ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES

THE IMPACT OF FINANCIAL LIBERALIZATION ON THE OWNERSHIP, MARKET STRUCTURE AND PERFORMANCE OF THE ETHIOPIAN BANKING INDUSTRY

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Declaration

I hereby declare that this thesis is my original work has not been presented for a degree in any other university and that all sources of material used for the thesis have been duly acknowledged.

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List of Acronyms

AIB -Awash International Bank S.C

AIDB- Agricultural and Industrial Development Bank

BOA- Bank of Abyssinia S.C

CBB - Construction and Business Bank

CBE - Commercial Bank of Ethiopia

CBO - Cooperative Bank of Oromia S.C

CR_{k}- k-firms Concentration Ratio

CR1 – the Single Largest Bank Concentration Ratio

CR2 – the Two Largest Banks Concentration Ratio

DB - Dashen Bank S.C

DBE- Development Bank of Ethiopia

DK- Do not Know

Freq. - Frequency

HHI- Herfindhal-Hirschman Index

HSB-Housing and Saving Bank

IT- Information Technology

LIB - Lion International Bank S.C

NIB - Nib International Bank S.C

Per. - Percent

ROA- Return on Asset

ROC- Return on Capital

ROE- Return on Equity

UB - United Bank S.C

WB - Wegagen Bank S.C

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Abstract

Ensuring the efficiency and stability of the banking system can play a vital role for the successful implementation of the monetary and economic policies of a country. Yet, to achieve such objective it would be essential to place financial reform measures that enhance the contribution of the banking system towards economic development. An emblematic reform measure undertaken by the Ethiopian government commencing the year 1992 was "liberalizing "the financial sector. The aim of the study is to assess the impact of financial liberalization on the ownership structure, market concentration and profitability performance of the Ethiopian banking industry. The study found out that the reform has brought a lot of remarkable changes on the structure and performance of the banking sector as compared with the situations prevalent before the reform period. However, the reform has restricted the advantages that could be obtained from a diversified ownership structure via prohibiting operation of foreign banks and participation of the private sector to the ownership of government banks. Furthermore ,as tested by both two firm concentration ratio and HHI using total deposits, loans, capital and assets, the banking industry in Ethiopia can still be distinguished by its market concentration towards the big government owned commercial banks and by a market characterized by little and insufficient competition. The profitability of the industry has also shown a tremendous improvement after the reform measure has been taken. However, the existing government banks are enjoying having the higher share of profit from the industry and still the pattern of the industry profit is following the profitability structure of the giant bank, CBE. The study identified and recommended areas that need further liberalization measures so as to enhance the performance of the industry. Yet, it should be seen as a first step, not the last word in this direction.

CHAPTER ONE
INTRODUCTION

1.1. Background of the Study

The contribution of the financial system to economic growth and development can only be maximized if the total financial system is subjected to adequate financial regulations and reforms. Especially, any threat to the stability and growth of the banking sector which manages the payment system is considered to be serious in a macro economic context in comparison to a threat elsewhere.

Any undesirable development in one bank adversely affects public confidence in the financial sector which is very fragile in nature. This can distort the sound operation of other banks through a chain reaction which would paralyze the entire banking system. The loss of public confidence in banks will also have a negative impact on the national effort towards mobilization of savings and the propagation of the banking habit among people. Economic growth would inevitably be retarded if savings are not mobilized and channeled to sectors which require funds for productive use.

Adequate reform measures and regulations, therefore, ensure efficient and stable financial system which is vital for the successful implementation of the monetary and economic policies of a country. To achieve this objective it is essential to place financial reform measures that enhance the contribution of the banking system towards economic development. One of this reform measures undertaken by the Ethiopian government commencing the year 1992 was “liberalizing” the financial sector.

Research has shown that financial liberalization is expected to enhance the growth of the financial sector, narrowing of the intermediation margin, efficient allocation of savings and ultimately lead to economic growth (Levine R. and Kunt D. 2001, James A. and Mickbbin W. 2005 and Fry 1995). On the other hand a financial market characterized by heavy regulations and restrictions is expected to exercise financial repression (Ikhide and Alawode, 2001, Chirwa, 2001). In Ethiopia, before 1992 (during the Derg period) the financial sector was highly repressed; differentiated by restricted entry, constrained banks' role on interest rates, credit limits and others.

Moreover, the then existing government owned banks were under pressure by regulation from the central government as the country was governed by command economy. This institutional framework led to a situation of virtually no competition in the banking market, with total concentration of banking activities in government owned banks. In fact, the government stance was to minimize the extent of competition between the commercial banks and existing specialized banks.

However, after the change of the government different reforms including in the financial sector were undertaken which enabled the banks to set lending interest rate by their own. Moreover, the ban on entry of private banks, owned by domestic businessmen was abandoned. Currently, ten commercial banks and one publicly owned specialized bank are operating in Ethiopia as compared to one government owned commercial bank and two specialized banks before the reform measures took place. Of the ten commercial banks, two are publicly owned and eight are privately owned banks. In addition, one of the eight private commercial banks was established as recently as October 2004 and is operating as a cooperative bank by restricting its area of operation only to Oromia region. During the year 2007, one additional private bank, Lion International Bank S.C, has got its license and commenced its operation. These all ranges of reforms were arisen from a significant change in the regulatory framework of the banking system after the reform.

Despite these changes, currently, the banking industry in Ethiopia is characterized by little and insufficient competition and perhaps can be distinguished by its market concentration towards the big government commercial banks and having undiversified ownership structure. The aim of this paper is to assess the impact of this policy reform with especial emphasis on the financial liberalization which marked a significant change in regulatory framework after the reform. The paper attempts to analyze the impact the financial liberalization has placed in the ownership structure, market concentration and profitability performance of the Ethiopian banking industry.

1.2. Statement of the Problem

The Ethiopian banking sector has undergone remarkable changes after the financial liberalization which is expected to change the ownership structure, the concentration and profitability performance of the sector as compared to the situations prevalent before the reform period. However, in terms of bank's ownership even if the then existing state owned banks have been re-organized to operate based on the market-oriented policy framework and the new private-owned banks are allowed to participate in the country's financial sector, the ownership diversification that was expected from liberalization has not yet been achieved . This further can be explained by the ban on foreign banks to operate in the country from the time of nationalization onwards (or since 1974) as well as the restriction of private banks not to participate in the ownership of government banks. On the other hand, despite the series of changes and liberalization measures undertaken, currently the sector performance in terms of deposits, loans, capital, total asset and profitability has been concentrated towards one big government bank namely, the Commercial Bank of Ethiopia (CBE). Although different market structure measures demonstrated a gradual declining trend of its dominance, the industry persisted with supremacy of a government owned bank (CBE).

1.3. Objectives of the Study

The main objectives of the study are:

1. To examine the effect of financial liberalization on the ownership structure of the banking industry and assess whether there is a need to incorporate other forms of bank ownership such as foreign banks in the Ethiopian banking industry,
2. To search out the effectiveness of the reform on reducing the concentration which prevailed in the banking sector during the pre-reform period and clearly elucidate the current picture of the Ethiopian banking system in terms of concentration by utilizing the top k-firms concentration ratio (CR_k) and the Herfindhal-Hirschman Index (HHI): both methods relying on the market share of banks in the industry,
3. To assess the impact of financial sector reform on the profitability performance of the banking industry by comparing the profitability of banks before and after the reform periods,
4. To identify areas that need further liberalization or reform measures so as to enhance the performance of the industry in due course of time ; and
5. To make recommendations based on the findings of the study.

1.4. Methodology Applied

1.4.1. Data Collection

The study attempted to gather data from both primary and secondary data sources. Primary data is collected based on a structurally designed questionnaire for 100 randomly selected employees' and management members of all the commercial banks operating in the country and from employees of the country's central bank. The selection of respondents was made in a way to represent the management and staffs of the bank as well as in a way to include persons working in different operations of the bank like credit, domestic banking, foreign banking, marketing and business development, human resource management, branch operations and risk management. However, only 58 questionnaires have been collected and used for the consumption of the study.

The study has also collected data from secondary sources. To this end, annual reports of the respective commercial banks for the period covering the year 1976 to 2006, websites, different literatures and publications on financial liberalization have been consulted. In addition, reference has been made to various annual reports of NBE, the Commercial Code, and pertinent banking regulations and reform measures so as to undertake quantitative and qualitative assessment of the impact of the financial liberalization on the ownership structure, market concentration and profitability performance of Ethiopian banks.

1.4.2. Data Analysis

Both the collected qualitative and the quantitative data will be thoroughly analyzed. Regarding the data analysis for the ownership structure of the Ethiopian banking system, historical transformation of the ownership structure as a result of different economic reforms of the governments will be observed starting from the time the history of the establishment of the first Bank in Ethiopia. In addition, further qualitative analysis of information gathered through the structured questionnaire has been done by processing the data on SPSS.

For further test of the Ethiopian banking system in terms of market concentration, quantitative data collected from the annual reports of the respective banks and the NBE for the period covering the year 1976 to year 2006 is analyzed by utilizing two measures of industry concentration, the top k-firms concentration ratio (CR_k) and the Herfindhal-Hirschman Index (HHI). Both methods relay on the market share of banks in terms of loans, deposits, capital and total assets in the industry and the analysis has been done by partitioning the time as a pre reform (1976 to 1991) and post reform period (1992-2006).

Regarding the data on the profitability performance of Ethiopian banks, the study used bank level (mainly selected big commercial banks in Ethiopia) as well as aggregate data of the industry. The data is analyzed relaying on the two measures of bank's profitability: the ROA and the ROE and using trend growth on trend line and ratio basis plus the qualitative data analysis is used to explain any relation ships established between any quantitative data. Further assessment of matters that hindered the performance of the banking industry and areas that needed further liberalization or reform measures is done by depending on qualitative assessment of the data obtained from the primary sources. On the basis of such analysis some conclusions are drawn and recommendations are made.

1.5. Scope and Limitations

The study, highly concentrated on reviewing and assessing the impact of the financial liberalization, has placed thrust in changing the ownership structure of the Ethiopian banking industry, the change it brought in alleviating the market dominance of government banks by reducing market concentration in the banking industry and any changes reflected in the profitability performance of the banking sector. However, assessing the flaws of the reform measure and recommending the financial reform that best fits for the banking system in Ethiopia is not the concern of this study. However, attempt to identify areas, if any that needs further liberalization will be done. In addition, for the sake of uniformity and fair comparison only data obtained from commercial banks that are established for profit motives and were in operation for more than three years are used for the industry analysis. Other banks with development objective, like Development Bank of Ethiopia (DBE), have not get attention in the study. In addition, only those data which can be publicly announced by the commercial banks will be referenced for the study. However, the study lacks access to various research literatures specifically done on the impact of financial liberalization in the banking industry, particularly of the Ethiopian case.

1.6. Significance of the Study

Despite many reforms and financial liberalization measures on the banking industry , further assessment of the impact of these reforms on the ownership structure, market concentration and on the performance of the banking system in Ethiopia has not been adequately investigated and this study attempts to fill this gap. More specifically, this study will:

- ☞ try to test the industry concentration through the market share of the big banks from the total banking industry .This will enable banking regulatory and supervisory authorities if there is a need to change the structure of the banking industry so as to enhance competition,
- ☞ contribute a lot in assessing the currently prevalent ownership structure of the banking sector,
- ☞ propose some suggestions whether there is a need for further attempt of liberalizing the banking sector so as to enhance the performance of the banking industry,
- ☞ provide a base for further study and research on assessment of the impact of the currently prevailed ownership and market structure on the performance of the Ethiopian banking industry and the level of competitiveness in the financial sector and the banking system in particular; and
- ☞ Finally, give insight to researchers and students about the problem and stimulate further investigation of the issue.

1.7 Organization of the Study

The rest of the paper will be organized as follows: Chapter two provides an overview of the banking system in Ethiopia. Chapter three reviews the theoretical and empirical literatures on financial liberalization, bank ownership structure, market structure and performance of banking industry. Chapter four presents the secondary and primary data analysis. Finally, the summary, conclusions and recommendations of the study will be presented in the fifth Chapter. A "Bibliography "of related literature referred to while writing the paper will be included after chapter five.

CHAPTER TWO

OVERVIEW OF THE BANKING SYSTEM IN ETHIOPIA

2.1. Financial Sector Reform

Economic liberalization began just before the fall of the Derg regime.[1] However, with the initiation of the economic reform program of the current government, two proclamations were issued in 1994, Monetary and Banking Proclamation (No. 83/1994), and the Licensing and Supervision of Banking Business (No. 84/1994). The first proclamation in addition to increasing the role of the National Bank of Ethiopia made illegal any NBE lending other than the government while the second proclamation empowered the Central Bank to supervise the financial institutions. Moreover, two further proclamations, 200/1994 and 203/1994 restructured and renamed the Agricultural and Industrial Bank, and Housing and Saving Bank into Development Bank of Ethiopia and Construction and Saving Bank of Ethiopia, respectively. It was also noted in the proclamations that that the two banks were re-capitalized as public enterprises and hence, the financial sector reform did not invite private sector participation in the incumbent government owned banks else entry of foreign banks in full share as well as with restricted share as partners with Ethiopian citizens.

After the 1994 financial liberalization measures, the authorities concentrated their efforts on building capacity in the financial sector as well as on other priority areas of economic transition, in particular further liberalization of the foreign exchange system and trade liberalization measures (Addison and Alemayehu:2001). In tandem with such institutional arrangement of the financial sector, sequence of policy measures, which include interest rate

[1] Market based reform began in December 1987; it was preceded by a Soviet report calling for market-oriented pricing, marketing and distribution of goods and services (Fantu Cheru, 1994 as cited in Harvey and Brownbridge, 1998)

and exchange rate reforms among others were undertaken. But financial liberalization accelerated again when the lending rate was decontrolled and left to be determined by the banks themselves as late as January 1998 as compared to October 1992 when the bias between public and private charging of deposit rate was abolished. In all the reform period a positive lending interest rate was recorded except in 2002/03, which was markedly known as sever draught year. However, the floor for saving deposit rate was set at 3.0 percent [2]commencing the year 2002; this resulted in a negative real deposit interest rate to be recorded triggered by the increasing inflationary pressure.

The financial sector liberalization was also strengthened by reform on financial instruments which includes devaluation of exchange rate, introduction of treasury Bills, inter-bank foreign exchange market and others. In addition, a framework for an inter bank money market, in which banks and non –bank financial institutions can borrow and lend at market-determined rates has been laid down.

2.2. The Current Structure and Performance of the Banking Sector

The Money and Banking Proclamation No. 83/1994 identifies banking business as an operation that involves such activities like receiving funds, discounting and negotiating of promissory notes, drafts, bills of exchange and other evidences of debt; receiving deposits of money and commercial paper, lending money, and buying and selling of gold and silver bullion and foreign exchange. Currently, we can divide the formal banking in Ethiopia as commercial banks and specialized development bank. The non-bank financial institutions

[2] Changed to 4% for controlling the augmenting inflation rate, announced on July 4,2007

may encompass insurance companies, pension fund, saving and credit cooperatives and micro-financial institutions.

The banking sector currently comprised ten commercial banks, of which two of them are owned by government and one is a state owned development bank leaving the rest for private banks. In addition, one of the eight private commercial banks was established as recently as October 2004 and is operating as a cooperative bank by restricting its area of operation only to Oromia region. Another private bank, Lion International Bank S.C, has got its license and commenced its operation during the year 2007.The list of banks operating in the country is in Annex 1)

In terms of branch expansion, bank branches have increased from 390 at the end of June 2005 to 421 branches at the end of June 2006 with largest expansion in branch network taking place in Oromia and Addis Ababa region. The number of private banks' branches grew from 158 in June 2005 to 185 in June 2006, while the state owned banks leisurely grow from 222 to 236 during the same period. This indicates that private banks have expanded rapidly, where as the state owned banks have been sluggish to open new branches. In June 2006, population to branch ratio of the country declined to 192,074 from 203,911 a year earlier. The Geographical Branch network of the banking industry is shown in Annex 2.

With regard to the performance of the banking industry, at the end of June 2006, the assets of the banking sector excluding DBE totaled Birr 54.1 billion: net loans Birr 19.5 billion; deposit liabilities of Birr 42.1 billion; and capital and reserves Birr 3.6 Billion.Net loans and deposits accounted for 36% and 78% of uses and sources of funds, respectively. However, CBE continued to be a single industrial giant accounting for 66.3% of assets, 39.3% of net loans, 66.8% of deposits and 41.7% of capital in the banking system. Public banks (CBE and CBB) accounted for 69.6% of assets, 44.6% of net loans, 69.1% of deposits and 46.1% of capital in the sector.

In terms of advancement in information technology, the Ethiopian banks are exceedingly slow to cope up with advancement in Information Technology around the globe. For instance out of the ten banks in the country only two private banks have networked all their city branches and partly their outlying branches. The other two banks (one government and one private bank) have attempted to link only some of their city branches. The banking industry has also served to create an employment opportunity for more than 23,334 people as at June 30, 2006.

CHPATER THREE

REVIEW OF RELATED LITERATURES

Review of the theoretical foundation of the paper is based on five main subsections. The first part reviews literatures on financial liberalization and repression. The second part is review on bank ownership structure and the third and fourth parts of the literature review are devoted to the discussion on market concentration and profitability performance of the banking industry. Finally, review of various studies from empirical evidences of developing and developed countries that examine the effects of market structure, liberalization and performance of the banking sector is made in the fifth part.

3.1. Financial Liberalization and Repression

The underlying outcomes of a deep rooted and well-grown financial system is economic development. Financial development and its correlation to economic growth have got a profound analysis and research in the field of development. To this end, the opponents of financial repression argue that financial liberalization can support economic growth (McKinnon: 1973; Shaw: 1973) as cited in Chirwa (2001). The paper further argued that financial sector of the economy is important in economic development as it supports in the breakaway from repetition repressed economic performance to accelerated economic growth.

A fully liberalized domestic financial system is characterized by lack of controls on lending / borrowing interest rates and certainly by lack of credit controls, i.e. no subsidies to certain sectors or certain credit allocations. In addition, it also entails permission of deposits in foreign currencies (Arestis and Caner, 2004). The paper further argued by citing Kaminsky and Schmukler (2003) financial liberalization consists of deregulation of the foreign sector capital account, the domestic financial sector, and the stock market sector viewed separately from the domestic financial sector. It is argued that full liberalization occurs when at least two of the three sectors are fully liberalized and the third one is partially liberalized.

However, studies show mixed result of the effect of liberalization. Senbet and Otchere (2005) conclude that despite the extensive financial sector reforms that have taken place it terms of interest and price liberalization, Sub-Saharan African financial systems face sever inefficiency and thinness. Ikhide and Alawode (2001) based on studies by Fry, 1978; De Melo, 1986; Khatkhate, 1988; Diaz-Alejandro, 1985 explain that certain countries experienced higher savings and investment following liberalization and others have chronicled disasters in economies that undertook financial liberalization.

On the other extreme, financial repression refers to the distortion of domestic financial markets through measures such as ceilings on interest rates and credit expansion, selective allocation of credit and high reserve requirements, Ikhide and Alawode (2001). The paper using the McKinnon and Shaw argument pointed out that such misguided policies have damaged the economies of many developing countries by reducing savings and encouraging investment in inefficient and unproductive activities. Excessive intervention by government results control of interest on loans and deposits rates. Aryeetey et al (1997) elucidate that ceilings on deposit and loan rates tend to raise the demand for and depress the supply of funds. This creates unsatisfied demand for invest-able funds which forces financial intermediaries to ration credit by means other than the interest rate while an informal market develops at uncontrolled rates.

The other feature of financial repression in the literatures is large differential between lending and deposit interest rates and implicit taxation (Aryeetey, 1997), (Chirwa, 2001). Seck and El Nil (1993) as explained in Chirwa (1993) argued that the high spread between lending and deposit rates can be viewed as an implicit tax through high reserve requirements on the banking sector by the monetary authorities. Moreover, governments often used banking institution as a source of implicit taxation by imposing high reserve requirement and financing operating losses of parastatals, Collier and Gunnings 1991 cited in (Aryeetey, 1997).

Concerning the standard recommendations to curb the financial repression, Ikhide and Alawode (2001) explained that positive interest rates be established on deposits and loans by eliminating interest rate and credit ceilings topping selective credit allocation and lowering reserve requirements. Finally, studies recommend that financial liberalization and bank restructuring should be accompanied by complementary measures to address institutional and structural problems (Areyeetey, 1997). In addition, studies emphasized the importance of attaining macroeconomic stability prior to financial liberalization (Dornbusch and Reynoso, 1993 in Ikhide and Alawode, 2001).

3.2. Bank Ownership Structure

The banking literature concludes that ownership structure matters in the performance of the banking sector; in particular, government ownership of banks is argued to be less efficient than private ownership (Bonin, Mizsei, Szekely and Wachtel, 1998). However,Boubakri et.al2002, suggested three arguments justifying state over private ownership of bank namely that private banks are more prone to crisis; that excessive private ownership may limit access to credit to many parts of society; and finally that the government is more fitted to allocate capital to certain investment (Boubakri et.al2002). Two additional theories have also been advanced for government participation in the financial market, namely, the development view and the political view. The development view suggests that in some countries where the economic institutions are not well developed, government ownership of strategic economic sectors such as banks is needed to jumpstart both financial and economic development and foster growth. The political view suggests that governments acquire control of enterprises and banks in order to provide employment and benefit to supporters in return for votes, contributions and bribes. Such approach is greater in countries with underdeveloped financial system and poorly developed property rights. Under the development view government finance projects that are socially desirable. In both views, the government finances projects that would not get privately financed (La Porta, et.al, 2002).

While such arguments have some validity, recent evidence however point to the costs of government ownership of banks, suggesting that state ownership have a depressing impact on overall growth (La Porta, et.al, 2002). There is a strong negative correlation between the share of sector assets in state banks and bank efficiency level. Greater state ownership of banks tends to be associated with lower bank efficiency, less saving and borrowing, lower productivity, and slower growth (Barth et.al, 2000). Even government residual ownership is likely to have an effect on performance (Boubakri, et al.; Littlechild, 1981). Majority of research indicate that private ownership of banks is associated with superior economic performance (Lang & So, 2002; Cornett et.al. 2000; Creane, et.al..). Theoretically, this is consistent with the agency relationship hypothesized by Jensen and Meckling (1976). State ownership would be deemed inefficient due to the lack of capital market monitoring which according to the Agency theory would tempt manager to pursue their own interest at the expense of the enterprise. Managers of private banks will have greater intensity of environmental pressure and capital market monitoring which punishes inefficiencies and makes private owned firms economically more efficient (Lang and So, 2002).

Studies that compared industrialized and developing countries have found that while foreign banks have lower interest margins, overhead expenses, and profitability than domestic banks in industrialized countries, the opposite is true in developing countries (Claessens, et al., 2000; Demirgüç-Kunt & Huizinga, 1999). Claessens et al (2000) reported that in many developing countries (for example Egypt, Indonesia, Argentina and Venezuela) foreign banks in fact report significantly higher net interest margins than domestic banks and in Asia and in Latin America foreign banks achieve significantly higher net profitability than domestic banks.

There have been different lines of reasoning put forward for the relatively lower performance of foreign banks compared with domestic banks in industrialized countries. These include different market, competitive and regulatory conditions between industrialized and developing countries (Claessens, et al., 2000); home field advantage of domestic banks (Clarke, et al., 2001). Within developing countries, the reasoning suggested for the improved performance of foreign over domestic banks included exemption from credit allocation regulation and other restriction, market inefficiencies and outmoded banking practices that allow foreign banks better performance (Claessens, Demirgüç-Kunt, & Huizinga 2000).

Claessens, et al, 2000, further pointed that for most countries a larger foreign ownership share of banks is associated with a reduction in the profitability and margins of domestically owned banks. The same study also found that the number of entrants matters rather than their market share. The authors pointed that this indicates that the impact of foreign bank entry on local bank competition is felt immediately upon entry rather than after they have gained substantial market share.

3.3. Market Concentration and Financial Sector Development

Theory provides conflicting predictions regarding the relationship between commercial bank concentration and financial sector development. One view assumes that greater concentration increases market power with positive effects on the cost of banking services and bank profits. According to this view, commercial bank concentration will be negatively associated with measures of banking sector efficiency and financial development. Other theories, however, suggest that some degree of monopoly power in banking is natural and beneficial. Petersen and Rajan (1995) argue that banks with monopolistic power have greater incentives to incur the costs associated with overcoming informational barriers, which then facilitates the flow of credit to worthy enterprises. An alternative view stresses the importance of increasing returns to scale in the production of banking services. With increasing returns, greater concentration may increase bank efficiency through more efficient scale, organization, management, scope, and product mix. According to this view, commercial bank concentration will be positively associated with measures of banking sector efficiency and financial development.

In a cross-country, cross-industry study, Cetorelli and Gambera (2000) show that banking sector concentration exerts a depressing effect on overall economic growth, though it promotes the growth of industries that depend heavily on external finance. Thus, existing research does not produce unambiguous conclusion regarding the relationship between concentrations and banking sector efficiency.

There is some evidence that banks in highly concentrated local markets charge higher rates on loans, give lower rates on deposits, and are slower to reduce rates in response to central banks reductions in interest rates than banks in less concentrated markets (Berger and Hannan, 1989; Hannan and Berger, 1991, Neumark and Sharp, 1992). In contrast, Petersen and Rajan(1995) find that firms are less credit constrained and young firms have access to cheaper credit in the more concentrated banking markets of the United States. Furthermore, there is very little relationship between concentration and bank profits (Berger, 1995) and the most profiTable banks are not systematically located in highly concentrated markets or markets protected by the greater entry barriers (Berger, Saunders, Scalise, and Udell, 1998). Thus, it is difficult to argue from U.S. evidence that more concentrated banking markets boost bank profitability. Similarly, ambiguous findings emerge from studies of European banking (Goldberg and Rai, 1996; Lloyd-Williams, Moyneux, and Thornton, 1994).

Furthermore, there are conflicting results on the impact of increased bank concentration - through mergers and acquisitions - on deposit rates and profitability (Prager and Hannan, 1999; Simons and Stavins, 1998; Berger and Humphrey, 1992; Pilloff, 1996). Finally, using bank-level data for 80 countries around the world, Demirguc-Kunt and Huizinga (1999) find little evidence that bank concentration has any effect on bank profitability or margins. Thus, evidence produces generally inconclusive conclusions regarding the nature of the relationship between bank concentrations and banking sector power.

3.4. Bank Profitability Performance

In analyzing the determinants of bank profitability and depending on the specification how the performance is measured, bank studies can be grouped into two.

In one group and as most studies employ, performance is defined by the level of bank profitability measured by Return on Assets (ROA), Return on Capital (ROC), and Return on Equity (ROE), Smirlock (1985), Civelec and Al-Almi (1991), Aug (1992) and Chirwa (2001). Gilbert (1984) in a survey of literatures argued that bank profit is an appropriate measure of bank performance and criticize average interest rate and average service charge rates as poor measures of bank performance.

On the other hand, different researchers assessed performance in terms of bank prices (as measured by interest rates) rather than bank profitability. The justification as explained by Berger and Hannan (1989) in Chirwa (2001) is that the use of price-concentration relationship instead of profit concentration relationship implies that high levels of concentration allow for noncompetitive behavior that would result in lower interest rates given to depositors and/or higher lending rates to browsers.

Regarding the determinants to banking performance, bank size as measured by total deposits (Civelic and Al-Alami (1991) or assets (Smirlock (1985) is one of the variables used in analyzing performance of the bank system. This is included to control for the possibility that large banks are likely to have greater product and loan diversification. The impact of bank size on profitability is uncertain a prior for the fact that on the one hand, increased diversification implies less risk and hence a lower required return, and on the other hand, bank size takes into account differences brought about by size such as economies of scale. For large firms their size permits them to bargain more effectively, administer prices and in the end realize significant higher prices for the particular product, Agu (1992). Among the variables that are common to measure bank specific risk is loan to asset ratio. The loan to asset ratio is commonly applied as a measure of risk and traditionally risky investments are associated with higher returns.

It is particularly known that demand deposit is a cheaper source of fund in the banking system. To this end, the ratio of demand deposit to total deposit is considered as determinant of profitability and the higher the ratio, the higher the level of profitability, Smirlock (1985).

Other variables that are theoretically and practically deemed as determinant to the banking performance are market size and market growth rate. Market size as measured by total market deposit in the literatures account for the possibility that entry is easier in larger markets than in smaller markets, hence a negative relationship prevailed between market entry and market size. However, as explained in Rhoades and Rutz (1982), Smirlock (185) argued that the relationship between market size and profitability could also be positive in which case banks in large markets take on riskier investments resulting higher returns (see also Chirwa (2001).

The percentage growth in market deposits is employed as a determinant to profitability because of the assertion that rapid market growth are expected to expand profit opportunities for existing banks. Civelic and Al-Alami (1991), Chirwa (2001), Smirlock (1985)

3.5. Empirical Evidences

There are various studies that examine the effects of liberalization, market structure and on the performance of the banking sector. Reviews of these are presented as follows.

Attempts for Developing Countries

Agu (1992) analyzed the hypothesis that profitability performance of banking system as a function of its market structure, policy and demand variables with particular reference to the Nigerian banking system. Market structure variables comprise total assets, deposit concentration ratio and number of bank offices. On the other hand, policy variables include time plus saving deposits to total deposit ratio, loans and advances to total deposits ratio, and the demand variable is proxies by per-capita income. The study reveals that market structure as measured by the number of bank offices matters for bank profitability performance in Nigeria. The policy and demand factors were found to be important determinants of profitability performance of the Nigerian banking system.

Okeahalam (2002) assessed concentration of the banking sector for the southern Africa Common Monetary Area (CMA). The study includes banking activities in South Africa, Namibia, Swaziland and Lesotho. The structure-conduct analysis was carried out to assess whether the level of concentration influences the pricing of retail banking products in the CMA fits with the structure- conduct- performance framework and the policy implications implied was a need for greater competition and regulatory reform to reduce welfare costs.

Chirwa (2001) examined the effect of financial sector reforms on market structure, financial intermediation, saving mobilization and commercial bank profitability in the Malawian banking industry. The empirical finding shows that some signs of financial repression till exist despite financial sector reform. On the other hand, financial liberalization has significantly increased financial depth and savings mobilization, increased credit to the manufacturing sector. However, real interest rate have fallen, intermediation margins have increased, credit to the public sector has increased and to that of the private sector has fallen. Thus, the study wind up although interest rates were under control for most of the study periods, other bank services that generate income for commercial banks were subject to monopoly power abuse.

Civielek and Al-Alami (1991) investigated the concentration-profitability relationship for the Jordanian banking system using the cross-sectional data collected from 1984-1988 and found a result in support of the structure performance hypothesis. However, the paper underscored the role of market structure could not be underscored for the fat that the appearance of the market growth variable as potential factor in the bank profitability relation and the empirical ambiguity introduced into the equation by the risk variable.

Attempts for Developed Countries

Smirlock (1985) for United State gave empirical evidence for the (non) relationship between concentration and profitability in banking. To test the hypothesis the interrelationship between profits, market structure, and concentration are investigated for over 2,700 unit states banks. The results of the analysis suggest that the link is no discernable positive relationship between concentration and profitability. However, the study asserts that before definitive statements regarding the source of the profitability/market share relationship can be made, more research needs to be made.

Jansen and Haan (2003) for the increasing concentration due to mergers and acquisitions in European banking examined the relationship between concentration, competitiveness, efficiency and profitability using panel regression for 15 countries. Both Hefindihal Hirchman Index (HHI) and concentration ratio (CR) were used as indicators of concentration and, ROA and ROE were used as indicators of profitability. The findings of the study do not suggest the existence of any connection at macro-level between concentration and competition, and there is also no robust relationship between concentration and profitability.

Concerning relevant studies in the Ethiopian banking sector, no formal studies examined the impact of financial liberalization on the ownership, market concentration and/or market share and relation with profitability. However, Tony Addison and Alemayehu Geda (August 2001), analyzed the Ethiopia’s financial sector and its regulation and stated that the financial reform measures undertaken in Ethiopia have been gradual but nevertheless determined despite disagreement with the IMF over restrictions on the entry of foreign banks and the role of the largest state bank. The study concludes that the creation of a sound financial system is crucial to reconstruction and transition to market based economy, and to raising the living standards of Ethiopia's people.

On the other hand, GN Jenber (2001) assessed developments in market share, balance sheet, capital adequacy and profitability using data for 1997/97-1999/00. According to the study, the banking sector is dominated by the CBE as measured by the share of total assets, loans and deposits. The study further pointed out that profitability of the banking industry in general was high in the study period and profitability of most private banks, in particular was encouraging considering the recent emergence of these banks.

CHAPTER FOUR

DATA PRESENTATION AND ANALYSIS

4.1. Data from Secondary Sources

4.1.1. Ownership Structure of the Ethiopian Banking System during the Pre-Reform and the Post- Reform Period

The Ethiopian banking industry has exhibited different ownership structure following the changes in government and the subsequent economic reforms. With such instance the pre-reform period can be categorized in to two distinct time periods as the Pre-Socialist and Socialist period. In both times of the pre-reform period the ownership structure of the banking system can be distinctly identified. The pre socialist period can be identified as the time for the existence of fully foreign owned banks, banks owned by private and foreign partners, and fully government owned banks and the socialist period can be distinguished as the time of fully government owned banks. In addition, the ownership structure in the post reform period can easily be identified as the time for the prevalence of fully government owned and fully private owned banks. Such facts are briefly explained hereunder.

4.1.1.1. The Pre- Reform Period (1905-1991)

i. The Pre socialist Period (1905-1974) *(fully foreign owned, combination of foreign and private ownership, and fully government owned banks)*

The beginning of the modern banking business in Ethiopia has started with foreign ownership, after the entry of the foreign- owned Bank of Abyssinia, which is based on 50 years franchise agreement with the Anglo-Egyptian National Bank. Moreover, Foreign banking activities particularly that of the Italian banks were expanded during the five years of the Italian occupation. However, except Banco di Roma and Banco di Napoli they all ceased operation soon after liberation. Then after the Italian occupation of 1933-1941, banks of Britain became active participants in the Ethiopian banking sector due to the political reasons and hence Barclay's bank had been established and was in operation in the country from 1941-1943.

However, the emergence of a nationally owned bank called the State Bank of Ethiopia in 1931 changed the foreign dominated ownership structure of the Ethiopian banking system. Even the bank has been quoted as the first nationally state owned bank in the African continent (NBE; 1999).

Table 1: Banks Operating In Ethiopia during the Pre reform- Pre-Socialist Period

Year of Establishment *	Name of Bank	ownership	Number of Branches
1905	Bank of Abyssinia	100% foreign owned	NA****
1914	Banco di Italia	100% foreign owned	9
1914	Banco di Roma	100% foreign owned	18
1931	State Bank of Ethiopia	100% state owned	*21*
1939	Banco di Napoli	100% foreign owned	4
1939	Banco Nacionale (De's voro)	100% foreign owned	4
1939	Casa de Creito	100% foreign owned	1
1939	Societe Nacionale di Ethiopia	100% foreign owned	4
1941	Barclay's bank	100% foreign owned	NA
1963	Addis Ababa Bank	40% foreign and 60% Private owned	*26*
1964	The National Bank of Ethiopia	100% state owned	Central bank
1964	The Commercial Bank of Ethiopia	100% state owned	177
1970	The Agricultural and Industrial Development Bank***	100% state owned	NA
1975	The Housing and Savings Bank**	100% state owned	NA

** In European year, ** renamed as Construction and Business Bank in 1994*** renamed as Development Bank of Ethiopia in 1994 **** NA-data Not Available*

Source: various Historical records

Further change in the ownership structure occurred after the introduction of the 1963, Monetary and Banking Proclamation No. 206 .According to the proclamation a license to carry on banking business in Ethiopia was granted only to partnerships with Ethiopian nationality with at least the Ethiopian nationals have owned 51% of the capital. Accordingly, foreign banks, which had already started their operations in the country re-applied for license (NBE, 1999). The biggest of these was the Addis Ababa Bank. This first privately owned bank, Addis Ababa Bank Share Company, was established by Ethiopians initiative and in association with Grindlay Bank, London which had 40 percent of the total share. Moreover, the proclamation has separated the functions of commercial and central banking. Accordingly the National Bank of Ethiopia and Commercial Bank of Ethiopia were created in 1963. The Commercial Bank of Ethiopia took over the commercial banking activities of the former State Bank of Ethiopia

In addition to the commercial banks, the government established two development banks, both of which were 100% state owned. The Agricultural and Industrial Development Bank (AIDB) was set up in 1970, taking over two earlier development banks: the Development Bank of Ethiopia and the Ethiopian Investment Corporation which had been established as the Investment Bank of Ethiopia. AIDB was 100% government owned and provided short, medium and long term loans to the agricultural and industrial sectors. The Housing and Savings Bank which was under full government ownership was created in 1975 out of a merger between two earlier housing and finance institutions created in 1962 and 1965.

ii. The Socialist Period (1975-1991) (*full government ownership*)

Following the emergence of military government in 1974, however, all foreign banks operating in the country in the form of partnership were nationalized and re-organized creating one national bank (re-institutionalized in 1976), two specialized banks (the Agricultural and Industrial Bank and Housing and Saving Bank), which currently re-named as the Development Bank of Ethiopia (DBE) and the Construction and Business Bank (CBB), respectively (Berhenu and Befakedu (1999/2000).

As far as ownership of banks was concerned, the new Ethiopian government shifted, therefore from owning most of the banking system to owning it completely by nationalizing and concentrating the remaining private commercial banks in to Commercial Bank of Ethiopia (CBE).Banks operating in the country during the socialist period are tabulated hereunder.

Table 2: Banks Operating in the Country during Pre-Reform- Socialist Period

Year of Establishment	Name of Bank	Owned by
1974*	Commercial Bank of Ethiopia (CBE)	100%government ownership
1970	The Agricultural and Industrial Bank	100% government ownership
1975	Housing and Saving Bank	100% government ownership

**year of restructuring, but established in 1963*

Source: Various Historical records

4.1.1.2. The Post Reform (1992-2006) (Pure private and pure government ownership)

Since economic reform of 1992 under the new government, the existing government banks have been re-organized so as to operate based on market-oriented policy framework but with 100% ownership of the government. Moreover, new Ethiopian private-owned financial institutions are allowed to participate in the country's financial sector. However, from the time of nationalization onwards (or since 1974), no foreign bank has been allowed to operate in Ethiopia and participation of the private sector to the ownership of government banks has been prohibited. This might be one cause for the concentration in the banking sector as well as it greatly restricted the advantages that the Ethiopian banking sector could earn by incorporating foreigners in to its ownership structure. The current ownership structure of Ethiopian banks is as indicated below.

Table 3: Currently Operating Banks by Ownership

No.	Year of Establishment	Name of Bank	Ownership	Number of Branch
1	1974	Commercial Bank of Ethiopia (CBE)	100% state owned	177
2	1975	Construction and Business Bank(CBB)	100% state owned	27
3	1994	Awash International Bank S.C (AIB)	100% private owned	37
4	1995	Dashen Bank S.C (DB)	100% private owned	36
5	1996	Bank of Abyssinia S.C (BOA)	100% private owned	26
6	1997	Wegagen Bank S.C (WB)	100% private owned	33
7	1998	United Bank S.C (UB)	100% private owned	22
8	1999	NIb international Bank S.C (NIB)	100% private owned	20
9	2004	Cooperative Bank of Oromia S.C (CBO)	100% private owned	11
10	2007	Lion International Bank S.C(LIB)	100% private owned	4

Source: National Bank of Ethiopia annual report

Many literatures accept that the entry of foreign banks play a great role in the banking system by improving efficiencies in the local banking sector through intensive competitive pressures; ensuring overall economic and financial stability; enhancing diffusion of modern technologies and innovations in the banking system; increasing know-how in the banking services; and creating pressures on domestic banking authorities in host countries to enhance and eventually harmonize regulatory and supervisory procedures and standards to international best practice levels. All these benefits, however, are not without costs particularly in the short-run and at low level of economic development. The costs include "over competition", which in the short-run could cause domestic banks to fail, exposure of economies of host countries to economic shocks of home countries, high capital flight especially during economic crisis and less credit to small and medium-sized firms. In short, according to many empirical studies, benefits of allowing foreign entry, on average, outweigh its risks. Thus, allowing the entry of foreign banks should be a great concern for the Ethiopian banking industry. In addition, allowing private investors participation in the ownership of government banks could also enable to pave the way for the gradual withdrawal of the government from the banking sector.

4.1.2. Market Concentration of the Ethiopian Banking System during the Pre-reform and Post-reform period

Market concentration is used as a measure of market power in a certain industry. In this paper, the top k-firms concentration ratio (CR_k) and the Herfindhal-Hirschman Index (HHI) are used to measure the market concentration of the Ethiopian banking system.

A. The k-firms Concentration Ratio (CR_k)

There are a number of measures of concentration that have been used in banking studies. However, both simplicity and limited data requirements make the k bank concentration ratio one of the most frequently used measures of concentration in the empirical literatures. CR_k is a relatively strong measure because it clearly caches the market structure through market shares of a few dominating firms, Sankyu and Jong-kun (2005).

Summing only the market shares of the k largest banks in the market, the formula to calculate the concentration ratio can be written as: $CR_k = \sum MS_i$, where MS, refer market share and i refers to number of largest banks taken for the calculation.

The index gives equal emphasis to the k leading banks, but neglects the many small banks in the market. There is no rule for the determination of the value of k, so that the number of banks included in the concentration index is a somewhat arbitrary decision. The index approaches 0 %for an infinite number of equally sized banks (given that the k chosen for the calculation of the concentration ratio is comparatively small when compared to the total number of banks) and it equals 100% if the banks included in the calculation of the concentration ratio make up the entire industry.

B. The Herfindahl Hirschman Index (HHI)

HHI is calculated as the sum of square of participating firm's share in the industry. According to the horizontal merger guideline of the US Department of Justice, a market whose HHI is below 1000 is defined as a non-concentrated market, 1000-1800, moderately concentrated market; and over 1800 as highly concentrated market, Sankyu and Jong-kun (2005) . The HHI can range from zero in a market having an infinite number of firms to 10,000 in a market having just one firm (with a 100 per cent market share). The HHI is a static measure and, therefore, gauges market concentration at a single point in time. Algebraically, it is calculated as $HHI = \sum MS^2i$, Where MS_i = market share of the with bank,

The index stresses the importance of larger banks by assigning them a greater weight than smaller banks, and it incorporates each bank individually, so that arbitrary cut- offs and insensitivity to the share distribution are avoided.

Following attempt is made to compute both the k-firms concentration ratio for the single largest bank and two largest banks (CR_k, k =1 and 2) and HHI using the total deposit, loan, capital, and assets of the banking industry. In this computation only deposit accepting banks established with profit motive and has been in operation for more than three years are considered. The computation has classified the periods in to pre-reform (1976-1991) and post-reform periods (1992-2006).

4.1.2.1. The Pre Reform Period

A. The k-firms Concentration Ratio (CR_k)

The single largest bank (CR_1) and the two-bank (CR_2) concentration ratios indicate that the Ethiopian banking sector has been highly concentrated during the pre-reform period. CBE, the largest bank at that time ,on average holds 77.75%, 90.07%, 93.76%, 91.44% of the total market shares of loans, deposits, capital and assets of the banking sector, respectively. In all the years of the reform period the single bank ratio has stayed above 66.60% for loans, 85.76 % for deposits, 85.85% for capital, and 89.20% for asset. .The average, minimum, maximum concentration ratios during the pre-reform periods are tabulated hereunder.

Table 4: The Concentration Ratio before the Reform Period

	Loan		Deposit		Capital		Asset	
	CR_1	CR_2	CR_1	CR_2	CR_1	CR_2	CR_1	CR_2
Average	77.75	100.00	90.07	100.00	93.76	100.00	91.44	100.00
Maximum	84.46	100.00	93.35	100.00	97.87	100.00	93.80	100.00
Minimum	66.60	100.00	85.76	100.00	85.85	100.00	89.20	100.00

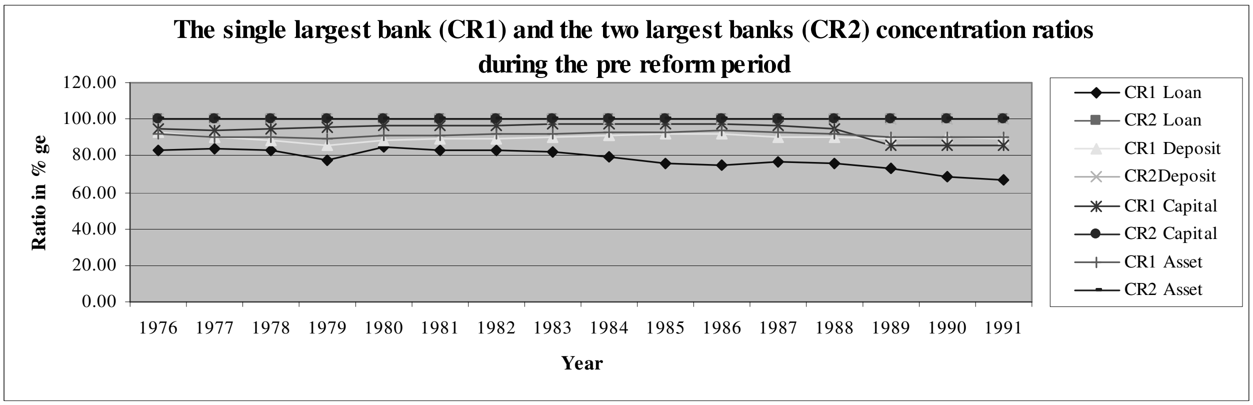
Source: Author computation

Excluding the then existing development bank, DBE [3]from the industry, in all concentration measures the remaining two banks hold 100% of the market share of the banking industry

[3] DBE is excluded for mere reason that it does not accept any deposit from the public as well as its purpose of establishment is not for profit or commercial purpose.

further signifying the great concentration of the banking industry at that time. The trend in the concentration ratios are displayed hereunder:

Chart 1: The Trend in CR_1 and CR_2 ratios during the Pre-Reform Period



B. The Herfindhal-Hirschman Index (HHI)

The HHI before the reform period also has further strengthened the argument for the excessive market concentration prevailed at the time preceding the reform measure. As shown in the Table below, the sum of square of the participating bank's share in the industry on average had stood at 5550.90, 7557.22, 7570.76, and 8072.88 for loan, deposit, and capital and asset market shares respectively.

Table 5: The HHI before the Reform Period

	Loan	Deposit	Capital	Asset
Average	6649.10	8206.00	8962.22	8434.16
Maximum	7374.98	8758.27	9583.68	8837.41
Minimum	5550.90	7557.22	7570.76	8072.88

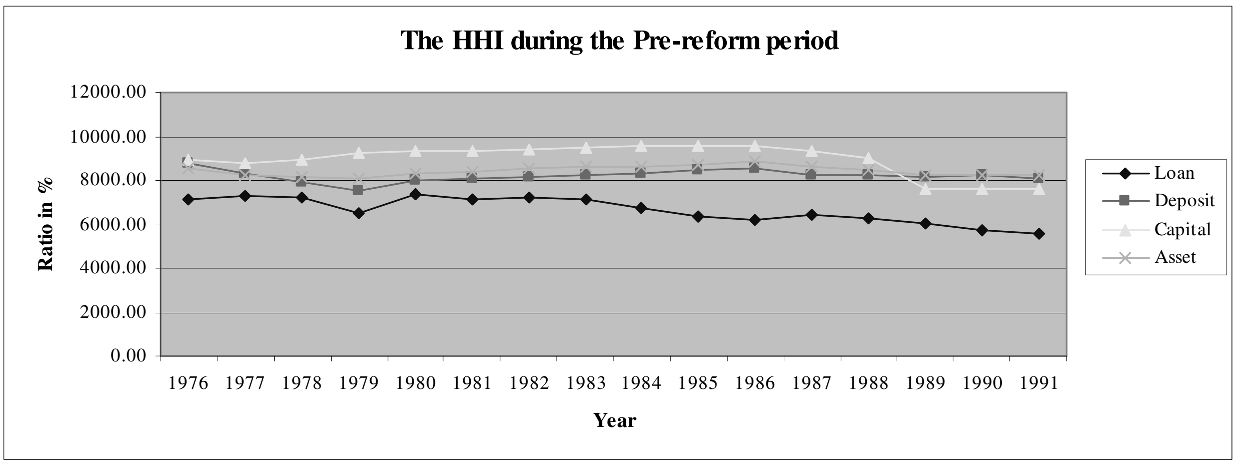
Source: Author computation

Thus, the ratio has greatly surpassed the non-concentrated (below 1000) and moderately concentrated (less than 1800) standards[24]. As the CBE was the main contributor to the HHI,

[4] According to the horizontal merger guideline of the US Department of Justice, a market whose HHI after merger is below 1000 is defined as a non-concentrated market, 1000-1800, moderately concentrated market; and over 1800 as highly concentrated market, Sangkyu and Jong-kun (2005)

by any standard the banking industry at that time can be identified as a mono banking system with no competition among the existing few government banks in fact the government stance was to minimize the extent of competition between the commercial banks and the existing specialized banks. The trend in the HHI during the pre-reform period is as shown in the Chart below:

Chart 2.: The Trend in HHI during the Pre reform Period



4.1.2.2. The Post Reform Period

A. The k-firms Concentration Ratio (CR_k)

During the post reform period, the average concentration ratio for the two largest banks (CR_2) in the concentration measure of the loans, deposits, assets and capital market in the industry stood at 83.83%, 90.18%, 89.10%, and 81.49%, respectively. In the same manner the single largest bank (CR_1) on average holds 71.85%, 84.55%, 72.08% and 83.20% of the industry's loans, deposits, capital and assets, respectively. Thus, the concentration ratios in all the measures revealed that the banking system in Ethiopia is highly concentrated (see Table6).

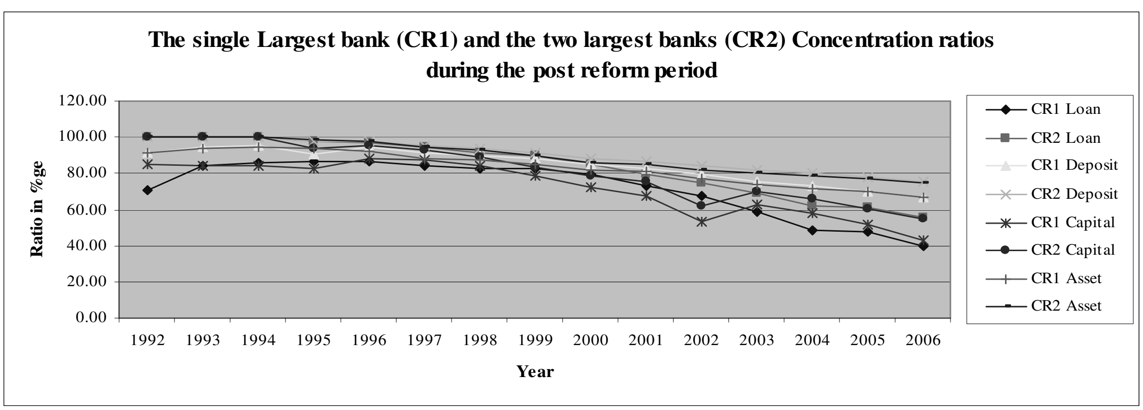
Table 6: The Concentration Ratio after the Reform Period

	Loan		Deposit		Capital		Asset	
	CR_1	CR_2	CR_1	CR_2	CR_1	CR_2	CR_1	CR_2
Average	71.85	83.83	84.55	90.18	72.08	81.49	83.20	89.10
Maximum	86.81	100.00	95.07	100.00	87.86	100.00	94.21	100.00
Minimum	39.62	55.57	66.99	75.78	43.21	54.73	66.55	74.99

Source: Author computation

However, in all the measures a declining trend is observed in the level of concentration. This is as a result of the introduction of new private banks into the banking system. For instance, the average CR_2 concentration ratio in terms of loan and capital has declined to the minimum 55.57% and 54.73%, respectively. Likewise, the CR_1 ratio for the aforementioned accounts dropped to the minimum 39.62% and 43.21%, respectively during the post reform period. This seems encouraging in comparison with the 100% CR_2 in all measures and the minimum CR_1 of 66.60%and 85.85% for loans and capital accounts, respectively before the allowance of new domestically owned banking businesses (see the trend in the Chart below).

Chart 3: The Trend in CR_1 and CR_2 ratios during the Post Reform Period



As shown in the Chart above, during the post reform period, the loan market revealed a relatively much declining trend as compared to the deposit and the industry's asset. This might be due to the simple observation that CBE in recent years is not aggressively interacted in the loan market but rather engaged itself in minimizing the non-performing loan. The CR_1 and CR_2 ratios for deposit market and using the total asset,[5] still exhibits a concentrated pattern as the CBE holds 66.99% of the deposit share and 66.55 % of the total asset of banking industry.

B. The Herfindhal-Hirschman Index (HHI)

In congruence with the concentration ratio, the level of market power using the HHI reveals a highly concentrated market. For instance, the average HHI in the deposit market has drooped to 7299.07 after the reform as compared with 8206.00 before the reform .This figure declined as low as 4673.09 by the end of 2006 as compared to 8217.49 just before the introduction of a single private bank, in 1995.

Table 7: The HHI after the Reform Period

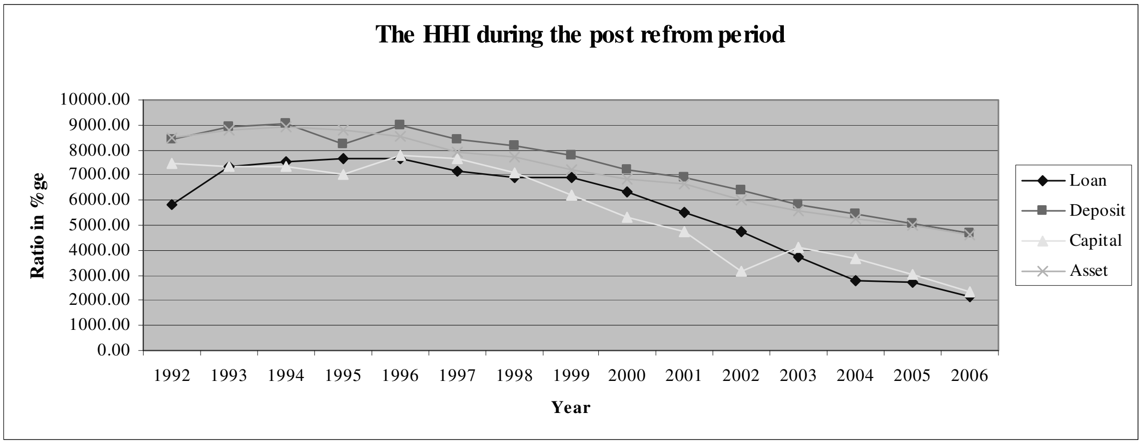
	Loan	Deposit	Capital	Asset
Average	5669.89	7299.07	5617.46	7082.76
Maximum	7647.45	9063.03	7798.81	8908.45
Minimum	2172.48	4673.09	2368.83	4609.85

Source: Author computation

The loan market also shows a declining trend from average HHI 6649.10 in the pre-reform period to average HHI of 5669.89in the post reform period and minimum of 2172.48 at the end of the year 2006. This is an indication that the banking system in terms of deposit relatively shows a more non-competitive behavior than the loan market. This perhaps is due to the fact that even after twelve years of the introduction of private banks the consumer at large and particularly, the different public enterprises seem to favor and rely on the CBE as CBE is the main contributor in the HH Index.

[5] The three banks concentration ratio for sub-Saharan average was 81 percent in 2003. For comparison for Kenya, Ghana and South Africa, the figure was 61.6, and 77 percent, respectively, Buchs and Mathisen (2003)

Chart 4: The Trend in HHI during the Post-reform Period



The HHI for the asset size of the industry also exhibited the same performance pattern as the deposit market and the HHI for capital revealed equivalent performance with the loan market.

4.1.2.3. The Current Market Share Profile of Ethiopian Banks

The country's giant bank, CBE continued to lead the industry in terms of market share in the loans (39.62%),deposits (66.99%),capital(43.21%) and assets (66.55%) and government owned banks (CBE and CBB) accounted for 45.04% of loans,69.31% of deposits,47.71% of capital and 69.89% of assets of the banking sector. In general, as shown in the Table below the market share of private banks in the loan and capital market is shown a progressive improvement where as in terms of deposit mobilization and total asset the CBE has still dominated the industry (the market share of individual banks is attached in Annex 3)

Table 8: Market Share of Commercial Banks by Ownership

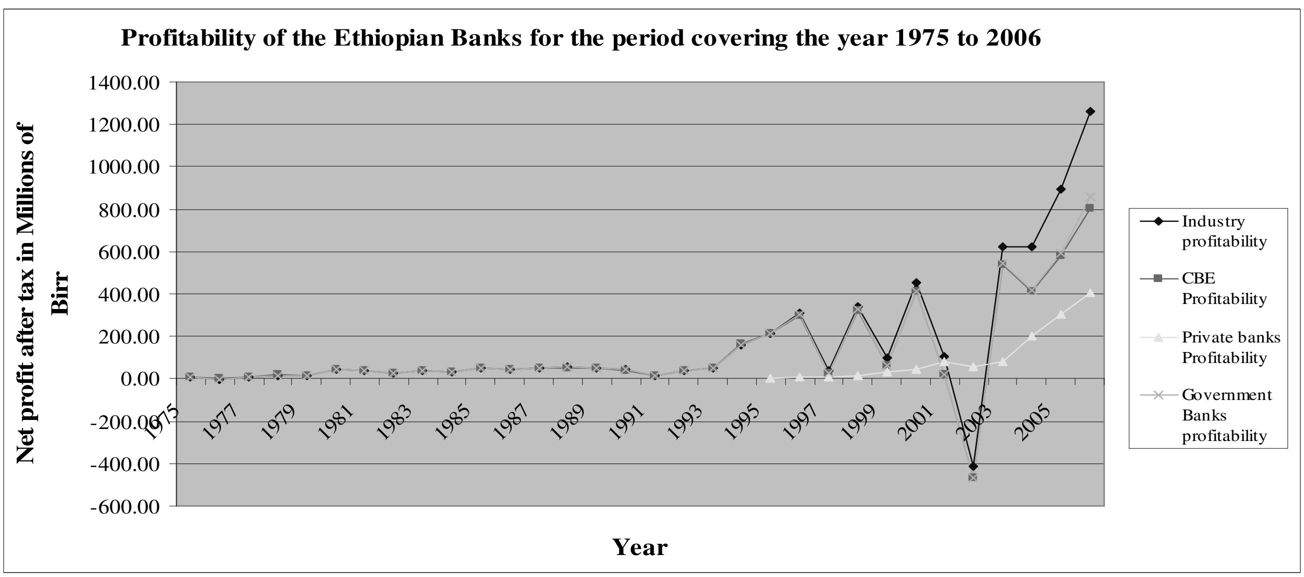
Banks	In terms of %ge			
	Loan	Deposit	Capital	asset
State banks	45.04	69.31	47.71	69.89
Private banks	54.96	30.69	52.29	30.11
CBE	39.62	66.99	43.21	66.55

Source: Author computation

4.1.3. Profitability Performance of the Ethiopian Banking Industry during the Pre Reform Period and Post Reform Period

The profitability of the industry has shown a tremendous improvement after the reform measure has been taken. The profit of the industry on average for the post reform period has reached to Birr 320 million as compared to Birr 31 million during the pre- reform period. Even the bank that has been in a loss in most years of the pre-reform period like CBB has become profitable after the reform measure has been taken (See Annex 4). From the year 1995 onwards, with the addition of the new private banks, the profitability of the industry further escalated on average to Birr379 million. This signified the banking industry has becoming a lucrative source for maximizing the wealth of the shareholders. The trend in profitability of Ethiopian banks is shown in the Chart below.

Chart 5: Trend in the Profitability Performance of Ethiopian Banks



However, as shown in Table 9 in terms of profit distribution even after the entry of private banks, the existing government banks are enjoying having the higher share of profit from the industry. From the introduction of the new banks in 1995, the average market share of the government banks in terms of profit has reached 75.8% of the total profit of the industry and they are also managed to earn an average ROA and ROE of 1.46% and 29.2%, respectively on the above same period.

Table 9: Share of CBE, Government Banks and Private Banks from the Total Industry Profit

Year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	Ave. *
CBE share	97.62	95.83	66.94	94.08	68.04	90.44	18.87	Loss	86.85	66.34	64.60	63.44	70.6
CBE ROA	2.37	2.59	2.56	1.73	2.68	2.33	3.1	Loss	2.85	2.99	2.38	2.32	2.54
CBE ROE	92.35	65	45.11	29.44	44.92	38.18	50.71	Loss	51.24	57.66	55.2	54.65	53.1
Government banks	98.56	97.81	73.09	96.17	68.03	90.44	20.50	Loss	87.29	67.40	66.40	67.87	75.8
Gov. banks ROA	1.22	1.39	1.31	0.95	1.34	1.17	1.57	Loss	1.46	1.57	1.35	2.76	1.46
Gov. banks ROE	46.72	33.96	23.04	16.09	22.46	19.09	25.64	Loss	26.05	29.86	29.95	48.63	29.2
Private Banks	1.44	2.19	26.91	3.83	31.96	9.56	79.50	91.99	12.71	32.59	33.60	32.13	29.9
Private Banks ROA	-	0.09	0.63	0.93	1.93	2.00	3.36	1.95	1.44	2.84	3.39	3.65	2.02
Private Banks ROE	-	0.97	15.82	18.10	23.45	25.32	32.18	22.44	22.38	33.44	38.96	38.33	24.7

Source: Author computation

* *includes the loss*

After the year 1995, about 71% of the average profit of the industry has been contributed by the giant bank, CBE. Even if the share currently (in 2006) is reduced to 63.44%, it can briefly explain that CBE's dominance in both market concentration and market share has resulted in higher profitability of the bank. And as shown in the Chart above, even after the entry of the private banks, the pattern of the industry profit is following the profitability structure of the giant bank further explaining even with the current liberalization measure CBE is enjoying the market by earning the maximum yield of the industry.

The profitability of the private banks as a group has also shown improvement through time; however it remained greatly lower than the profit registered by the government banks and the single largest bank. The maximum profit, Birr 406.2 million, of the private sector has been registered in the year 2006 that enables them to hold only 32.13% of the total profit of the industry which is equivalent to 50% of the net profit performance (which is Birr 802 million) of the CBE during the same period.

4.2 Data from Primary Sources

In addition to data gathered from secondary sources, a structured questionnaire was developed incorporating four focus areas such as personal details of the respondents, their attitude towards the impact of financial liberalization on the ownership structure, on the market concentration and the profitability performance of the Ethiopian banking industry. Furthermore, in each part attempt has been also made to seek information on the areas that need further liberalization or reform measures (see Annex 8). The questionnaire has been distributed to 100 randomly selected employees and management members of all the commercial banks operating in the country and from the employees of the country's central bank. The selection of respondents was made in a way to represent the management and staffs of the bank as well as in a way to include persons working in different operations of the banking industry. However, only 58 questionnaires have been fully filled and returned for use in the study .The responses have been analyzed in the following pages in 14 Tables.

4.2.1. Background Information of Respondents

More than half (56.9%) of the respondents are employees of the government banks[6] where as the rest (43.1%) belong to the private banks[7].

Table 10: Respondents Category by Bank Ownership and Position

Position	Bank		Total*	
	Private Bank	State Bank	Frequency	Percent
Senior Management	9	6	**15**	**25.9**
Middle Level Management	6	9	**15**	**25.9**
Officers	18	10	**28**	**48.3**
Frequency*	**33**	**25**	**58**	**-**
Percent*	**56.9**	**43.1**	**-**	**100.0**

** Vertical- Respondents bank, Horizontal -Position of respondents*

6 CBE,CBB,NBE

7 AIB,DB,BOA, WB, ,UB NIB,LIB,CBO

In addition, 51.7% of the respondents are serving their banks at the management (either senior or middle) level and the remaining portion (48.3%) of the respondents are officers working in different operations [8] of their respective bank.

Table 11: Age and Sex of Respondents

Respondents Sex	Respondents Age				Total*	
	Below 25	26-35 year old	36-55 years old	Above 55 years old	Frequency	Percent
Male	2	38	11	3	**54**	**93.1**
Female	-	3	1	-	**4**	**6.9**
Frequency*	**2**	**41**	**12**	**3**	**58**	**-**
Percent*	**3.4**	**70.7**	**20.7**	**5.2**	**-**	**100.0**

**Vertical – Age of respondents, Horizontal -Respondents sex*

As displayed in the above Table, the greater part (70.7%) of the respondents exist within the age of 26-35 years, while 20.7% are between 36-55 years and the remaining 5.2% and 3.4% are above 55 years old and below 25 years, respectively. On the other hand, the 93.1% of the respondents are males and the remaining 6.9% are females.

Regarding the educational background, 77.6 % of the 58 respondents are first degree holders, 20.7% of them are having educational qualification of second degree and above and only 1.7% of them are diploma holders. The above figures roughly explain that the study has got an input from well educated employees of the banking industry.

Table 12: Educational Level and Experience of Respondents

Experience	Educational level			Total*	
	Collage Diploma	First Degree	Second Degree and Above	Frequency	Percent
Below 1 year	-	2	-	**2**	**3.4**
1-5 years	-	16	2	**18**	**31**
6-10 years	-	16	5	**21**	**36.2**
Above 10 years	1	11	5	**17**	**29.3**
Frequency*	**1**	**45**	**12**	**58**	**-**
Percent*	**1.7**	**77.6**	**20.7**	**-**	**100**

**Vertical – Educational level of respondents, Horizontal- Experience of respondents*

[8] like Credit, Domestic banking, Foreign banking, Marketing and Business Development, Human Resource Management, Branch operations and Risk Management

In terms of experience, the major portion (67.2%) have served in the banking industry for more than 6 years and the rest 31% and 3.4% have served in the industry between 1-5 years and below 1 year ,respectively further indicating the study's reliance on well experienced employees of the sector. In addition, about 34% of the respondents have worked in both private and state banks and the rest 66% lack that experience (Table 13).

Table 13: Respondents Experience in Both Private and State Banks

If you are working in a state/private owned bank, have you got a chance to join any private/state bank?						
	Yes		**No**		**Total**	
Bank by ownership	**Frequency**	**Percent**	**Frequency**	**Percent**	**Frequency**	**Percent**
State Bank	2	8	23	92	**25**	**43.1**
Private Bank	18	54.55	15	45.45	**33**	**56.9**
Total	**20**	**34.48**	**38**	**65.52**	**58**	**100**

4.2.2. Impact of Financial Liberalization on the Ownership Structure

Questions pertaining to the impact the financial liberalization have placed in the ownership structure of the Ethiopian banking industry have been asked so as to uncover the attitude of employees towards the change and take their ideas for further improvement of the ownership structure of the industry. Summary of the responses are summarized in the Tables below:

Table 14: Impact of Financial Liberalization on the Market Concentration

Do you believe that the financial liberalization and other reform measures undertaken have brought a favorable ownership structure for the Ethiopian banking Industry?	**Responses***						**Total**	
	Yes		**NO**		**DK**			
	Freq. **	**Per. ****	**Freq.**	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**
	48	82.8	10	17.2	**-**	**-**	**58**	**100**
Reasons by Those who said Yes								
Enhanced Competition	42	72.4	8	13.8	**-**	**-**	**50**	**100**
Enabled to serve more of the Society	45	77.6	2	3.4	3	5.2	**50**	**100**
Improved efficient use of capital	31	53. 4	15	25.9	4	6.9	**50**	**100**
Help to reduce unemployment	49	84.5	1	1.7	-	-	**50**	**100**
Enhanced fund mobilization in the economy	44	75.9	6	10.3	-	-	**50**	**100**
Created a level playing field	17	29.3	26	44.8	7	12.1	**50**	**100**
Enhanced equity in regulation	18	31.0	18	31.0	14	24.1	**50**	**100**
Strengthened local banks	37	63.8	8	13.8	5	8.6	**50**	**100**

Reasons By Those Who Said No								
Prohibited participation of foreign banks	6	75	-	-	2	25	**8**	**100**
Allowed inefficiency to reign in the sector	7	87.5	1	12.5	-	-	**8**	**100**
Helped to tighten dominance of government banks	8	100.0	-	-	-	-	**8**	**100**

* The responses are provided in comparison with the Pre-reform period ** Freq. – Frequency Per. - Percent

As displayed in Table 14, a good number, 48 or 82.8% of the respondents are in support of the favorable impact the financial liberalization have placed on the ownership structure of the Ethiopian banking industry. Most of the respondents who accepted the reforms favorable change stated that the financial liberalization has enabled to enhance the competition in the sector (72.4%) which was non-existent before the reform measure was undertaken; it also enabled to serve the society (77.6%)through bank expansion and improved efficient use of capital (53.4%) by injecting funds to the private sector in the form of loans and enhancing fund mobilization (75.9%) in the form of deposit .The reform also greatly helped in the reduction of unemployment (84.5%) by creating job opportunities to skilled Ethiopian nationals; it has also contributed for the strength of local banks (63.8%) by protecting them from the fierce competition they might encounter from foreign banks in addition to the aforesaid reasons. However, respondents have a reservation on the reforms capacity to create ownership structure that enhances a level playing field (44.8%) for all commercial banks operating in the country .Equal number of respondents (31% for each) gave their comment on the reforms capacity in enhancing equity in regulation.

On the other hand 10 or 17.2% of the respondents are of the opinion that the financial liberalization has not brought a favorable ownership structure for the Ethiopian banking industry. They claim that it has prohibited the participation of foreign banks (75%); it allowed inefficiency to reign in the sector (87.5%) by accumulating excess funds in government banks and helped to tighten dominance of the government banks (100%).From the analysis it can be inferred that there were lots of remarkable changes brought to the banking sector as a result of the reform measures as compared with the pre-reform period but the reform lacked the capacity to create a level playing field, equal opportunity to play in the field competitively, for both private- and government-owned banks.

Concerning the type of ownership structure that best suits for the Ethiopian banking system more than half (56.9%) of the respondents have selected ownership structure consisting Private, State and Foreign composition .The reasons cited by the respondents are such ownership structure would improve the competition in the industry ,improve the efficiency of the sector, help for the introduction of new banking services and technologies, propel for appropriate fund mobilization and credit extension and could serve as an attraction for foreign direct investment.

Table 15: The Ownership Structure That Best Suits for the Ethiopian Banking System

What type of ownership structure best suits for the Ethiopian banking system?	**Responses**			
	Frequency	**Percent**	**Valid Percent**	**Cumulative Percent**
Private only	1	1.7	1.7	1.7
Combination of Private And State Bank	15	25.9	25.9	27.6
Private and Foreign Only	9	15.5	15.5	43.1
Combination of Private State and Foreign	33	56.9	56.9	100.0
Total	**58**	**100.0**	**100.0**	-

On the other hand, 25.9% of the respondents voted for the continuity of the current (private and state bank) ownership structure. They claimed that it would be too early to incorporate foreign ownership in the Ethiopian banking industry as the local banks do not fit to withstand the fierce competition coming from the foreign banks as well as with the current undeveloped capacity of the regulatory organ it would be too risky to allow foreign banks to operate in the country so they selected for the persistence of the current ownership structure. The rest 15.5% and 1.7% of the respondents were in favor of Private and foreign composition and ownership by private banks only, in that order. Both claimed that the government stay in the banking sector would be a barrier for the country's move towards market economy rather the government should enhance its supervisory role in the sector.

Regarding the view respondents have towards the participation of foreigners in the Ethiopian banking industry, most respondents (53.4%) consider foreign participation as an opportunity for the Ethiopian banking system as it enhances the flow of modern technologies and innovations in the banking system, increases know-how in the banking services, enables to deepen competition in the sector and improves efficiency of the banking sector. In contrast 13.8% of the respondents assert that foreign participation would be a great threat for the industry as it might lead to over competition, high capital flight and could be a cause for the collapse of domestic banks. The remaining portions of the respondents (32.8%) see foreign banks involvement as both an opportunity and threat by combining the reason forwarded by those respondents who answered as an opportunity and as a threat.

Table 16: Attitude towards Participation of Foreigners and the Form of Entry in the Ethiopian Banking Industry

What sort of liberalization do you suggest in the process of embracing foreign participation of the Ethiopian banking sector?[9]	***How do you view participation of foreigners in the Ethiopian banking industry?***							
	As a threat		**As an Opportunity**		**Both as an Opportunity & Threat**		**Total****	
	Freq.	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**
Partial Liberalization Through Joint Venture	1	12.5	15	48.4	12	63.2	**18**	**48.3**
Partial Liberalization Through Branching	-	-	5	16.1	2	10.5	**7**	**12.1**
Partial Liberalization Through Subsidiary	-	-	5	16.1	3	15.8	**8**	**13.8**
Partial Liberalization Through Agency	1	12.5	2	6.5	-	-	**3**	**5.2**
Fully Foreign Owned Banks	-	-	4	12.9	1	5.26	**5**	**8.6**
Others *	6	75.0	-	-	1	5.26	**7**	**12.1**
Total**	**8**	**13.8**	**31**	**53.4**	**19**	**32.8**	**58**	**100**

**No need of entry*, to *early to worry about it*
*** Vertical –view regarding foreign participation, Horizontal- view towards sort of liberalization*

About 48.3% of the total respondents and 48.4% and 63.2% those respondents who see foreign participation as an opportunity and both as an opportunity and threat, respectively claimed that rather than allowing fully foreign owned banks to operate in the banking system as selected by 8.6% of the respondents, forming Joint venture with Ethiopian allies is the best liberalization measure in embracing foreign participation in the Ethiopian banking industry (Table 16). Others also voted for foreign participation through branching (12.1%), subsidiary (13.8%) and agency (5.2%).The remaining part (12.1%), those who see foreign participation as a threat, stated that it is not the time to worry about foreign participation. Some of the respondents (72%) who voted for partial liberalization through different forms of entry have

[9] *A representative office (or agency) is the easiest form of organization, which neither takes deposits nor makes loans. Most of the time it is established to test possibility of further involvement in a host country. A branch, which is an integral part of a parent bank, however, can offer a wider range of services than agencies or representative offices. On the other hand, a subsidiary is permitted to engage in a broader range of financial services compared to both branch and representative office and in many countries, it has identical power as domestic* banks *and hence is regulated in the same manner (George Clarke et al, 2001). Merger and acquisition refers to takeover of small domestic banks by larger foreign entrants and Joint venture refers working in alignment with Ethiopian partners.*

stated that the selected option is a viable alternative in the short term but in the long term Ethiopia should allow fully foreign owned banks to operate in the industry (Table 16).

The respondents' views towards the current involvement of the government in the banking sector (Table 17) displayed that most (58.6%) of the respondents dislike the excessive involvement of the government in the current Ethiopian banking system on the ground that it limited the growth of banks (79.4%) , limited the competition expected from the banking industry (91.2%) ,it contributed less in the private capital accumulation (61.8%) than the expected ,contributed for bank inefficiency (73.5%) and contributed to the limited infrastructural development (such as IT) (88.2%) in the banking sector.

Table 17: View towards the Current Involvement of the Government in the Banking Sector

	*What is your view towards the current involvement of the government (partial liberalization) in the banking sector?**											
	Adequate						**Excessive**					
	Yes		**No**		**DK**		**Yes**		**No**		**DK**	
Reasons	**Freq.++**	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**
Enhanced financial stability	19	79.17	5	20.83	-	-	***58.6% of the respondents disliking excessive government involvement***					
Attempt to build strong banking culture	18	75.00	6	25.00	-	-						
Fair distribution of banking services	13	54.17	9	37.50	2	8.33						
Better social responsibility being delivered	22	91.67	-	-	2	8.33						
Limited bank growth	***41.4% of the respondents supporting the adequate involvement of the government***						27	79.4	5	14.7	2	5.9
Limited bank competition							30	91.2	2	5.9	1	2.9
Less contribution to private capital accumulation							21	61.8	8	23.5	5	14.7
Contributed for bank Inefficiency							24	73.5	8	23.5	1	2.9
Limited infrastructural development such as IT							30	88.2	1	2.9	3	8.8

** Response by comparing with the appropriate or the expected banking sector performance*
*** Freq. – Frequency Per. Percent*

On the other side of the continuum, (Table 17) 24 or 41.4% of the respondents support the adequate involvement of the government in the banking sector. They explain that the current government involvement in the banking sector has led to enhanced financial stability (79.17%), has contributed to the attempt in building banking culture to the wider part of the society (75%) ,has manifested fair distribution of banking services (54.17%); and better socially responsible banking service has been delivered (91.67%) by such satisfactory involvement of the government. The above opinions indicate that there is a need to work for minimizing the currently prevailing excessive involvement of the government in the banking industry.

4.2.3. Impact of Financial Liberalization on the Market Concentration

To see the outlook of respondents towards the impact the financial liberalization has placed in the market concentration of the Ethiopian banking industry different questions were asked. The responses to the questions are summarized in the Tables 18-21 below:

Concerning the views respondents have towards the categorization of the Ethiopian banking industry as a mono-banking system, half (50%) of the respondents explicated that they do not agree with such proposition and the others, 48.3%of them, accepted the Ethiopian banking as a system dominated by one bank. The rest 1.7% don't know or have reservation to state their feelings on the issue. This indicates that even if most respondents don't agree to the proposition, a considerable number of employees in the industry believe that the Ethiopian banking industry is dominated by one giant bank.

Table 18: Respondents Outlook towards the Categorization of the Ethiopian Banking Sector as a Mono-Banking System

Do you agree with the categorization of the Ethiopian banking system as a mono-banking system where one bank sits dominant over the others?				
	Frequency	**Percent**	**Valid Percent**	**Cumulative Percent**
Yes	28	48.3	48.3	48.3
No	29	50.0	50.0	98.3
DK	1	1.7	1.7	100.0
Total	**58**	**100.0**	**100.0**	-

On the other hand, to the question intended for finding out the attitude of the commercial banks employees and management towards the reforms impact in reducing the dominance of the government banks in the industry from the situation prevailed in the pre-reform period (full government ownership), a great majority (81%) of respondents accepted the positive impact the reform have placed in reducing the dominance of government banks (Table 5-10).

Table 19: Respondents Attitude towards the Impact the Reform Brought In Reducing Government Banks Dominance in the Industry

*Do the financial liberalization and other reform measures have contributed to reduce the dominance of the government banks in the industry?**				
	Frequency	**Percent**	**Valid Percent**	**Cumulative Percent**
Yes	47	81.0	81.0	81.0
No	9	15.5	15.5	96.6
DK	2	3.4	3.4	100.0
Total	**58**	**100.0**	**100.0**	-

**Response provided in comparison with the pre-reform period*

However 15.5% of the respondents believe that the government banks' dominance is not yet reduced and 3.4% of the have either don't know or have reservation to forward their ideas. Most respondents (56%) who accepted the decline in government banks dominance claimed that even with such declining trend the existing dominance by government banks especially in the deposit market is considerably significant.

Relaying on the test made by the secondary data, questions have been forwarded towards the factors contributing to the concentration prevailing in the Ethiopian banking industry (Table 20).

Table 20: Factors Contributing in the Concentration of the Ethiopian Banking System

Factors contributing for the concentration of the Ethiopian Banking system	**Responses**						**Total**	
	Yes		**NO**		**DK**			
	Freq.	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**
More public confidence in government banks	49	84.5	7	12.1	2	3.4	**58**	**100.0**
Low profitability of the industry	4	6.9	47	81.0	7	12.1	**58**	**100.0**
Higher entry capital requirement	29	50.0	23	39.7	6	10.3	**58**	**100.0**
Limited growth of private banks	37	63.8	15	25.9	6	10.3	**58**	**100.0**
Absence of foreign banks	31	53.4	13	22.4	14	24.1	**58**	**100.0**
Capacity of the regulatory body	28	48.3	22	37.9	8	13.8	**58**	**100.0**

The respondents elucidated more public confidence in government banks (84.5%, limited growth of private banks (63.8%), absence of foreign banks (53.4%), loss of capacity by the regulatory body (48.3%) and higher capital requirement (50%) could serve as a main cause for the concentration reigned in the banking industry. However, nearly all (81%) respondents decline the low profitability of the industry as a contributing factor for bank concentration.

Some respondents also additionally raised the banking proclamation proclaimed in 1994 as a contributing factor for the concentration which prevailed in the sector. The proclamation seemed to have limiting conditions with regard to entry, which can be considered as the main contributor for concentration of the banking services among a few banks. For example it is clearly stated in the Licensing and Supervisions of Banking Proclamation No. 84/1994 that no foreign national should undertake banking business in Ethiopia. In addition, the minimum capital required to establish a new bank was raised from Birr 10 million in 1994 to Birr 75 million in 1999. It can be argued that although these directives and proclamations are enacted to strengthen the capacity of existing banks, they have seemingly become a barrier as to why the number of operating banks did not flourish in the banking system of the country.

In addition the respondents' stance towards the currently observed decline in the market concentration depicted that 65.5% of them believe that the competition succeeded after the entrance of the new privately owned banks has contributed for the decline in the concentration of the market of the banking industry. However, the respondents raised the problem of balanced competition between private and state banks (Table 21).

Table 21: Respondents Stance towards the Declining Trend in the Market Concentration of the Ethiopian Banking Industry

Different tools for assessing the level of concentration reveal the concentration of the banking industry but in all measures a declining trend is observed in the level of concentration, does this can be ascribed to an enhanced competition in the industry?				
	Frequency	**Percent**	**Valid Percent**	**Cumulative Percent**
Yes	38	65.5	65.5	65.5
No	14	24.1	24.1	89.7
DK	6	10.3	10.3	100.0
Total	**58**	**100.0**	**100.0**	-

On the other side, 24.1% of the respondents claim that the decline for the concentration could not be aligned with bank competition rather it is ascribed to the normal growth trend of private banks and the rest 10.3% choose to stay reserved in the issue.

4.2.4. Impact of Financial Liberalization on Profitability Performance of the Ethiopian Banking Industry

Relaying on the trend of the industry's profitability and other factors that influence the banking industry both open ended and choice questions were designed and forwarded to the respondents. The responses to the questions are presented in Table 21 as follows:

(Table 21) The majority (81%) of the respondents believe that the financial liberalization has placed a positive impact on the profitability of banks. Furthermore, respondents also believe that the reform positively impacted the performance of the industry by deepening competition in the banking sector (67.2%), by improving the productivity of loans and/or other investments (65.5%) via directing funds to different sectors of the economy.

Table 22: Impact of the Reform on Profitability and Other Performance Factors in the Banking Environment

Impact on profitability and other performance factors	**Responses***								**Total**	
	Positive		**Negative**		**Nothing**		**DK**			
	Freq.	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**	**Freq.**	**Per.**
Profitability of banks	47	81.0	6	10.3	**-**	**-**	5	8.6	**58**	**100.0**
Deepening Competition in the banking sector	39	67.2	4	6.9	12	20.7	3	5.2	**58**	**100.0**
Fairness in fund mobilization	10	17.2	19	32.8	22	**37.9**	7	12.1	**58**	**100.0**
Market based asset(e.g. Loan) and Liability (e.g. Deposit) Pricing	17	29.3	6	10.3	28	**48.3**	7	12.1	**58**	**100.0**
Improved productivity/efficiency of loans and /or other investments	38	65.5	3	5.2	15	25.9	2	3.4	**58**	**100.0**
Strengthening the Regulation/Supervision	30	51.7	8	13.8	14	24.1	6	10.3	**58**	**100.0**
Enhancing the establishment of capital markets	19	32.8	9	15.5	24	**41.4**	6	10.3	**58**	**100.0**
Liberalizing the foreign exchange market	39	67.2	6	10.3	9	15.5	4	6.9	**58**	**100.0**

** Response by comparing with the performance in the pre-reform period*

It has also made positive contribution in strengthening the regulation/supervision of banks (51.7%) and liberalizing the foreign exchange market (67.2%). However, those who commented on the reforms' positive impact have revealed that although the competition among private banks was a competition among equals, it was between unequals as far as private banks and state-owned banks were concerned as the state-owned banks were relatively well established, with large network of branches, high capital and reserve base and own premises of bank branches .They all contribute towards reducing costs of state owned banks and enhance their capacity to give out big loans. In addition, there exists no competition among the state owned banks; they work in cooperative manner rather than competing among themselves. However, even with such trend the Ethiopian banking industry is rounding over the verge of competition. In addition, some of the directives of the National Bank of Ethiopia (NBE) also provided competitive edge to the state-owned banks inadvertently. The upper limit of a loan, which could be granted to a single borrower and related party to a bank, is set by the NBE to be determined based on the capital of the bank that helps the state owned banks to grant big loans as they have maintained a strong capital base through their long years of experience..

On the other side, respondents believe that the reform has brought no considerable effect in manifesting fair fund mobilization (37.9%), market based asset and liability pricing (48.3%) and enhancing the establishment of capital markets (41.4%). The reason cited by most respondents regarding for the absence of change due to the reform measure is that both the state-owned and private banks competed for obtaining businesses of the private sector. However, Ethiopia's large public enterprise system is still the domain of the Commercial Bank of Ethiopia, giving it a competitive advantage over private banks by reducing its costs. This competitive advantage makes the CBE a pace-setter in the realm of asset pricing, which private banks have to follow closely despite their relatively high cost of money.

Regarding the areas that needs to be further liberalized so as to enhance the performance of the overall banking industry (Table 22), a great number of respondents favor liberalization in the deposit market (81 %) through lifting the minimum deposit rate (3%)[10] sanctioned by the supervisory organ, by encouraging public enterprises to do business with a financial

[10] raised to 4% with a reserve ratio of 10% during my completion of the project (publicized on July 4,2007)

institution of their own choice rather than the current implicit sanction not to do business with private banks.

Table 23: Respondents Comment on the Areas that Need Further Liberalization Measures

Areas that need further liberalization measures	Responses						Total	
	Yes		NO		DK			
	Freq.	Per.	Freq.	Per.	Freq.	Per.	Freq.	Per.
Loan market	20	34.5	30	51.7	8	13.8	**58**	**100.0**
Deposits market	47	**81.0**	9	15.5	2	3.4	**58**	**100.0**
Information technology	39	**67.2**	13	22.4	6	10.3	**58**	**100.0**
Entry capital requirement	26	44.8	29	50	3	5.2	**58**	**100.0**
Enhancing regulatory/supervisory capacity	47	**81.0**	7	12.1	4	6.9	**58**	**100.0**
Establishing and enhancing market for securities	49	**84.5**	7	12.1	2	3.4	**58**	**100.0**
Lifting entry barriers on foreign banks	40	**69.0**	14	24.1	4	6.9	**58**	**100.0**
Full liberalization of the foreign market	39	**67.2**	13	22.4	6	10.3	**58**	**100.0**
Enhancing the inter- bank borrowing market	19	32.8	33	56.9	6	10.3	**58**	**100.0**

Enhancing the capacity of the regulatory/supervisory organ is another area identified by 84.5% of the respondents. Respondents claim that the capacity as well as the independence of the regulatory body has to be improved so as to positively contribute to the growth of the banking industry. With regard to Information Technology most respondents (67.2%) claim strong legal ground for rendering technologically supported banking activities and they raised e- banking as an instance which needs to have a good legal ground to provide the service but failure of the banking laws or the commercial code to incorporate any article regarding the issue would serve as a barrier for expansion of the Information Technology. Furthermore, lifting entry barriers on foreign banks (69%) and full liberalization of the foreign market (67.2%) are the areas identified for further liberalization measures. The respondents raised similar reasons described in section 4.2.2 for the advantage of allowing foreign entrants and some recommended a gradual approach in allowing foreign banks in the system. They raised the form of entry of China as an instance which can be divided into four stages[11]: representative offices, branches in special economic zones, allowing foreign banks to operate in selected cities and allowing opening of branches all over China. As these stages reveal, till now, China doesn't allow foreign banks to open subsidiaries in the country. This clearly indicates such gradual approach is very important for Ethiopia to follow although the time framework and mode of entry might not be necessarily as in the case of China. Concerning the reason for the full liberalization of the foreign market some respondents said that banks should hold their money by any dependable currency they wish as well as freely hold any amount of foreign currency as per their need and requirement rather than placing a statutory requirement for the amount and type of currency to be held by banks "as it is one of the areas where they demonstrate that they are the banks "as per the words of one respondent.

[11] Stage I, form late 1970s to early 1980s, China allowed foreign banks to open representative offices. Stage II, from 1980s to early 1990s, it permitted foreign banks to open operational branches in special economic zones. Stage III, during mid 1990s, improved regulations on opening up to and supervising foreign banks were formally promulgated, allowing foreign banks to operate in 23 cities. The last stage started since 1996. In this stage foreign banks have been allowed to open branches all across China (Tinghuan, Liu (2001)

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1. Summary and Conclusions

The study attempted to look into the existing ownership and market structure by assessing the historical transformation of the ownership structure of the Ethiopian banking industry and applying the standard measures of market concentration, namely, the k-firms concentration ratio and HH Index, respectively. Furthermore, the paper tried to look at the trend in the profitability performance of the industry during the pre reform (1976-1991) and the post reform period (1992-2006). The study has also tried to collect opinions from the bank's community regarding the abovementioned issues which have been analyzed subsequently. Thus, based on such analysis on the primary and secondary data, the following conclusions are drawn:

- In terms of ownership structure, the Ethiopian banking industry has shown transitions from fully foreign owned banks, banks owned by private and foreign partners, and fully government owned banks in the pre-reform -pre-socialist period to fully government banks in pre-reform- socialist period and to pure private and pure government ownership of the post-reform period. However, from the time of nationalization onwards (or since 1974), no foreign bank has been allowed to operate in Ethiopia and participation of the private sector to the ownership of government banks has been prohibited. This might be one cause for the concentration in the banking sector and for the restrictions of the advantages the Ethiopian banking sector could earn by incorporating foreigners in to its ownership structure.

- As compared with the ownership structure during the pre-reform period, the current ownership structure of the banking industry has enabled to develop the competition in the sector which was non -existent before the reform measures were undertaken; it also enabled to serve the society through bank expansion and improved efficient use of capital by injecting funds to the private sector in the form of loans and enhancing fund mobilization in the form of deposits .The reform also greatly helped in the reduction of unemployment by creating job opportunities to skilled Ethiopian nationals; it has also contributed to the strength of local banks by protecting them from the fierce competition they may encounter from foreign banks. However, the reform lacked the capacity to create ownership structure that enhances a level playing field for all commercial banks operating in the country.

- In addition, due to the excessive involvement of the government in the banking sector and absence of foreign banks, the current banking structure has paved the way for inefficiency by accumulating excess funds in government banks, by maintaining the dominance of government banks, limiting the competition expected from the banking industry, and contributing to limited infrastructural development (such as IT) in the banking sector.

- There is considerable concentration in the Ethiopian banking industry. Even if its share shows a declining trend, CBE still dominated the market share of the industry in terms of loans, deposits, assets, capital and profit. Both two firm concentration ratio and HH Index using total deposits, loans, capital and assets show the high level of concentration and the characterization of the market as less competitive. However, after the economic reform and particularly after the allowance of entry of domestically owned private banks, the concentration ratio shows a declining trend especially, in the loan market. But, still the market can not be regarded as highly competitive[12].

☞ Concerning the degree of competition, although the competition among private banks was a competition among equals, it was between unequals as far as private banks and state-owned banks were concerned as the state-owned banks were relatively well established, with large network of branches, high capital and reserve base and own premises of bank branches .They all contribute towards reducing costs of state owned banks and enhance their capacity to give out big loans. In addition, there exists no competition among the state owned banks; they are working in cooperative manner rather than competing among themselves. However, with such a trend the incumbent banking institutions started facing competition, if not stiff, after the reform and the majority of the competition in the banking sector could be attributed to the competition among private banks. The level of competitiveness in the financial sector and the banking system in particular needs further assessment and is an open area of research in this regard.

☞ The profitability of the industry has also shown a tremendous improvement after the reform measure has been taken. Even banks that have been in a loss in most years of the pre-reform period like CBB have become profitable after the reform measures

[12] Buchs and Mathisen (2003) using data from 1996-2001 for 7 banks in Ethiopia calculated the level of competitiveness (H-statistics equal to 0.85 for Ethiopia, 0.6 for Kenya and 0.69 for South Africa) and characterized the market structures as monopolistic.

have been taken. In addition, the profitability of the private banks as a group is showing improvement through time. However, the existing government banks are enjoying having the higher share of profit from the industry and still the pattern of the industry profit is following the profitability structure of the giant bank.

- ☞ Besides the advantages it obtained from its early entry in the banking market, Ethiopia's large public enterprise system, still being in the domain of the Commercial Bank of Ethiopia, has provided a competitive advantage over private banks by reducing its costs. This competitive advantage makes the CBE a pace-setter in the realm of asset pricing which the private banks have to follow closely despite their relatively high cost of money.

- ☞ The study also found that to further strengthen the performance of the industry enacting the reform measures in the deposit market, in improving the capacity and independence of the regulatory/supervisory organ, in establishing strong legal ground for rendering technologically supported banking activities, for the full liberalization of the foreign market and for lifting entry barriers on foreign banks needs to be a concern of the Ethiopian banking industry. It has also found that the reform needs to be gradual and, as most studies recommend, financial liberalization and bank restructuring should be accompanied by complementary measures to address institutional and structural problems (Areyeetey, 1997). In addition, studies emphasized the importance of attaining macroeconomic stability prior to financial liberalization (Dornbusch and Reynoso, 1993 in Ikhide and Alawode, 2001).

5.2. Recommendations

Conclusive recommendations on the impact of financial liberalization need further research on the structure and performance of the financial sector and the macro-economy as a whole. Thus, the present project should be seen as a first step, not the last word in this direction. . The following recommendations are forwarded from the findings of the study:

- Allowing the entry of foreign banks and participation of the private ownership in the government owned banks should be a concern of the Ethiopian banking industry. The government should give due consideration in permitting entry of foreign banks which have the capacity to introduce new technology, diversification and competition in the banking sector while enhancing the autonomy and prudential regulation capacity of the National Bank of Ethiopia to avoid bank-runs and financial crises. In addition, the government can follow a gradual approach in the course of embracing the involvement of foreign banks in which foreign banks could be allowed to operate in the industry through joint ventures, branches, representative offices in the short term and allowed to open subsidiaries and fully operate in the country in the long term. The experience of other countries such as China can be benchmarked for such approach although the time framework and mode of entry might not be necessarily as in the case of China.

- A banking (financial sector) structure that enhances the competitiveness of the industry and efficiency of the sector , creates a level playing field for both state and private banks and reduces the high degree of domination in the banking sector should be designed.

- The capacity as well as the independence of the regulatory body has to be improved so as to positively contribute to the growth of the banking industry. In the long term the government mainly should undertake the supervisory and regulatory role rather than fighting to maintain its ownership /stake and dominance in the banking sector.

- The level of competitiveness in the financial sector and the banking system in particular and the best liberalization measure that deepens the competition in the financial sector need further assessment and is an open area of research in this regard.

- Gradually, further liberalization and reform measures should be initiated on lifting the minimum interest rate for deposit to be determined on market basis, providing legal framework to enhance IT such as e- banking, enhance the promotion and expansion of money and bond (security) markets, fully liberalizing the foreign market and encouraging public enterprises to do business with a financial institution of their own choice rather than the current implicit sanction not to do business with private banks.

- In order to further improve the environment within which banks operate and accommodate the reform measures, training programs for the development of qualified professionals in the banking sector should be planned and implemented.

- As many literatures support, in order to realize the results of financial market liberalization, liberalization measures should be effectively implemented in other sectors of the economy as well.

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