the highest, only about 30 percent of the population has access to clean water, about 47 percent of children under the age of five are underweight, over 12 million people are chronically or transitorily food-insecure and most of rural households live on a daily per capita income of less than US \$ 0.50. And most rural households are finding it increasingly difficult to survive without recourse to seasonal or permanent urban migration in search of wage employment. Overall progress in reducing poverty since 1992 falls short of what is required to meet MDG1 by 2015 as a result of high variability in agricultural GDP and rapid population growth.

One of the reasons behind low level of economic performance, as pointed earlier, is the ineffectiveness in the financial sector development. In very broad terms financial sector development means improving the whole financial sector—everything from banks, stock exchanges, money market, insurers, microfinance institutions and the like. The Ethiopian financial system is dominated by the banking sector and lacks some institutions like the stock exchange and money market. Even though there is expansion of banking, insurance and microfinance services after the 1994 reform, the development of well-built financial sector is still questionable. The financial deepening, which is one of the financial development indicator can be mentioned in this regard. Financial deepening as measured by broad money to GDP ratio does not show improvement after the reform and stood at 34% of GDP, which is below that of the pre-reform period. On the other hand, financial deepening as measured by commercial banks deposit

to GDP ratio showed only a slight improvement to 31% from its pre-reform figure of 27% (see Table 3.14).

Table 3.14: Pre- and Post-Reform Financial Deepening, average in millions of Br

Period	Nominal GDP	Broad Money	Financial Deepening based on broad money	Commercial Banks Deposit	Financial Deepening based on deposit
Pre-reform, 1985/86-1994/95	20437.71	8000.48	0.39	5577.58	0.27
Post-reform, 1998/99-2007/08	107564.70	36649.48	0.34	33274.17	0.31

Source: NBE and Own Computation

In general, though the Ethiopian financial system is improving overtime; it still remains traditional and lack transformation. Most of banks are enjoying profit by financing mainly trade and services; and financing of the production of goods in agricultural and manufacturing sector is still underdeveloped. In addition, financial intermediation system of the country has several problems and is impeded with shortage of capacity. The basic intermediation role envisaged in the purpose and objective of the reform proclamation is hardly met. In this regard, identifying major problems that hamper the required development is fundamental. Hence, chapter four of the study focuses on explaining of issues and problems constraining the development of banking services in the country.

3.4 Analyses of Market Share

3.4.1 The optimal Market Share

Market share in any business is an important variable for most executives and owners; because the revenue generating capacity of a business highly depends on it. The firm's performance relative to competitors can be measured by the proportion of the market that the firm is able to capture, which is a market share. The optimal market share of a business firm is a market share that is comparable with the investment share of that firm relative to the total investment in the industry. To easily understand this concept, let's assume there are five firms in an industry with equal investment allocation and enjoying equal resources, business opportunities and experience with perfect knowledge and information. Then, one can reasonably expect that the market share of one of the five firms will be 20% (one fifth of the total market of the industry); which is just equal to its investment share in the industry. So, given these assumptions, the optimal market share of any firm eventually equalizes with its investment share in the business.

If one computes the ratio of market share to investment share (Market-Investment, M/I, ratio), it becomes 1 indicating a figure below 1 implies the potential improvement gap of the firm whereas a figure above 1 implies the strength of the firm—by enjoying more than its optimal market share. That is, optimal M/I ratio = 1 or fluctuates around 1. For instance, the average market share of CBE (1974-2008) was 60.9% while its investment share (capital share), for the same time, recorded 52.89% making the M/I ratio of 1.15, which is not a bad result for CBE. Usually, new firms take lower-than optimal M/I ratio whereas senior firms enjoy above-optimal ratio because of various reasons including experience and customer loyalty.

3.4.2 Determinants of Market Share

Econometric method is included in this paper to estimate the major market share determinants of the banking business in Ethiopia. To select the set of regressors or to find potentially relevant variables, economic arguments are more appropriate than statistical one. The market share in any business firm is based on the products or services which that firm makes and supply to the market with acceptance. In this perspective, since product diversity in the Ethiopian banking sector is limited to few and traditional banking products, the components of the dependent variable as well as the number of explanatory variables happen to be few.

The major product of banking business in the country, which directly generates revenue, is credit and hence the study considered credit as the main component of market share in the Ethiopian banking business. The other fundamental variable, which indirectly contributes to the revenue generating capacity of a bank, is the asset of the bank. Thus, the average market share of credit and asset is considered as banks market share in this study and is taken as the dependent variable of the model to be estimated (see Annex 8 for the market share position of banks in Ethiopia).

With regard to the determinants of the market share, the possible candidates include activities like capital investment, deposit mobilization, efficiency improvement, management quality, good will, reliability, etc. Among these, the major ones like the capital, deposit and efficiency are taken as the explanatory variables of the model. The others like the management quality, good will, reliability, etc, are difficult to measure but fortunately since they are firm specific aspects and are more likely expected to be fixed overtime, the fixed effect panel data model will appropriately

carry out the estimation. More detail on the data and methodology of the model is discussed in the next section.

3.4.3 Data used and Selection of the Specific Econometric Model

The data are collected from annual bulletin of banks and comprises data of three government banks (CBE, DBE and CBB) and seven private banks (AIB, DB, BOA, HB, WB, NIB, LIB) over the period 1974—2008 (see Annex 14). Average market shares are explained from capital share, deposit share and efficiency measures.

The estimation is based on the unbalanced panel data because of the difference in period that banks enter the banking industry. The data for CBE and DBE begins from 1974 and that of CBB begins from 1985 while the data of private banks begin just as they start banking business.

To select among the alternative approaches of fixed effect vs. random effect panel data model, a Hausman test is conducted.

Test: H0: difference in coefficients not systematic

Result: $\chi^2(4) = 104.65$

Prob> $\chi^2 = 0.0000$

The result indicates rejection of the null hypothesis implying the appropriateness of the fixed effect model.

The standard fixed effect model allows for different α_i that captures the effects of those variables that are peculiar to the i^{th} firm (firm specific effects). This approach is particularly helpful for analyzing those types of firms as in the banking industry where unobservable variables such as management quality, good will, reliability, etc play an important role.

3.4.4 Econometric Results

The linear equation (1) is estimated using unbalanced panel data for the years 1973/74—2007/08 to determine the coefficients of the explanatory variables based on fixed effects (within) regression and the results are presented in Table 3.15.

Table 3.15: Estimates of Fixed Effects Panel Data Model 1:

Dependent Variable: MS, No of Observations: 167, No of Groups = 10, Method: OLS

Variable	Coefficient	Std. Error	t-statistic	Prob.
CS	0.1253254	0.0513797	2.44	0.016
DS	0.560861	0.1215935	4.61	0.000
EM	-0.0131144	0.0170006	-0.77	0.442

R-sq: within = 0.1630,

F (3, 154) = 9.99, Probability > F = 0.0000

F test that all $u_i = 0$: F (9, 154) = 7.70

However, testing for Heteroskedasticity and Autocorrelation indicate the presence of both:

Autocorrelation Test Result:

Modified Baharagava et al. Durbin-watson = 0.16681878 which indicates positive autocorrelation.

Baltagi-Wu LBI = 0.20241428

Heteroskedasticity Test Result:

The R-squared of the auxiliary regression becomes 0.5594 and its coefficients are significant indicating the presence of heteroskedasticity. Also $\chi^2 = N \cdot T^{-1} \cdot R\text{-sq} = 3176.27$ implying rejection of the null hypothesis of homoskedasticity.

The suspect on the presence of both heteroskedasticity and autocorrelation lead to another regression based on robust standard errors. That is, regression based on the OLS while adjusting its standard errors and the results are presented in Table 3.16.

Table 3.16: Estimates of Fixed Effects Panel Data Model 2:

Dependent Variable: MS, No of observations: 167, No of groups = 10, Method: OLS

Variable	Coefficient	Robust Std. Error	t-statistic	Prob.
CS	0.1253254	0.811662	1.54	0.125
DS	0.560861	0.0958683	5.85	0.000
EM	-0.0131144	0.0179697	-0.73	0.467
CONS	7.218902	2.874753	2.51	0.013

R-sq: within = 0.1630, F (3, 154) = 13.91, Probability > F = 0.0000

Table 3.17: Fixed Effect Results:

CBE = 5.90	BOA = 2.45
DBB = -21.56	HB = 1.94
CBB = 2.8	WB = 2.48
AIB = 2.25	NIB = 2.52
DB = 3.11	LIB = 0.63

As can be seen from Table 3.16, the only statistically significant dependent variable (at the 5% significance level) in the market share function is the deposit share (DS) variable. The sign of the deposit share is as expected and the interpretation of its result is quite straightforward: As the deposit share of a bank in the total deposit of banking industry increases by one unit, the market share (defined as the average of asset share and loan share) of that bank increases by 0.56 unit—other things being equal.

The other two variables, contrary to the research hypothesis, appear to be insignificant. Though insignificant the coefficient of the CS variable shows the expected sign whereas that of the EM did not. One reason for the unexpected sign of the EM variable would be the fact that the market share of CBE is falling in the face of its improving efficiency and profitability. This condition could usually happen during the early stage of competition following the change of market structure from monopoly to competitive market pattern.

Firm specific fixed effect results for all banks are also computed and the results are listed in Table 3.17. The fixed effect for DBE of 21.56, which is relatively very big, indicate the importance of special line of business the bank has engaged in—like long term loan in industry and agricultural sector. Such kind of specialization will highly contribute to the market share of

banking business. Generally, the econometric analysis reveal interesting results which are important in designing business strategy, identifying problems and realizing opportunities.

Chapter Four

Problems and Constraints

In the previous chapter, an analysis of the post-reform performance of the banking sector in relation to the pre-reform period was conducted. The performance evaluation results indicate that, there are improvements in the banking business following the 1994 financial sector reform. Nevertheless, the performance analysis only indicates progress within the banking sector in which banks improved their profitability, asset quality and efficiency.

However, the main purpose of a financial sector set-up is not only to grow on its own but also to bring about overall development in the economy through its role of intermediation. Judged on this ground, the contribution of the Ethiopian financial sector is not significant (more discussion on this issue is found in section 3.3 of this study). Then, the questions raised here include: what are the major problems that limit the Ethiopian banking sector in carrying out its task as a financial intermediary; what difficulties are caused by the government action and its economic policy towards such ineffective financial intermediation; and what are the problems in the conduct of the NBE as a regulatory authority and in its effort of achieving the objective of financial sector development.

Answering such questions is fundamental and important in dealing with the overall problems in the financial system of the economy. Thus, this chapter focuses on discussing the problems in the intermediary role of the Ethiopian banking sector in light of the abovementioned questions. Accordingly, section 4.2 is on problems relating to the role of the banking sector in trade and

services. Section 4.3 looks at the fiscal performance and economic policy of the government with regard to problems in banking operation. And finally, in section 4.4, major issues and problems concerning the role of the NBE in monitoring and regulating the banking business will be discussed.

4.1 Focus of the Banking Sector in Trade and Services

A major problem of the banking service in Ethiopia is that it is aimed at financing not the production of goods and services primarily, but instead focuses on financing trade and services and pay for the ever growing imports of the country. The magnitude of the trade balance and its proportion in relation to GDP is depicted in Table 4.1. Trade deficits which averaged Br 1.9 billion per annum during the pre-reform decade had astronomical growth and reached Br 20.5 billion per annum during the post reform decade.

Major parts of these foreign exchange requirements (to finance trade deficits) are made available from foreign aid and loans. This in itself shows the vulnerability of the Ethiopian banking sector, which is dependent on trade and hence on foreign aid and loan. That is, since the flow of aid and loan is uncertain for various reasons; it affects the operation of banking business through import compression.



Table 4.1: Trade Balance and GDP, in millions of Br

Period	Export	Import	Trade Balance	Nominal GDP	Trade balance to GDP ratio
Pre-reform period Average 1985/86-1994/95	990.93	2901.16	-1910.22	20437.71	-0.09
Post-reform Period Average 1998/99-2007/08	6466.90	26988.88	-20521.98	107564.70	-0.19

Source: NBE and Own Computation

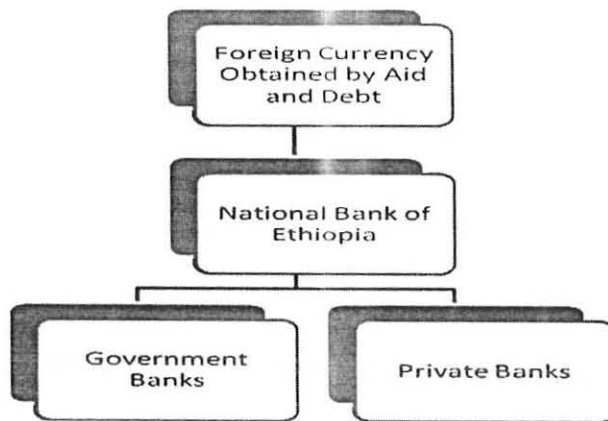
Thus, when the foreign donors and creditors fail to supply the foreign exchange needs of the banking service, it immediately results in credit squeeze – importers fail to pay in foreign exchange their import bills. Prices rise and domestic production, which is dependent on imported inputs, also suffers and a stagflation trend in the Ethiopian economy sets in. Such an occurrence is in evidence today, following deceleration in the flow of foreign aid and loans, resulting from two processes. One is the global economic recession and the other emanates from the 2005 political dispute between opponent parties following the election result—the problem to meet the condition of good-governance government. In this regard, improving the political tolerance and working towards good-governance government will help to advance international relationship and economic performance of the country.

The vulnerability of the Ethiopian banking service is also indicated by the bonding relationships between banking institutions and the National bank which also acts as the regulatory authority of financial services in the country. As shown in the chart below, foreign exchange received by the National Bank (in the form of aid/grant and loans from foreign governments and international

banking services) is made available to public and private banks through auction. These are then sold to traders to finance their imports. In difficult times, the National Bank would restrict such operations to public banks, and private banks will not have foreign exchange with which they can service their client importers.

By order of NBE Directives No FXD/02/1996 and FXD/07/1998, banks could use the foreign exchange obtained from export earnings of their customers, but these are insignificant for private banks; partly due to the small share of the export revenue in relation to foreign currency requirements of import. Besides, all government foreign purchases are serviced by the government banks, which leaves the private banks stranded as it were. Moreover, restrictions are imposed on banks by NBE directive No SBB/23/97, according to which banks are required to surrender to the NBE without delay any excess foreign exchange over and above 15 percent of the total capital of the bank.

Chart 1: The External Support Channel to the Financial System



As the NBE receives external aid and debt of the government in foreign exchange, it primarily allocate for the government external purchase via government owned banks. It also delivers the remainder for auction in the interbank foreign exchange market where all banks can participate on the bid. The flow of the external fund is depicted in chart 1 above. So reducing the government's involvement in the economy will expand the private bank's chance of obtaining the scarce foreign currency in the economy and hence improve the private sector's performance. Furthermore, relaxation of the restrictions imposed by the NBE is necessary to more liberalize the foreign exchange dealing of banks in Ethiopia. This can encourage banks to generate more external resources through financing export of the country.

4.2 Fiscal Performance and Economic Policy of the Government

High inflation rate, growing debt and deteriorating fiscal stance are major indicators of the poor performance of the Ethiopian economy and are causing problems on effective intermediation role of the banking sector. Budget deficit reached Br. 17.1 billion in 2007/08 from its figure of 7.2 billion in 2001/02. The budget deficit is partially financed by external grant, debt and the rest by direct advance from NBE and borrowing from commercial banks. Hence the increasing budget deficit of the country is one major contributor for the growing external and domestic debt. External and domestic debt of the country is too much, relative to the productive capacity of the economy and stood at 10.9% and 21.6% of GDP, respectively.

High and growing level of public debt exert pressure on real interest rates and could also lead to financial volatility and macroeconomic instability (Agenor, 2006). Such pressure mainly comes through the effect of debt on the general inflation rate in the economy. Inflation rate in Ethiopia

has recently recorded 12.3%, 17.8%, 25.3% and 34.6% over the period 2005/06-2008/09 indicating the incidence of macroeconomic instability in the country (see Table 4.2).

Increasing budget deficit, which cause high government indebtedness were mainly driven by excessive government expenditure towards non-productive sectors and inefficient government projects. Many quasi-fiscal activities of the government like subsidized credit, manipulation of reserve and liquidity requirements, multiple exchange rate practices and exchange rate guarantees are becoming common practice of the Ethiopian government in recent times. According to Agenor (2006), they constrain attempts to assess the stance of fiscal policy like an analysis of public debt sustainability and could lead to the creation of contingent implicit liabilities (obligations that the government is expected to fulfill).

Such types of government activities have also been increasing the possibilities for misbehavior of bureaucrats (corruption) and creating problems to the private investment activities in the economy. Crowding out effect of the government activity is accountable for the weak private sector (which would have been the efficient sector) and is negatively affecting the overall economic performance of the country.

Table 4.2: Government Budget Deficit, Debt, and Others, in millions of Br

Description	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Overall budget Balance	-7247	-9355	-6592	-9213	-9755	-13810	-17121
Total Grants	2424	4554	4002	4565	3732	7583	9911
Government External Debt	52994	58282	62188	52094	52339	20230	26852
Government Domestic Debt	24147.4	27575.3	28804.9	32514	36013	46728	53125
Inflation Rate	-7.22	15.06	8.62	6.83	12.27	17.82	25.3
Exchange Rate, Br./1USD	8.5425	8.5809	8.6197	8.6518	8.681	8.7943	9.2441
Nominal GDP	66557	73432	86661	106473	131641	171834	245585

Source: NBE and MOFED

Weak performance of the private sector can be evidenced by the very low ratio of operational to licensed investment activities. The ratio indicates the poor performance of private sector investment and weak intermediation role of the banking sector in the country. The amount of operational capital investments has recorded only 11.5% of the total licensed investment while that of the operational number of projects has recorded only about 15.5% of the total licensed investment, over the period of 1992-2007 (Annex 12). The low level of operational activity is in part explained by investor behavior (see Teshome, 1994). In order to secure land, utilities and other government services, prospective investors rush to obtain government license at a small fee. However, when these prospective investors fail to pass the test for government support, they withdraw their license and stop attempting to graduate from holders of “temporary license” to “permanent license”. That is what explains the poor performance of the business licensing system in Ethiopia.

Generally, there is no single explanation for economic failure. It is an accumulation of inaccurate policies and sometimes lack of policies by the main entities that manage the economy. There are lots of government involvement in the economy including owning, renting and construction of houses; involving in import businesses and wholesale trading; and participating in the manufacturing and service sector of the economy. All these increase government expenditure while they provide only sub-standard and inefficient services. Due to much of its involvement in the economy, the government is not willing to adjust (reduce) its spending to maintain macroeconomic stability. Rather it is pushing or crowding out the private sector by restraining credit in different ways.

Furthermore, the government is spending a lot of time in organizing non-productive institutions like youth, women, etc, associations and cooperatives, which aggravate its budget deficit, rather than encouraging private share companies throughout the country and creating an enabling environment to develop market led economy. There are also problems in the area of property right, good governance, accountability, transparency, equal opportunity and in the implementation of the rule of law.

The right of ownership in an asset, whether by a private party or the state, is understood to consist of the right to use it, to change its form and substance, and to transfer all rights in the asset through, e.g., sale, or some rights through, e.g., rental. It is important to recognize that the attenuation of private (or state) property rights in an asset, through the imposition of restrictive measures, affects the owner's expectations about the uses to which he can put the asset, the value of the asset to the owner and to others, and consequently, the terms of trade. A more complete

specification of individual property rights diminishes uncertainty and tends to promote efficient allocation and use of resources (Eirik G & Svetozar, 1972).

The nurturing of private property emanates from the very nature of the type of government under consideration. To protect and foster private property, the government should have the policy of good governance, honesty, transparency, real democracy and legitimacy. The property right issue in Ethiopia hardly follows the acceptable rules discussed above. The foundation of any property, which is land, is prohibited for private ownership by government law. Even, the rights to use or to rent the land are not properly protected; in many instances local authorities and groups violate these rights. Hence the land user's expectation about the uses to which they can put and the value of the asset on the land have been highly affected and there is enormous uncertainty regarding the future right.

The government economic policy, which is Agriculture Led Industrialization, did not bring credible success and development even though it was the primary agenda for more than a decade. No sign of new industrialization is seen so far as the share of industry in the total GDP did not show significant improvement but fluctuating around 12-14% (see Table 3.11). The trade policy like taxes and tariffs, monetary policy, and fiscal policy all are not doing well and they typically seem designed to accomplish the policy of strong government role and involvement in the economy.

An effective government participates in the economy in a range of different ways. According to Hassen Y. Aly (2008), the acceptable and required functions of the government in a market

economy call upon the government to perform five functions. These functions are: providing the economy with a legal structure, maintaining competition, redistribution of income, provision of public and quasi-public goods and promoting growth and stability.

If the government failed to perform one or more of these functions or extended its power beyond these functions, then negative consequences might be expected. The role of government is not to take the place of the marketplace, but to improve the functioning of the market economy. Further, any decision to regulate or intervene in the play of market forces must carefully balance the costs of such regulation against the benefits that such intervention will bring.

4.3 Problems related to the Role of the NBE

Financial sector development has a vital role in encouraging economic growth and reducing poverty. Poor communities are unable to escape poverty when they depend on risky and expensive informal financial services. Existing government and private financial institutions are unlikely to offer financial services to low income customers because of the small margins and high risks associated with low-income customers. Other formal financial institutions such as microfinance schemes and credit unions lack adequate capital and reach small numbers of the poor and can't adequately replace formal financial institutions themselves.

Thus, only developing the financial sector as a whole and establishing capital and money market that can link all financial and non-financial institutions can help. Theoretical and practical examples of financial sector development include: improving efficiency and competitiveness; extending the range of financial services; increasing the flow of money through the financial

sector; increasing private sector capital; improving regulation and stability; improving access to financial products and services; stimulating investment in new technologies; and encouraging safe borrowing and investment in small business and income improving schemes. The responsible organ to bring about these developments and to realize the establishment of a sound financial system in any country is the central bank in collaboration with the government and the financial institutions themselves.

In the Ethiopian banking sector, although banks improve their performance and profitability; the range of financial products in the sector has not changed much since the post-reform period. The main banking services have continued to be deposit mobilization, checking accounts, loans and advances, local transfers and foreign letters of credit facilities and safe custody. The use of credit and debit cards, ATM (Automatic Teller Machine) services and telephone (mobile) banking is still in its infancy stage. Internet banking is nonexistent. The type of specialized banks like investment and merchant banks are not there (Tekle-Birhan, 2008).

The major problem of banks in Ethiopia is their inability to transform the resources they mobilize into productive investments. In the past they were enjoying profitability mainly by doing simple businesses like providing working capital to borrowers and financing external and domestic trade and services. How long such kind of conditions will continue is uncertain because the domestic and international trades of the country especially import and related trades are increasingly dependent on foreign aid and support; which itself is uncertain due to a number of pre conditions attached to international aid and borrowing.

The regulatory body (the NBE) has several weaknesses in achieving macro stability and in monitoring the financial institutions. It fails to make banking institutions perform their financial intermediation role properly and effectively. The recently increasing and tightening rules and regulations of the central bank would create the situation of financial repression in the country. The policies that cause financial repression include interest rate ceilings, high liquidity ratio requirements, high bank reserve requirements, capital controls and restrictions on market entry into the financial sector, credit ceilings or restrictions on directions of credit allocation and government ownership or domination of banks.

Economists have commonly argued that financial repression prevents the efficient allocation of capital and thereby impairs economic growth. In such a system, financial intermediaries do not function at their full capacity and fail to channel saving into investment efficiently, thereby impeding the development of the overall economic system. The key reason for the government to implement financially repressive policies is to control fiscal resources. By having a direct control over the financial system, the government can funnel funds to itself without going through legislative procedures and more cheaply than it could when it resorts to market financing. More specifically, by restricting the behavior of existing and potential participants of the financial markets, the government can create monopoly or captive rents for the existing banks and also tax some of these rents so as to finance its overall budget.

The major weaknesses of the NBE in recent times include boundless lending freedom to the government through direct advance, excessive regulation practice on banking institutions, failure

in maintaining macroeconomic stability and lack of long term strategy in financial sector development.

The limit on the borrowing of government set by the monetary and banking proclamation No. 83/1994 was repealed by the latest NBE establishment proclamation No. 591/2008 (as amended). Previously, article 25 of proclamation No. 83/1994 listed out the limits to the government borrowing in its subsection 3 from a to e. For instance, the limit on direct advance to the government was set as 15% of the average annual revenue of the government for the three previous years. However, the amended proclamation only says in its article 13 No. 1 that the amount of advances and credit to the government for each fiscal year shall be determined in consultation between NBE and the government. This amendment leaves both government organs outside the monitoring and regulatory oversight of parliament or any other authority sanctioned by parliament to perform that task. That is, such declaration is open for mishandling the issue and would lead to excessive government borrowing. Moreover, the limitless lending of NBE by means of direct advance, which is non market operation, literally implies printing of money and monetization of deficits that result in high inflation in the economy.

Moreover, among the major indicators of financial repression cited above, the NBE has recently increased the liquidity and reserve requirement ratios from 15% to 25% and from 5% to 15% of the current liability and deposit, by its directive No SBB/44/2008 and SBB 45/2008, respectively. Such high reserve and liquidity requirements imposed by the NBE will affect the lending capacity of banks and its persistence could be a sign of financial repression in the economy.

The policy measures and actions taken by NBE in recent times seems to be directed at government deficit financing while increasing blockages to the private sector financial need. Such multifaceted pressure on the private sector and banking institutions would result in poor performance of the financial sector that could cause credit crunch in the economy; and eventually endanger the prospect for growth and sustainable economic development.

Besides, the NBE fail to develop appropriate bond and Treasury bill market that can be effectively used rather than direct advance to finance long term government financial need and short term budget deficit. Underdeveloped financial and capital markets would result in a limited scope of issuing domestic debt and could lead to more reliance on seigniorage and inflationary financing of the government deficit (Agenor, 2006).

The NBE also did not act upon motivating and issuing directives for introducing modern banking services like credit and debit carding systems, investments in new financial technology and in the establishment of specialized banks like investment banks. The absence of stock market (secondary market) and the nonexistence of all rounded money market are also indicators of the underdevelopment of the Ethiopian financial system, which has not been addressed by the central bank and the Ethiopian government.

Chapter 5

Conclusion and Recommendation

5.1 Conclusion

In this study, standard measures of performance were used to evaluate the operations of the financial service in Ethiopia. Fixed effect panel data model was also employed to estimate the determinants of the market share in the industry. Since the banking sector accounts for more than 90% of the assets of the financial sector in the economy; the study focused on evaluating the performance of the banking sector.

The results of the descriptive analysis generally indicate improvements in the performance of banks, following the 1994 reform. That is, based on comparative analysis, the post-reform performance of banks is found to be better, relative to the pre-reform period; indicating the positive effect of the reform. These results together with the growing amount of capital, asset, loan and deposits as well as increasing number of bank branches indicate progresses achieved in the banking services. Based on the performance indicators examined so far, the conclusion that can be drawn here is, therefore: the financial service and banking business in the economy has been enhanced as a result of the financial sector reform.

But direct interpretation of these performance results could be misleading if seen in isolation of the rest of the economy. What matters is the intermediation role of the financial sector in the whole economy and its integration with other instruments of economic policy. In this regard, the study found that banking services had been organized poorly and their impacting on the economy

has also been weak. The poor performance of the banking sector is evidenced by lack of intermediation effect to reverse the downward development trend in the economy: rising domestic and external indebtedness, deteriorating balance of trade, rising inflation, growing government budget mismatch and low level of operational investment.

Banking services were primarily directed to financing trade and services while resource allocation towards agricultural production and manufacturing of goods has been insignificant. The problems that constrained proactive delivery of banking services are examined in-depth and the major problems discussed are as follows:

- 1) The focus of the banking sector towards financing trade and services. Large dependence of banking sector on trade and service is creating vulnerability to the sector since trade in the country highly depends on import business, which itself is vulnerable due to foreign exchange shortage. That is, banking business is also exposed to problems related to foreign exchange shortage due to its dependence on trade and service businesses.
- 2) The poor fiscal performance and economic policy of the government. The continuously increasing budget deficit of the government is creating a crowding out effect on the private sector as the NBE tries to balance the increasing money supply (through direct advance and credit to the government), by restraining credit supply to the private business. Moreover, the Agricultural Led Industrialization economic policy of the government failed to create vibrant private sector. Conversely, the strong government involvement in

the economy is negatively affecting private investment, which would have been the primary target of the banking sector services.

- 3) Weak financial policy development of the central bank. Financial regulation of the central bank is becoming tight and creating financial repression in the economy. The high liquidity and reserve requirement ratio in addition to limits imposed on holding of foreign exchange by banks are the major difficulties in this regard.

In general, without the presence of favorable economic and fiscal policy, vibrant and competitive private sector and well organized financial system; it is difficult for the banking sector to effectively reallocate the resources they mobilize. Therefore, the main conclusion here is that; unless such problems and constraints are resolved, the financial sector reform only may not stimulate economic development in the country.

The other major theme of the study was that of estimating the market share determinants in the banking industry of Ethiopia. The econometric analyses produced interesting results that have important implications to future business strategies of banks. Deposit share of banks is found to be the major market share determinant and the estimates of individual banks fixed effect have shown the essentiality of firm specific characteristics. The conclusion derived here is: To be successful in the banking business a reliable deposit base is an essential condition and having firm specific characteristic is also a vital factor to maintain the market share in the banking industry.

Though found insignificant, the coefficients of capital share and efficiency measure also have meaningful implications. The positive expected sign of the coefficient of capital share indicates the importance of increasing the amount of capital investment if to have a steady market share in the banking industry. On the other hand, the unexpected negative sign of the efficiency measure might be due to simultaneous improvements of individual banks efficiency and continued new entrants in the banking business, at the same time. That means, improving efficiency only cannot stop the declining market share of existing banks because as new entrants invest and the banks start lending; the industry's total loan and asset will grow by causing the existing individual bank's market share to fall.

Thus, unless banks are able to improve their other explanatory variables of market share like deposit share and capital share, enhancing efficiency only may not protect their market share from declining. For instance, as customers of a bank become bigger, they may develop the interest of owning banks share. And when new bank start set up, they immediately take off their deposits from the existing banks and join the new bank—if there is no option of having a share in the existing banks. That is, the withdrawal of big deposit and loan customers because of their interest to become owner could highly affect the market share of existing banks.

5.2 Recommendation

Given the complexity and sensitivity of the financial sector; its reform and successful setup depends on a number of key institutional, policy, market and other external factors. The study finds that the financial sector reforms have had little impact in transforming the country's economy towards modern and production based economy. Thus, with a view to have the proper financial intermediation and stable and sustainable financial system, the study identified most important areas that demand adequate attention. Accordingly, based on the findings, the following recommendations are made.

1. Banks should try to reduce their dependence on trade and services by increasing their participation in production and manufacturing sector of the economy in order to have long term and sustainable financial performance and to improve their financial intermediation role.
2. The government's overall economic policy needs to be revised substantially. The land policy which is linked to the property right issue and hence the private sector performance has to include the right of private ownership in land. The policy will better initiate economic activity if it allows for mutually reinforcing co-existence of public and private property development program. Also the government has to reduce its involvement in the economy in the effort to achieve budget rationalization and to minimize crowding out effect to the private sector. Privatization of government owned enterprises including kebele houses and renting agency houses is required.

3. The central bank of Ethiopia, the NBE, must plan a long term strategy of diversifying and modernizing the banking activity; by encouraging the establishment of investment bank and by arranging incentives for technological adoption and innovation in the financial sector. In addition, its activity of tightening the banking regulation (such as increasing reserve and liquidity requirement ratios and exerting pressures on foreign exchange and bank credit), for the purpose of macro stability, have to be of short span; otherwise their persistence may develop into financial repression and credit crunch in the economy.

4. Though the government owned banks are under continued reorganization and implementation of Business Process Reengineering (BPR) in order to improve their efficiency; the basic thing to retain the outgoing customers who could develop ownership interest is: to partially privatize government owned banks and liberalize the banking services. Therefore, government may need to re-examine its regulatory functions and carry out a bank ownership restructuring and re-engineering work alongside the BPR.

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Annexes

Annex 1: Capital and Branch Network of Banking System

Banks	Branch Network				Capital in millions of Br			
	2005/06		2006/07		2005/06		2006/07	
	Total	% Share	Total	% Share	Total	% Share	Total	% Share
1. Public Banks								
Commercial Bank of Ethiopia	177	42.0	196	40.2	1,505.3	27.8	4,220.0	45.6
Construction & Business Bank	27	6.4	27	5.5	179.0	3.3	257.0	2.8
Development Bank of Ethiopia	32	7.6	32	6.6	1,822.0	33.6	1,865.0	20.1
Total Public Banks	236	56.0	255	52.4	3,506.3	64.7	6,342.0	68.5
2. Private Banks								
Awash International Bank	36	8.6	43	8.8	304.3	5.6	434.0	4.7
Dashen Bank	37	8.8	42	8.6	311.1	5.8	612.0	6.6
Abyssinia Bank	26	6.2	28	5.7	406.8	7.5	419.0	4.5
Wegagen Bank	33	7.8	39	8.0	256.8	4.7	401.0	4.3
United Bank	22	5.2	27	5.5	193.2	3.6	359.0	3.9
Nib International Bank	20	4.8	25	5.1	313.4	5.8	426.0	4.6
Cooperative Bank of Oromiya	11	2.6	16	3.3	122.7	2.3	131.0	1.4
Lion International Bank			12	2.5			134.0	1.4
Total Private Banks	185	44.0	232	48	1,908.3	35.3	2,916.0	31.5

Source: NBE Annual Report 2005/06

Annex 2: Capital and Branch Network of Insurance Companies in Ethiopia

No.	Insurance Companies	Branch Network		Capital in millions of Br	
		2005/06	2005/06	2005/06	2006/07
		Total	Total	A	B
1	Ethiopian Ins. Cor.	34.0	36.0	204.5	211.7
2	Awash Ins. S.C.	15.0	18.0	43.9	46.3
3	Africa Ins. S.C.	9.0	9.0	40.3	48.6
4	National Ins. C of Eth.	12.0	12.0	11.0	14.8
5	United Ins. S.C	17.0	18.0	44.3	45.2
6	Global Ins. S.C	5.0	6.0	17.8	18.9
7	Nile Ins. S.C	18.0	18.0	56.7	60.2
8	Nyala Ins. S.C	15.0	15.0	53.2	46.9
9	Nib Ins. S.C	13.0	14.0	32.7	29.4
TOTAL		138.0	146.0	504.4	522.0

Source: NBE Annual Report 2005/06

Annex 3: ROE of all Banks as measured by Gross Profit to Capital Ratio

Bank	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Average
CBE	0.23	0.48	0.16	-0.61	0.52	0.35	0.55	0.72	0.28	0.41	0.3521
DBE	0.15	0.17	0.15	0.13	-0.03	-0.01	0.03	0.02	0.03	0.04	0.0455
CBB	0.04	0.04	0.01	0.06	0.09	0.13	0.24	0.46	0.38	0.45	0.2709
Gov't banks	0.20	0.39	0.15	-0.33	0.36	0.25	0.26	0.34	0.21	0.31	0.2464
AIB	0.23	0.20	0.22	0.09	0.14	0.24	0.26	0.39	0.37	0.26	0.2752
DB	0.32	0.25	0.41	0.31	0.29	0.46	0.40	0.48	0.48	0.46	0.4328
BOA	0.31	0.17	0.24	0.05	0.05	0.28	0.32	0.31	0.24	0.05	0.2028
HB	0.03	0.11	0.13	0.07	0.08	0.10	0.34	0.31	0.24	0.27	0.2275
WB	0.23	0.14	0.24	0.20	0.16	0.35	0.35	0.37	0.38	0.31	0.3207
NIB		0.03	0.29	0.22	0.15	0.28	0.29	0.28	0.25	0.27	0.2555
LIB									-0.04	0.00	-0.0186
Private banks	0.24	0.17	0.26	0.15	0.15	0.30	0.33	0.36	0.32	0.27	0.2842
All banks ROE	0.21	0.35	0.18	-0.17	0.30	0.26	0.28	0.35	0.24	0.30	0.2578

Source: Annual Reports of Banks and Own Computation

Annex 4: ROA of all Banks as measured by gross Profit to Asset Ratio

Bank	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Average
CBE	0.01	0.03	0.01	-0.02	0.03	0.02	0.02	0.03	0.03	0.04	0.0225
DBE	0.02	0.03	0.03	0.02	-0.01	0.00	0.01	0.01	0.01	0.01	0.0119
CBB	0.00	0.00	0.00	0.00	0.01	0.01	0.01	0.04	0.04	0.05	0.0234
Gov't banks	0.01	0.03	0.01	-0.02	0.03	0.02	0.02	0.03	0.03	0.03	0.0214
AIB	0.02	0.02	0.03	0.01	0.01	0.02	0.02	0.04	0.04	0.03	0.0277
DB	0.02	0.02	0.03	0.03	0.02	0.03	0.03	0.04	0.04	0.04	0.0356
BOA	0.03	0.03	0.04	0.01	0.01	0.03	0.04	0.04	0.03	0.00	0.0235
HB	0.01	0.03	0.04	0.02	0.01	0.01	0.04	0.04	0.04	0.04	0.0349
WB	0.03	0.01	0.02	0.02	0.02	0.04	0.04	0.04	0.04	0.05	0.0387
NIB		0.01	0.05	0.04	0.02	0.03	0.04	0.04	0.04	0.04	0.0381
LIB									-0.02	0.00	-0.0068
Private banks	0.03	0.02	0.03	0.02	0.01	0.03	0.03	0.04	0.04	0.03	0.0322
All banks ROA	0.02	0.03	0.01	-0.01	0.02	0.02	0.02	0.03	0.03	0.03	0.0241

Source: Annual Reports of Banks and Own Computation

Annex 5: Selected Figures at the end of 2007/08 fiscal year, in 000' of Br

	Outstanding Deposit	Outstanding Loan	No of Branches	Total Capital	Total Asset
CBE	36,966,600.00	17,338,500.00	205	4,560,000.00	50,347,800.00
DBE	500,589.00	5,389,249.00	30	1,910,001.00	6,969,971.00
CBB	1,488,522.66	1,207,857.61	30	259,007.43	2,393,899.52
Total of Gov't banks	38,955,711.66	23,935,606.61	265	6,729,008.43	59,711,670.52
AIB	4,468,611.00	2,862,255.00	55	735,665.00	5,874,373.00
DB	6,151,521.55	4,291,704.48	37	730,609.66	7,839,844.53
BOA	3,477,767.01	2,566,577.38	43	420,080.16	4,532,469.13
HB	2,443,351.91	1,809,902.84	35	467,871.94	3,250,281.32
WB	2,956,330.16	2,207,928.13	44	605,448.79	4,124,891.89
NIB	2,469,931.30	2,033,788.61	40	598,124.67	3,650,111.16
LIB	375,228.54	180,348.26	11	171,011.63	574,138.12
Total of Private banks	22,342,741.47	15,952,504.70	265	3,728,811.85	29,846,109.15
Overall Total	61,298,453.13	39,888,111.31	530	10,457,820.28	89,557,779.67

Source: Annual Reports of Banks and Own Computation

Annex 6: Asset Quality measures after the Reform, in 2007/08 fiscal year

Name of Bank	Capital Adequacy ratio (average)	Provision/total loan ratio, 2007/08	Provision/total asset ratio, 2007/08	Liquidity ratio (average)
CBE	0.0639	0.0616	0.0212	61.73
DBE	0.2612	0.0279	0.0215	-320.18
CBB	0.0865	0.1505	0.0759	-2.28
Total of Gov't banks	0.0867	0.0585	0.0234	49.09
AIB	0.1007	0.0444	0.0216	31.45
DB	0.0822	0.0019	0.0010	23.95
BOA	0.1159	0.0976	0.0553	21.45
HB	0.1533	0.0075	0.0042	23.07
WB	0.1206	0.0629	0.0337	23.34
NIB	0.1492	0.0393	0.0219	10.02
LIB	0.3639	0.0118	0.0037	48.76
Total of Private banks	0.1131	0.0389	0.0208	23.69
Overall Total	0.0933	0.0506	0.0226	42.43

Source: Annual Reports of Banks and Own Computation

Annex 7: Profit to Expense Ratio of Banks after the Reform

Bank	1998/99	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	Average
CBE	0.29	0.88	0.19	-0.34	1.22	0.65	1.31	1.56	1.08	1.71	0.7417
DBE	0.43	0.45	0.39	0.30	-0.07	-0.03	0.25	0.12	0.43	0.54	0.2475
CBB	0.05	0.06	0.01	0.07	0.13	0.21	0.37	0.84	0.59	1.10	0.44
Gov't banks	0.30	0.77	0.21	-0.25	0.82	0.50	0.97	1.12	0.96	1.52	0.6433
AIB	0.40	0.42	0.43	0.16	0.24	0.55	0.54	0.89	0.88	0.79	0.6364
DB	0.44	0.37	0.53	0.50	0.38	0.69	0.71	1.02	1.15	0.99	0.8294
BOA	0.54	0.68	0.67	0.10	0.10	0.79	1.18	1.26	0.55	0.07	0.4668
HB	0.24	0.52	0.61	0.37	0.32	0.27	0.89	0.92	1.66	1.63	1.0217
WB	0.46	0.22	0.31	0.25	0.35	0.86	0.98	0.97	1.12	1.01	0.8251
NIB		0.33	1.36	0.93	0.41	1.10	0.94	1.01	1.03	1.01	0.96
LIB									-0.52	-0.03	-0.1365
Private banks	0.44	0.42	0.54	0.31	0.29	0.71	0.82	1.01	0.97	0.75	0.7351
All banks profit, expense ratio	0.31	0.71	0.26	-0.17	0.66	0.56	0.92	1.08	0.97	1.14	0.6712

Source: Annual Reports of Banks and Own Computation

Annex 8: Market Share of Banks

Market Share as measured by average of loan and asset, in % (Before the financial sector reform)										
Bank	1985/86	1986/87	1987/88	1988/89	1989/90	1990/91	1991/92	1992/93	1993/94	1994/95
CBE	53.55	49.41	48.24	48.54	46.13	43.95	42.67	45.67	70.15	79.01
DBE	44.86	43.22	44.35	43.19	45.07	46.87	47.90	45.81	21.03	12.41
CBB	1.59	7.37	7.41	8.27	8.80	9.18	9.43	8.51	8.81	8.58
Market Share as measured by average of loan and asset, in % (After the financial sector reform)										
Bank	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
CBE	72.58	70.04	67.54	64.14	58.77	55.89	51.48	46.22	45.45	49.84
DBE	12.49	12.25	11.56	11.11	10.31	9.39	13.37	11.89	12.79	10.65
CBB	5.43	4.51	4.01	4.06	3.86	3.60	3.67	3.72	3.19	2.85
AIB	3.03	3.50	3.97	4.83	5.60	6.66	6.59	8.07	7.26	6.87
DB	2.80	3.53	4.56	5.68	7.66	9.00	8.82	10.33	10.61	9.76
BOA	1.81	3.16	3.91	4.29	4.98	5.15	5.15	6.55	6.11	5.75
HB	0.33	0.61	0.86	1.15	1.85	2.12	2.49	3.40	3.77	4.08
WB	1.53	1.85	2.17	2.54	3.42	3.84	3.99	5.11	5.81	5.07
NIB	0.00	0.56	1.42	2.20	3.54	4.37	4.45	4.70	4.71	4.59
LIB	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.30	0.55
	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

Source: Annual Reports of Banks and Own Computation

Annex 9: Trade Balance and GDP, in millions of Br

Period	Export	Import	Trade Balance	Nominal GDP	Trade balance to GDP ratio
1985/86	923.85	2210.96	-1287.11	13575.20	-0.09
1986/87	794.85	2236.95	-1442.09	14391.00	-0.10
1987/88	773.67	2274.66	-1500.99	14970.50	-0.10
1988/89	903.24	2110.38	-1207.15	15742.10	-0.08
1989/90	736.81	1824.16	-1087.35	16825.70	-0.06
1990/91	498.28	2130.34	-1632.05	19195.30	-0.09
1991/92	279.03	1810.90	-1531.87	20792.00	-0.07
1992/93	828.53	3126.65	-2298.12	26671.40	-0.09
1993/94	1439.32	4740.31	-3300.99	28328.90	-0.12
1994/95	2731.75	6546.28	-3814.52	33885.00	-0.11
Average 1985/86-1994/95	990.93	2901.16	-1910.22	20437.71	-0.09
1998/99	3637.35	11702.00	-8064.66	55051.44	-0.15
1999/00	3957.80	13115.88	-9158.08	62299.38	-0.15
2000/01	3866.61	12967.70	-9101.09	63069.21	-0.14
2001/02	3864.32	14485.29	-10620.97	61778.65	-0.17
2002/03	4142.36	15929.48	-11787.12	68204.22	-0.17
2003/04	5176.64	22297.69	-17121.05	79184.95	-0.22
2004/05	7331.26	31434.37	-24103.12	98005.76	-0.25
2005/06	8685.38	39870.35	-31184.97	121943.45	-0.26
2006/07	10457.62	45126.44	-34668.82	159648.46	-0.22
2007/08	13549.69	62959.57	-49409.88	228799.75	-0.22
Average 1998/99-2007/08	6466.90	26988.88	-20521.98	99798.53	-0.21

Source: NBE and Own Computation

Annex 10: Pre- and Post-Reform of Financial Deepening, in millions of Br

Pre-Reform				Post-Reform			
Period	Broad Money	Nominal GDP	Financial Deepening	G.C	Broad Money	Nominal GDP	Financial Deepening
1985/86	4448.20	13575.20	0.33	1998/99	19399.40	55051.44	0.35
1986/87	4808.70	14391.00	0.33	1999/00	22177.80	62299.38	0.36
1987/88	5238.70	14970.50	0.35	2000/01	24516.20	63069.21	0.39
1988/89	5704.40	15742.10	0.36	2001/02	26292.10	61778.65	0.43
1989/90	6708.20	16825.70	0.40	2002/03	29060.20	68204.22	0.43
1990/91	7962.20	19195.30	0.41	2003/04	33626.00	79184.95	0.42
1991/92	9010.90	20792.00	0.43	2004/05	40211.70	98005.76	0.41
1992/93	10522.00	26671.40	0.39	2005/06	46377.40	121943.45	0.38
1993/94	11598.70	28328.90	0.41	2006/07	56651.90	159648.46	0.35
1994/95	14002.80	33885.00	0.41	2007/08	68182.10	228799.75	0.30
Average	8000.48	20437.71	0.39	Average	31695.60	82038.14	0.37

Source: NBE and Own Computation

Annex 11: Government Fiscal Performance, External Debt and Trade Balance (millions of Br)

Description	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Total Revenue	10409	11149	13917	15582	19530	21797	29794
Total Grants	2424	4554	4002	4565	3732	7583	9911
Total Revenue and Grants	12832	15703	17918	20147	23262	29381	39705
Overall Balance excluding Grants	-7247	-9355	-6592	-9213	-9755	-13810	-17121
Current Expenditure	10555	13536	11965	13228	15234	17165	22794
Capital Expenditure	6129	6313	8271	11343	14042	18398	24121
Special Program	971	655	272	224	50	44	0
Total Expenditure	17655	20504	20509	24795	29325	35607	46915
Overall Balance Including Grants	-3852	-4146	-2318	-4425	-6064	-6227	-7210
External net	4905	3865	2399	2384	1512	1913	2396
Domestic net	309	1653	2147	3492	2735	6246	6400
Privatization	0	0	0	0	0	0	1008
Other and Residual	-459	-724	-1967	-1237	1816	-1932	-2595
Government Debt	52994.25	58281.46	62187.89	52094.22	52338.62	20229.53	26852.07
Trade Balance	-53453.25	-59005.46	-64154.89	-53331.22	-50522.62	-22161.53	-29447.07

Source: NBE and MOFED

Annex 12: Cumulative Licensed Investment Projects—July 1992–July 2007

Investment Status	Investment Type	No of Projects	%	Capital (millions of Br)	%	Perm. Emp.	%	Temp. Emp.	%
Implementation	Domestic	1492	5.95	13612.39	4.37	72148	6.42	114716	5.73
	Foreign	151	0.6	6590.53	2.12	16827	1.5	11436	0.57
	Public	12	0.05	5832.36	1.87	673	0.06	467	0.02
Implement Total		1655	6.6	26035.28	8.37	89648	7.97	126619	6.32
Operation	Domestic	3267	13.04	19663.02	6.32	110204	9.8	332797	16.62
	Foreign	590	2.35	11549.97	3.71	46476	4.13	43051	2.15
	Public	23	0.09	4648.42	1.49	4279	0.38	583	0.03
Operation Total		3880	15.48	35861.41	11.52	160959	14.32	376431	18.8
Pre-Implementation	Domestic	17181	68.55	138395.22	44.47	640429	56.97	1129772	56.42
	Foreign	2292	9.15	81525.85	26.19	225257	20.04	262060	13.09
	Public	54	0.22	29417.21	9.45	7898	0.7	107465	5.37
Pre-implementation Total		19527	77.91	249338.3	80.11	873584	77.71	1499297	74.88
Grand Total		25062	100	311235	100	1124191	100	2002347	100

Source: Ethiopian Investment Agency

Annex 13: Microfinance Institutions operating in Ethiopia as of June 2007 (Amount in thousands of Br)

No.	Micro-Financing Institutions	Regions	Total Capital		Saving		Credit		Total Assets	
			Amount	%	Amount	% share	Amount	% share	Amount	% share
1	Amhara Credit & Saving Ins.	Amhara	268,251.00	27.39	447,649.00	43.04	874,160.00	31.95	1,044,256.00	29.98
2	Dedebit Credit & Saving Ins.	Tigray	234,840.20	23.98	261,329.60	25.13	853,259.60	31.19	1,134,615.30	32.58
3	Oromia Credit & Saving S.C	Oromia	135,878.70	13.88	135,087.80	12.99	407,271.30	14.89	495,427.00	14.23
4	Omo Credit & Saving Ins.	SNNP	21,255.00	2.17	62,768.80	6.04	135,418.50	4.95	178,958.60	5.14
5	Specialized Finan. & Pro. Ins.	A.A	11,988.30	1.22	10,691.00	1.03	24,602.80	0.9	30,322.90	0.87
6	Gasha Micro-fin. Ins.	A.A	4,557.90	0.47	5,128.20	0.49	13,448.20	0.49	18,645.00	0.54
7	Wisdom Micro-financing Ins.	A.A	22,732.60	2.32	14,374.00	1.38	57,194.00	2.09	69,277.60	1.99
8	Sidama Micro-finance Ins.	SNNP	11,865.90	1.21	7,096.80	0.68	20,781.40	0.76	29,922.70	0.86
9	Aser Micro-financing Ins.	A.A	366.2	0.04	245.2	0.02	311.4	0.01	651.5	0.02
10	Africa Village Financial Service	A.A	7,207.10	0.74	2,458.00	0.24	7,924.40	0.29	11,922.50	0.34
11	Bussa Gonofaa Micro-fin. Ins.	Oromia	10,374.50	1.06	3,379.00	0.32	18,474.00	0.68	24,446.20	0.7
12	Peace Micro-finance Ins.	A.A	9,382.80	0.96	7,091.20	0.68	30,024.80	1.1	32,002.20	0.92
13	Meket Micro-financing Ins.	Amhara	2,069.30	0.21	507.8	0.05	2,165.10	0.08	2,935.60	0.08
14	Addis Credit & Saving Ins.	A.A	158,183.00	16.15	51,529.00	4.95	166,037.00	6.07	238,188.00	6.84
15	Meklit Micro-financing Ins.	A.A	4,743.60	0.48	4,948.00	0.48	14,181.90	0.52	16,219.40	0.47
16	Eshet Micro-financing Ins.	Oromia	11,447.00	1.17	3,554.50	0.34	33,004.60	1.21	36,662.50	1.05
17	Wasasa Micro-financing Ins.	Oromia	9,956.60	1.02	6,487.70	0.62	29,809.80	1.09	32,603.10	0.94
18	Benishangul-Gumuz MFI	Banishing	18,015.90	1.84	7,687.80	0.74	25,004.40	0.91	32,778.80	0.94
19	Shashemene Idir Yelmat Agar MFI	Oromia	2,939.70	0.3	819.1	0.08	2,581.10	0.09	3,784.50	0.11
20	Metemamen MFI	A.A	6,004.00	0.61	820.1	0.08	4,984.70	0.18	6,847.10	0.2
21	Dire MFI	Dire Dawa	16,199.50	1.65	1,457.90	0.14	4,295.70	0.16	23,801.40	0.68
22	Agar MFI	A.A	3,097.20	0.32	1,720.30	0.17	3,807.10	0.14	5,659.90	0.16
23	Harbu MFI	Oromia	1,200.00	0.12	1,612.00	0.16	3,849.00	0.14	4,383.70	0.13
24	Ghion MFI	Amhara	242.9	0.02	310.6	0.03	348.1	0.01	555.3	0.02
25	Leta MFI	Oromia	754.1	0.08	57.5	0.01	464.2	0.02	815.1	0.02
26	Digaf MFI	A.A	218.8	0.02	778.5	0.07	583.4	0.02	1,078.10	0.03
27	Harar MFI	Harar	5,493.20	0.6	372.2	0.03	1,673.90	0.06	5,897.00	0.17
28	Lefayeda and Saving Institution*									
	Total		979,265.00	100	1,039,961.60	100	2,735,660.40	100	3,482,657.00	100

Source: NBE Annual Report 2005/06

Annex 14: Data used in Econometric Model of the Study, in %

Bank	NR*	Year	MS	CS	DS	EM
CBE	1	1974	76.07	33.47	99.40	40.66
DBE	2	1974	23.93	66.53	0.60	46.67
CBE	1	1975	73.62	31.46	99.28	46.63
DBE	2	1975	26.38	68.54	0.72	-30.98
CBE	1	1976	72.32	31.51	99.90	37.60
DBE	2	1976	27.68	68.49	0.10	14.83
CBE	1	1977	72.13	32.14	99.95	43.95
DBE	2	1977	27.87	67.86	0.05	9.67
CBE	1	1978	69.83	33.00	99.95	83.65
DBE	2	1978	30.17	67.00	0.05	14.45
CBE	1	1979	61.84	36.99	96.92	96.24
DBE	2	1979	38.16	63.01	3.08	8.40
CBE	1	1980	61.84	36.99	96.92	96.24
DBE	2	1980	38.16	63.01	3.08	8.40
CBE	1	1981	60.69	45.68	97.09	87.13
DBE	2	1981	39.31	54.32	2.91	-6.47
CBE	1	1982	51.99	50.66	88.50	56.52
DBE	2	1982	41.13	47.68	2.43	2.23
CBB	3	1982	6.88	1.66	9.07	11.78
CBE	1	1983	55.01	55.66	89.72	67.67
DBE	2	1983	37.69	42.92	1.65	8.84
CBB	3	1983	7.30	1.42	8.63	3.31
CBE	1	1984	56.21	58.23	95.98	84.83
DBE	2	1984	42.60	40.06	2.01	1.32
CBB	3	1984	1.20	1.72	2.01	13.19
CBE	1	1985	53.55	57.60	95.51	69.22
DBE	2	1985	44.86	40.42	1.76	33.25
CBB	3	1985	1.59	1.98	2.73	26.59

CBE	1	1986	49.41	49.52	91.35	36.32
DBE	2	1986	43.22	49.36	1.44	131.20
CBB	3	1986	7.37	1.11	7.21	8.02
CBE	1	1987	48.24	52.03	87.79	46.58
DBE	2	1987	44.35	46.16	3.59	7.43
CBB	3	1987	7.41	1.82	8.62	89.19
CBE	1	1988	48.54	54.39	87.46	45.03
DBE	2	1988	43.19	42.76	3.31	10.64
CBB	3	1988	8.27	2.85	9.23	92.76
CBE	1	1989	46.13	54.48	86.73	38.69
DBE	2	1989	45.07	42.19	3.12	12.09
CBB	3	1989	8.80	3.32	10.14	79.00
CBE	1	1990	43.95	75.89	86.62	21.45
DBE	2	1990	46.87	11.47	3.75	-22.68
CBB	3	1990	9.18	12.63	9.62	98.55
CBE	1	1991	42.67	85.86	86.24	8.52
DBE	2	1991	47.90	0.00	3.60	-7.04
CBB	3	1991	9.43	14.14	10.16	49.53
CBE	1	1992	45.67	84.92	88.53	19.97
DBE	2	1992	45.81	0.00	2.91	-29.81
CBB	3	1992	8.51	15.08	8.56	41.97
CBE	1	1993	70.15	84.03	91.83	18.08
DBE	2	1993	21.03	0.00	2.51	-38.33
CBB	3	1993	8.81	15.97	5.66	13.47
CBE	1	1994	79.01	84.18	93.06	62.59
DBE	2	1994	12.41	0.00	2.12	-5.21
CBB	3	1994	8.58	15.82	4.82	-17.35
CBE	1	1995	80.12	66.38	94.65	64.30
DBE	2	1995	11.25	19.70	0.48	107.38
CBB	3	1995	6.90	9.02	3.86	7.73

AIB	4	1995	1.72	4.90	1.01	95.13
CBE	1	1996	80.89	60.36	94.79	84.94
DBE	2	1996	11.37	31.88	0.00	137.25
CBB	3	1996	5.37	4.75	3.34	7.73
AIB	4	1996	2.37	3.00	1.87	58.07
CBE	1	1997	75.90	65.40	91.08	24.50
DBE	2	1997	12.14	24.46	0.27	40.65
CBB	3	1997	7.02	4.85	4.10	28.09
AIB	4	1997	2.66	2.68	2.40	42.75
DB	5	1997	1.90	1.28	1.83	27.00
BOA	6	1997	0.38	1.32	0.32	4.00
CBE	1	1998	73.74	65.20	86.68	54.21
DBE	2	1998	13.46	22.40	3.81	51.15
CBB	3	1998	6.05	4.17	3.42	28.09
AIB	4	1998	2.81	2.96	2.32	64.47
DB	5	1998	2.25	1.30	2.19	23.38
BOA	6	1998	0.88	1.60	0.91	25.98
WB	8	1998	0.81	2.36	0.67	-29.28
CBE	1	1999	72.58	61.61	82.58	29.25
DBE	2	1999	12.49	21.34	4.69	43.48
CBB	3	1999	5.43	3.77	3.36	5.39
AIB	4	1999	3.03	4.07	3.00	40.22
DB	5	1999	2.80	3.19	2.84	44.27
BOA	6	1999	1.81	2.12	1.78	53.50
HB	7	1999	0.33	1.39	0.22	24.49
WB	8	1999	1.53	2.51	1.54	46.00
CBE	1	2000	70.04	58.69	81.48	88.38
DBE	2	2000	12.25	18.52	3.80	45.47
CBB	3	2000	4.51	3.13	2.63	5.77
AIB	4	2000	3.50	4.78	3.68	41.86

DB	5	2000	3.53	3.28	3.16	37.02
BOA	6	2000	3.16	5.62	2.52	67.81
HB	7	2000	0.61	1.89	0.37	51.96
WB	8	2000	1.85	2.26	1.95	21.67
NIB	9	2000	0.56	1.83	0.41	33.08
CBE	1	2001	67.54	55.65	80.00	18.92
DBE	2	2001	11.56	17.92	3.34	39.32
CBB	3	2001	4.01	3.26	2.38	0.87
AIB	4	2001	3.97	5.41	3.76	43.36
DB	5	2001	4.56	3.76	3.94	52.76
BOA	6	2001	3.91	6.24	2.98	67.24
HB	7	2001	0.86	2.66	0.59	61.43
WB	8	2001	2.17	2.46	2.05	31.35
NIB	9	2001	1.42	2.65	0.95	136.44
CBE	1	2002	64.14	41.78	77.16	-33.50
DBE	2	2002	11.11	21.55	2.87	29.89
CBB	3	2002	4.06	3.90	2.51	6.96
AIB	4	2002	4.83	6.91	4.34	16.40
DB	5	2002	5.68	6.16	4.96	50.15
BOA	6	2002	4.29	7.09	3.79	9.97
HB	7	2002	1.15	4.43	0.79	36.85
WB	8	2002	2.54	3.22	2.15	25.20
NIB	9	2002	2.20	4.95	1.44	93.00
CBE	1	2003	58.77	50.37	73.65	121.86
DBE	2	2003	10.31	19.30	2.81	-6.64
CBB	3	2003	3.86	3.02	2.32	13.33
AIB	4	2003	5.60	5.67	5.08	24.37
DB	5	2003	7.66	4.74	6.12	38.02
BOA	6	2003	4.98	5.47	4.06	10.46
HB	7	2003	1.85	3.36	1.08	31.61

WB	8	2003	3.42	3.47	2.65	34.78
NIB	9	2003	3.54	4.60	2.22	41.44
CBE	1	2004	55.89	48.00	71.77	65.41
DBE	2	2004	9.39	17.24	2.27	-2.81
CBB	3	2004	3.60	2.96	2.19	20.73
AIB	4	2004	6.66	6.53	5.54	55.38
DB	5	2004	9.00	5.71	6.97	69.23
BOA	6	2004	5.15	6.38	4.08	79.04
HB	7	2004	2.12	3.19	1.71	26.68
WB	8	2004	3.84	4.27	2.80	85.60
NIB	9	2004	4.37	5.72	2.66	109.59
CBE	1	2005	51.48	30.81	68.28	131.37
DBE	2	2005	13.37	39.73	1.83	25.09
CBB	3	2005	3.67	2.29	2.84	36.51
AIB	4	2005	6.59	5.18	5.95	53.55
DB	5	2005	8.82	5.22	7.62	71.28
BOA	6	2005	5.15	5.44	4.38	117.89
HB	7	2005	2.49	2.68	2.33	89.39
WB	8	2005	3.99	3.87	3.47	98.18
NIB	9	2005	4.45	4.79	3.29	93.61
CBE	1	2006	46.22	28.04	65.65	156.39
DBE	2	2006	11.89	34.67	1.49	11.87
CBB	3	2006	3.72	2.89	2.27	84.47
AIB	4	2006	8.07	6.32	6.35	89.43
DB	5	2006	10.33	7.14	8.61	102.27
BOA	6	2006	6.55	7.43	5.08	126.05
HB	7	2006	3.40	3.54	3.02	92.06
WB	8	2006	5.11	4.71	4.15	97.01
NIB	9	2006	4.70	5.27	3.39	101.40
CBE	1	2007	45.45	46.63	63.31	108.01

DBE	2	2007	12.79	20.61	1.10	42.57
CBB	3	2007	3.19	2.35	2.18	58.96
AIB	4	2007	7.26	5.33	6.56	88.44
DB	5	2007	10.61	6.02	9.33	114.87
BOA	6	2007	6.11	4.45	5.22	55.32
HB	7	2007	3.77	3.97	3.23	165.76
WB	8	2007	5.81	4.46	5.23	112.29
NIB	9	2007	4.71	4.70	3.61	103.14
LIB	10	2007	0.30	1.49	0.23	-52.08
CBE	1	2008	49.84	43.60	60.31	170.69
DBE	2	2008	10.65	18.26	0.82	53.77
CBB	3	2008	2.85	2.48	2.43	109.69
AIB	4	2008	6.87	7.03	7.29	78.51
DB	5	2008	9.76	6.99	10.04	98.61
BOA	6	2008	5.75	4.02	5.67	6.73
HB	7	2008	4.08	4.47	3.99	162.56
WB	8	2008	5.07	5.79	4.82	101.18
NIB	9	2008	4.59	5.72	4.03	100.61
LIB	10	2008	0.55	1.64	0.61	-2.56

Source: Annual Bulletin of banks and own computation, *NR is abbreviation for identification number

DECLARATION

I, the undersigned, declare that this thesis entitled as “Effects of the Ethiopian Financial Sector Reform on the Performance of Banks and the Market Share Dynamics” is my original work and has not been presented for a degree in any other university, and that all source of materials used for the thesis have been duly acknowledged.

The examiners’ comments have been dully incorporated.

Declared by:

Name: Dawit Keno

Signature: *Dawit Keno*

Date: 14/12/09



Confirmed By:

Name: Professor Teshome Mulat

Signature: *Teshome Mulat*

Date: 14/12/09

