UNIT 7

MONETARY POLICY AND FINANCIAL SECTORS IN ETHIOPIA

Unit Objectives

After completing this unit, you will be able to:

- report on how monetary policy is applied in Ethiopia; and
- understand the different policies and strategies applied by the Imperial, Derg, and current governments.

Main Contents

INTRODUCTION

Monetary policy refers to the management of the money supply and its link to prices, interest rates and other economic variables. More generally, monetary policy is a bundle of actions and regulatory stances taken by the central bank including all of the following:

- *Setting a minimum interest rate on deposit*
- *Setting reserve requirements on various classes of deposit*
- *Increasing or decreasing commercial bank reserves through open market purchase and sales of government securities.*
- *Constraining commercial bank financial activities by setting minimum capital requirement*
- *Intervening in foreign exchange markets to buy and sell domestic currency for foreign exchanges*
- *Decide the level of total-deposit required reserve of commercial banks*

The principal objective of the monetary policy of the National Bank of Ethiopia (NBE) is to maintain price and exchange rate stability and support sustainable economic growth of Ethiopia. Price stability is a measure for macroeconomic stability which is important in private sector economic decision-making about investment, consumption, international trade and saving. Macroeconomic stability also fosters employment and economic growth. Maintaining exchange rate stability, on the other hand, promotes competitiveness in international trade.

Financial institutions (FIs) such as commercial banks, credit unions, insurance companies, etc. perform the essential functions of channelling funds from those with surplus funds (suppliers of funds) to those with shortage of funds (users of funds). Hence, the existence of such kinds of institutions helps to facilitate domestic saving and investment.

7.1 HISTORICAL BACKGROUND OF MONEY AND THE FINANCIAL SECTOR IN ETHIOPIA

At the end of this section, you will be able to:

- review the historical background of money and the financial sector in Ethiopia;

Key Terms and Concepts

- barter system
- the evolution of money
- types of money
- evolution of banking system

What is your opinion about the historical and recent development of money?

7.1.1 Historical Development of Money

Figure 7.1 **A Picture of bars of salt**

Before the invention of money, trade was based on the barter system. It is a system of transaction where goods and services are directly exchanged with goods and services. The barter system had many pitfalls. Among others, the need for double coincidence of wants was the prominent problem of barter system. People have to find someone who has a good or service they want and who also wants the good or service they have to offer.

Figure 7.2 **Pictures of coins used in Ethiopia**

Money is anything that people are willing to accept in payment for goods and services or to pay off debt. Some form of rudimentary financial activities and exchange with the help of money in Ethiopia is dated back to the Axumite kingdom. Coins were mainly minted to facilitate external trade transactions. Usually, these coins were made of precious metals such as gold, silver, and bronze. Iron and salt bars were used to conduct domestic trade transaction. Later on, due to the fact that the intrinsic value of some precious metals and coins was greater than their face value, and hence used for making ornaments and other purposes, exchanges of goods and services were replaced by commodity money.

In addition to the intrinsic value, the downfall of the Axumite kingdom eliminated the circulation of coins, and trade was conducted by the traditional form of exchange, using commodities that served as medium of exchange. This is what is known as the stage of commodity money. Commodities such as bars of salt, pieces of cloth, bars of iron and different types of shells were used as a medium of exchange.

Other currencies that were issued and circulated in and around Harar city after the Axumite coins were the "Mahalek" and the "Ashrafi" that existed from 1789-1887. These were hand-made currencies for local use by the habitats of Harar.

Later the entire region used "Amole Chew" (Salt Bar) for many years. In the nineteenth century and early twentieth century, Austrian thaler (the Maria Theresa dollar) served as a medium of exchange together with the use of Amole.

The thaler was first minted in Vienna, the capital city of Austria in 1741 and named after the Empress Maria Theresa of Austria. It had a silver purity of 800 karats, which means it contained 80% of pure silver. Hence, after a long time the country was back to metallic money. Thaler was a widely acceptable means of exchange until it was replaced by the national currency in 1945. During the Italian short occupation (1935 – 1941) there were about 50 million Marie Theresa thalers circulating in the economy.

Activity 7.1

Collect information on the evolution of money from the nearby relevant institutions and discuss in groups.

Figure 7.3 **The Present Ethiopian currency notes and coins**

In 1894 coins bearing the image of Emperor Menelik II appeared, these were. Made of silver and copper, the first national currencies after the fall of the Axumite kingdom. In 1908, "Birr", containing the image of Emperor Menelik II, was declared as a medium of exchange and a legal tender throughout Ethiopia by proclamation.

Historical Note

In 1933, the first coins under Emperor Haile Sellasie's regime replaced Menelik's coins. The new dollar notes were printed with denominations of Birr 5, Birr 10, Birr 20, Birr 50, Birr 100 and Birr 500 values. These currencies bore the image of Emperor Haile Sellasie I. The coins were made of copper with denominations of one cent, five cents, ten cents, and twenty five cents. Also, there was a coin made of silver for fifty cents ("Shilling").

These notes and coins served for a long time until the fall of the Imperial regime in 1974. The Millitary regime (Derg) introduced a new legal tender in 1976 with the same denomination without the twenty and five hundred Birr.

In 1998 the new government (EPRDF) slightly changed the currency notes but not the coins, using the same denominations as they were also circulating in Eriteria after independence in 1991. Paper currency decreed by governments as legal tender (meaning that legally it must be accepted as payment for debts) but not convertible into coins or precious metal is known as ***Fiat Money***.

7.1.2 The Financial Sector in Ethiopia

Historical Note

Modern banking in Ethiopia started in 1905 with the establishment of Abyssinian Bank, which was based on a fifty year agreement with the Anglo-Egyptian National Bank. In 1908 a new development bank (called Societe Nationale d' Ethiope Pour le Development de l'Agriculture et du Commerce) and two other foreign banks (Banque de l'Indochine and the Compagnie de l'Afrique Orientale) were also established. These banks were criticized for being wholly foreign owned.

Table 7.1: **Banks in operation during the brief period of Italian occupation (1936-41)**

Year of establishment	Bank name	Number of branches
1934	Banco di Italy	9
1934	Banco di Roma	18
1939	Banco di Napoli	4
1939	Banco Nacionale (De'sVoro)	4
1939	Casa de Creito	1
1939	Society Nacionale di Ethiopia	1
	Total	37

Source: *Gedey, B. (1990) Money, Banking and Insurance in Ethiopia, Addis Ababa: Berhanena Selam Printing Press (in Amharic).*

After independence from Italy's brief occupation, where the role of Britain was paramount owing to its strategic planning during the Second World War, Barclay's Bank was established and it remained in business in Ethiopia between 1941 and 1943. Following this, in 1943, the Ethiopian government established the State Bank of Ethiopia. The establishment of this bank by Ethiopia was a painful process because Britain was against it. The Bank of Ethiopia operated as both a commercial and a central bank until 1963 when it was split and remodelled into today's National Bank of Ethiopia (re-established the Central Bank, as in 1976) and the Commercial Bank of Ethiopia (CBE). After this period, many other banks were established during Emperor Haile Sellasie I's regime. Just before the 1974 revolution, the banks listed in Table 7.2 were in operation.

Table 7.2: **Banks in Operation before 1974 in Ethiopia**

Years of establishment	Name of the bank	Number of Branches before 1974	Capital before 1974 (in millions Birr)
1939	Banco di Napoli	1	2.0
1963	Imperial Saving and Home Ownership Public Association	1	0.6
1963	National Bank of Ethiopia, NBE	4	10.0
1963	Commercial Bank of Ethiopia, CBE	65	35.0
1963	Addis Bank Share Co.	26	5.0
1964	Addis Bank Share Co.	2	3.0
1964	Ethiopian Investment Corporation S.C.	1	20.0
1966	Banco di Roma (Ethiopia) S.C.	8	4.0
1969	Agricultural and Industrial Development Bank	5	100.0

Source: *Gedey, B. (1990) Money, Banking and Insurance in Ethiopia, Addis Ababa: BerhanenaSelam Printing Press (in Amharic).*

All privately owned financial institutions, including three commercial banks, thirteen insurance companies, and two non-bank financial intermediaries, were nationalized on 1 January 1975 under the Derg regime. The nationalized banks were reorganized into one commercial bank (namely, the Commercial Bank of Ethiopia), two specialized banks – the Agricultural and Industrial Development Bank (AIDB), and Housing and Saving Bank (HSB), and one insurance company.

Following the regime change in 1991 and the liberalization policy in 1992, these financial institutions were reorganized to work in a market-oriented-policy framework. The CBE, EIC and NBE have retained their names and functions, whereas the AIDB was renamed as Development Bank of Ethiopia (DBE), and the HSB was renamed as Construction and Business Bank (CBB).

Currently the major financial institutions operating in Ethiopia are banks, insurance companies and micro-finance institutions. A number of commercial banks and insurance companies have also been established in the reform period. In 2008/09, the number of commercial banks operating in the country reached 13, of which ten were private commercial banks, and the remaining three were state owned.

Figure 7.4 **Commercial Bank and National Bank of Ethiopia**

Table 7.3: **Public and private banks currently working in Ethiopia**

Banks	Branch Network 2008/2009		
	Addis Ababa	Regions	Total
1 Public banks			
Commercial Bank of Ethiopia	160	49	209
Construction and Business Bank	17	15	32
Development Bank of Ethiopia	1	31	32
Total public banks	178	95	273
2 Private banks			
Awash International Bank	29	31	60
Dashen Bank	28	26	54
Abyssinia Bank	22	25	47
Wegagen Bank	26	23	49
United Bank	15	26	41
Nib International Bank	17	28	45
Cooperative Bank of Oromiya	23	3	26
Lion International Bank	11	9	20
Zemen Bank	1	0	1
Oromia International Bank	16	4	20
Total Private banks	187	176	363
Grand Total Banks	354	282	636

Source: *National Bank Ethiopia, Annual Report (2008/2009).*

Activity 7.2

List and discuss the advantages of Banks for economic growth.

In 2008/09, with the launching of new insurance companies, namely Ethio-Life and Oromia Insurance Company, the number of insurance companies in the country expanded to 12. In terms of ownership, all insurance companies, except the Ethiopian Insurance Corporation (EIC), are privately owned.

Table 7.4: 008/2009

Insurance Companies	Numbers of Branches		
	Addis Ababa	Regions	Total
Ethiopian Ins. Cor.	11	28	39
Awash Ins. S.C.	13	9	22
Africa Ins. S.C.	6	7	13
National Ins. Co. of Eth.	8	8	16
United Ins. S.C.	14	7	21
Global Ins. S.C.	4	3	7
Nile Ins. S.C.	11	9	20
Nyala Ins. S.C.	8	8	16
Nib Ins. S.C.	13	8	21
Lion Ins. S.C.	6	4	10
Ethio-life Ins. S.C.	-	-	-
Oromia Ins. S.C.	4	5	9
Total	98	96	194

Source: *NBE, Annual Report (2008/2009).*

Content Check 7.1

1 The management of money supply and its link to prices, interest rates and other economic variables by a government regulatory body is known as __________.

2 Which one of the following government institutions is directly responsible for the conduct of monetary policy?

A Ministry of Finance and Economic Development

B Ministry of Trade and Industry

C Commercial Bank of Ethiopia

D National Bank of Ethiopia

3 List the major pitfalls of barter systems.

A ______________________________

B ______________________________

C ______________________________

D ______________________________

4 Briefly discuss the evolution of money.

5 What was the first modern bank in Ethiopia?

Match those in Column 'B' with those in 'A'.

	"A"		"B"
6	Commercial Bank of Ethiopia _____	A	1964
7	Bank di Roma (Ethiopia) S.C._____	B	1966
8	Ethiopian Investment corporation S/C _____	C	1969
9	Bank di Napoli _____	D	1963
10	National Bank of Ethiopia _____	E	1939

7.1.3 The Roles and Functions of the National Bank of Ethiopia and Commercial Banks of Ethiopia

Roles and Functions of the National Bank of Ethiopia

Among the most important players in financial markets throughout the world are national banks, which are the government authorities in charge of monetary policies. National banks' actions affect interest rates, the amount of credit available, and the money supply, all of which have direct impacts not only on financial markets, but also on aggregate output and inflation. A national bank is a financial institution established to act on behalf of the government to control and regulate activities of the financial sector. It has different names in different countries. It is usually referred to as Central Bank, which is the apex of the banking sector. For instance, in Kenya it is "Central Bank of Kenya", in the U.S.A., "The Federal Reserve Bank.", in the U.K, "The Bank of England"

Unlike commercial banks, the objective of national banks is not generating profit by transacting with the general public in depositing, borrowing, and lending activities. The duties and responsibilities of national banks are far more extensive than those of commercial banks or of any other financial institutions.

The National Bank of Ethiopia (NBE) was established with capital of Birr ten million. It was owned and operated by the government and managed by a board of directors. The NBE was restructured by the government with Proclamation No 206/1963 and began its operation in 1964. After the fall of Emperor Haile Sellasie I, it was restructured by Proclamation No 99/1976. The roles and functions of the NBE were redefined again after the downfall of the Derg in Proclamation No 83-84/1994. The bank has now, among other things, the following responsibilities. It

- *has the exclusive right to mint coins and print (issue) currency notes that circulate in the national economy;*
- *issues government debt instruments or securities such as bonds, treasury bills, and promissory notes on behalf of the government;*
- *promotes the existence of balanced and accelerated economic growth;*
- *reduces the level of unemployment and maintains low levels of inflation;*
- *encourages the formation of micro and other financial institutions and supervises and regulates the activities and operations of these financial institutions in general and of commercial banks in particular;*
- *acts as the banker of the government: deposits government money and provides direct advances to the government;*
- *acts as a last resort for commercial banks that need to borrow money at times of shortage;*
- *regulates the money supply, interest rates and other charges, and the creation of credit by commercial banks;*
- *formulates the monetary policy framework for the country;*
- *manages and administers the international reserve of the country;*
- *regulates the foreign exchange of the country and organizes the foreign exchange auction market for the determination of the exchange rates; and*
- *prepares regular reports on the money supply, production of goods and services, and official international economic transactions carried out by the country.*

Activity 7.3

Discuss the economic rationale for the existence of different denominations; particularly the choice of metallic coins that represents one Birr which we are using it at present.

Roles and Functions of Commercial Banks and Insurance Companies

A The Commercial Bank of Ethiopia (CBE)

The Commercial Bank of Ethiopia is the biggest and the leading commercial bank in Ethiopia. It had 32.9 % of the banking sector in Ethiopia in 2008/09. It had 209 branches throughout the country and 5 billion Birr capital in the same year. It was incorporated as a share company in December as per the Monetary and Banking Proclamation No 207/1995. It took over the banking activities of the former State Bank of Ethiopia and began operation in January 1964. The initial capital of the bank was Birr 20 million.

The first private bank that was in operation together with the Commercial Bank of Ethiopia was Addis Bank S.C. It was established in October 1964 as a joint venture (JV) between Ethiopians and National and Grindlays Banks of London. The bank was established with a paid up capital of 2 million Birr. Its capital increased to 5 million Birr by the year 1968 with a total of 26 branches and 300 employees. By 1976, Addis Bank was merged with other banks, of Italian origin, under Proclamation No 69/1975. The capital had increased to 20 miilion Birr, and there were 34 branches and 480 employees, making it the second largest commercial bank in the country.

Due to the change of regime and the Derg economic policy, the Addis Bank and the former Commercial Bank of Ethiopia were merged to form the present day Commercial Bank of Ethiopia on August 2, 1980. In the same year, the bank had 65 million Birr capital and 155 branches throughout the country.

Roles and functions of CBE:

- *Help to encourage households to save money, since saving is important for investment;*

- *Accept Deposits of different kinds, such as saving, time, and demand deposit;*
- *Advance loans, credit, overdrafts, and other services for individuals and firms;*
- *Conduct supervision and follow-up on the use of credit and loans provided to customers;*
- *Maintain safe-deposit vaults and lockers and receive valuables and securities for safe custody;*
- *Sell and purchase foreign currencies;*
- *Issue letters of credit (LC), travellers cheques, etc;*
- *Issue bonds and participate in the buying and selling of treasury bills, bonds, and other negotiable instruments and securities;*
- *Conduct the transfer of money from one place to another;*
- *Prepare regular financial reports to the NBE;*
- *Accelerate the process of monetization in the economy.*

Broadly speaking, the following are the major types of bank, classified based on their functions:

- ***Commercial Banks:*** *advance short-term funds/loans to business people and traders. Their deposits are only for a short period. The loan period extends from 3 to 6 months.*
- ***Industrial Banks:*** *provide long-term loans to industries*
- ***Agricultural Banks:*** *meet the requirements of the agricultural community, particularly in a predominantly agricultural country.*
- ***Foreign Exchange Banks:*** *specialize in facilitating foreign trade by making international payments.*

B *Development Bank of Ethiopia (DBE)*

One of the two specialized banks established in the 1940s, during the Imperial region, was the Agricultural Bank. It was initially established in 1945, and it was replaced by the Development Bank of Ethiopia in 1951. The purpose of the bank was to foster the development of the agricultural sector. On the other hand, the Investment Bank of Ethiopia (IBE) was established in 1963 for the purpose of developing the industrial sector. The Agricultural and Industrial Development Bank (AID Bank) was established in 1974 with the paid up capital of 100,000 Birr by the government to take over the activities of the former DBE and IBE. The objectives, functions, and roles of the AID bank include the following:

- *To advance loans and credit for the development of both the agricultural and industrial sectors;*
- *To act as agent or representative of individuals and firms to effect payment on their behalf;*
- *To act as a guarantor to viable agricultural and industrial projects;*
- *To supervise and control the activities of projects financed by the bank;*
- *To engage in investment of equities; and*
- *To perform other similar functions and responsibilities like the commercial banks.*

C *The Construction and Business Bank (CBB)*

The other specialized bank was the Housing and Saving Bank (HSB) which was established in November 1975. The bank was created by amalgamating the former Imperial Saving and Home Ownership Public Association and the Saving and Mortgage Corporation S.C. The purpose of the bank was to encourage the construction of residential houses by providing long-term loans at a low rate of interest in urban areas. The working capital of the bank in 2008/09 was 196 million Birr. It had 32 branches by the same year.

The objectives, functions and roles of the bank are, among other:

- *Provision of long-term loans and credits in the construction and acquisition of buildings;*
- *Accepting saving, demand, and time deposit so as to mobilise funds for investment in construction;*
- *Conducting, monitoring and following up end uses of loans advanced;*
- *Discounting promissory notes and other securities issued by other parties; and*
- *Performing similar other functions as commercial banks as per the Commercial Code of Ethiopia.*

D *Insurance Services in Ethiopia*

Every day we face the possibility of the occurrence of certain problems leading to uncertainities that could lead to large financial losses. A spouse's earnings might disappear due to death or illness; a car accident might result in costly repair bills or payments to an injured party. Because financial losses from crises could be large relative to our financial resources, we protect ourselves against them by purchasing insurance coverage that will pay a sum of money if the uncertainty occurs. Life insurance companies sell policies that provide income if a person dies, is incapacitated by illness, or retires.

History tells us that insurance services in Ethiopia have been known since the Axumite era. However, the collapse of the Axumite kingdom led to the formation of local and indigenous self-help groups, such as “Idir”, “Ekub”, and “Mahiber”. These informal institutions are serving the peoples of Ethiopia up to now.

- *Modern forms of insurance service are said to have been introduced in Ethiopia by Europeans.*
- *The practice of modern insurance services started in the 1920s when the Bank of Abyssinia started underwriting fire and marine insurance as an agency to a foreign bank.*
- *The first insurance company was established in 1923 by an Austrian named Muzinger, which served as an agency for a foreign Fire Insurance Company.*
- *During the Italian invasion, no insurance company was allowed to operate except the Italian insurance companies.*

Historical Note

The first insurance company owned by the Ethiopian government was established in 1951 with the name of Imperial Insurance Company of Ethiopia.

There were about 13 insurance companies operating in Ethiopia before 1974.

The nationalization of foreign and local private insurance companies in 1975 led to the formation and establishment of the Ethiopian Insurance Corporation (EIC) in January 1976 by Proclaimation No. 68/1975 with a paid capital of 11 million Birr with the aim of providing all kinds of insurance services in Ethiopia. In 2008/09, EIC had 39 branches and 249.4 million Birr capital.

Content Check 7.2

1 A financial institution established to act on behalf of the government to control and regulate the activities in the financial sector is known as _____.

2 What is the major role of financial institutions?

3 Mention at least five major functions and roles of the NBE.

4 Which of the following cannot be regarded as function of central banks?

A Issuing notes

B Acting as custodian of cash reserves

C Acting as custodian of foreign exchange

D Acting as controller of credit

E None of the above

5 Mention some of the functions and roles of CBE.

6 What is the basic difference between NBE and CBE?

7.2 FINANCIAL SECTOR POLICIES AND REFORMS IN ETHIOPIA

At the end of this section, you will be able to:

- examine the financial policies that existed during the Monarchy, Derge and EPRDF.

Key Terms and Concepts

- Financial policies
- Performances
- Imperial
- Derg
- EPRDF

What is your opinion about the major financial economic policies that are undertaken by the current government?

Following the McKinnon and Shaw (1973) paradigm, financial liberalization has been high on the agenda of developing countries. The financial repression school argues that government intervention in the finance sector, in particular through subsidized interest rates and credit allocation, not only distorts the financial market but also depresses savings and leads to inefficient investment. The policy prescription that follows is liberalization. This has been endorsed by international financial and development institutions, such as the World Bank (WB) and the International Monetary Fund (IMF), and was high on the agenda of the reform packages prescribed for most developing countries, called Structural Adjustment Programs (SAPs).

7.2.1 The Financial Policies During the Imperial Period (pre-1974)

The pre-1974 financial sector policy of the government was in line with the pro-capitalist economic system, which allows the participation of the private sector in the economy, particularly in the financial sector. As a result, there were both foreign as well as local private banks and insurance companies operating in Ethiopia until they were nationalized in 1974. There was no capital ceiling requirement by the government. However, the monitoring and regulatory capacity of the National Bank of Ethiopia was limited in the period under discussion.

7.2.2 The Financial Policies of the Derg Period (1974-1991)

The pre-reform period here refers to the Derg period from 1974 to 1991. This was a regime characterized by absolute government control of major economic activities in the country. During this period all private banks were nationalized and converted into institutions organized along socialist principles. It was the duty of the National Bank of Ethiopia to regulate the activities of these institutions on behalf of the government. As noted earlier, CBE, AIDB (DBE), HSB (CBB) were in operation during this period. In addition to these banks, there were also two other financial institutions: Ethiopian Insurance Corporation (EIC) and the Pension and Social Security Authority (PSSA).

The government also attempted to offset its budget deficit by borrowing from the banking system which constrains the amount of money that goes to the private sector; this reduced the participation of the private sector. For instance, the interest on saving deposits made by the private sector remained at 6% on deposits up to 100,000 Birr and 2% over this amount so as to discourage "accumulation of capital". In fact, saving deposits by socialized sectors were not allowed. Interest rates on time deposits were between a minimum of 4% to 7.5%, depending on the sources of the funds.

Lending rates were also discriminatory in nature. Cooperatives were the most favoured customers of banks, followed by public enterprises. The lending rates remained between 9% and 10.5% for most of the activities in the different sectors of the economy: 8.5% for export trade, 3-5% to the central government, and 5-6.5% for banks until June 1986. These rates were revised on July 1, 1986, becoming slightly higher for public enterprises, and were further raised for the private sectors.

All in all, the financial policy of the Derg favored inefficient public sectors at the expense of private sectors, and it proved to be a failure for the development of the financial sector. The attempt of the government to expand the public sector was very much limited due to the shortage of foreign exchange. This in turn led to borrowing and dependency on foreign assistance. However, it was difficult to get external financial assistance due to political ideology differences, and the funds were allocated in non-development areas such as defences, and military expansion.

The government kept the exchange rate at a low level by establishing a fixed exchange rate regime. Exchange rate, as price of domestic currency expressed in terms of foreign currency, affects the price of both export and import goods. The fixed exchange rate policy was adopted primarily to prevent the domestic cost of imported goods, especially that of imported raw materials and inputs. However, the overvalued exchange rate has affected the growth of the export sector by making the price of exported goods expensive at abroad.

The government also adopted a very restrictive foreign exchange policy in order to reduce aggregate demand for foreign exchange in the economy. It also introduced a high import tariff. This restrictive measure, however, led to the smuggling of goods, both imported and exported, and to the flourishing of a black-market foreign exchange market.

In general, huge government borrowing, restrictive financial policies, and lack of participation of private sector and inefficient use of financial resources by the public sector were the major characteristics of the Derg regime. However, relative macroeconomic stability was achieved at the expense of overall economic growth due to forced measures of saving by the good-performing public enterprises and non-bank financial institutions, and by the draining of the foreign reserve.

7.2.3 The Financial Policies of EPRDF (Post-1991)

Proclamation No. 84/1994, which allowed the private sector (owners have to be Ethiopian nationals, however) to engage in the banking and insurance businesses, marked the beginning of a new era in Ethiopia’s financial sector. Following this proclamation the country witnessed a proliferation of private banking and insurance companies.

The attempt to control inflation, to maintain it at a low level was mainly carried out by adopting a monetary policy which kept the pace of growth in money supply in line with the growth rate of the nominal gross domestic product (NGDP). The government has also envisaged ensuring the availability and expansion of credit to the growing private sector and has made some adjustments to interest rates. For instance, the government abolished the discriminatory lending interest rates and fixed minimum deposit and the maximum lending rates since 1994/1995. However, the government later abolished the ceiling rates, freeing them to be determined by market forces of demand and supply in January 1998.

Note:

The government used indirect monetary policy instruments such as Open Market Operation (OMO) for government securities. These are markets for Treasury Bills (TB) and Government Bonds (GB). OMO (Open Market Operation) refers to the purchase and sale of securities such as bonds by the central bank to the public. The purchase of bonds by the central bank is known as Open Market Purchase (OMP), and the sale of bonds by the central bank which is known as Open Market Sale (OMS).

Auctioning of securities in the open market was started in January 1994/95 with three types of TBs maturing in 28, 91, and 180 days, respectively. This marked the start of the development of the money and capital market in the country. Besides, such instruments relate to non-inflationary financing monetary policy which could help to avoid draining the amount of credit available to the private sector.

The government devalued the Birr in October 1992 and introduced the auction market for foreign exchange in May 1993 in an attempt to determine the exchange rates by market forces and to increase exports. Importers, banks and investors participated in the retail market until it was replaced by the weekly wholesale foreign exchange market in 1999 that only allowed the participation of banks and investors. This was replaced by the inter-bank foreign exchange market in 2001 which allows the participation of licensed foreign exchange dealer banks to determine the daily value of a foreign currency in terms of Ethiopian Birr.

In general, the EPRDF government has taken a number of policy measures to enable the financial sector to contribute to the development of the economy since 1992. Among these measures:

- *The adoption of monetary and banking proclamation that enabled the NBE, the licensing and supervision of banking;*
- *The formation and reorganization of the two government owned specialized banks of DBE and CBB;*
- *The transferring of non-performing loans from the existing banks to the Ministry of Finance;*

- *The restructuring of NBE as a separate entity outside the government with the foreign exchange management and other functions; and*
- *The proclamation for the establishing and restructuring of Agricultural Cooperative Societies so as to mobilize savings and allocate credits in rural areas.*

Activity 7.4

Discuss the financial sectors evolution policies in Ethiopia.

7.3 PERFORMANCE OF THE FINANCIAL SECTOR IN ETHIOPIA

At the end of this section, you will be able to:

- evaluate the performance of the financial sector in Ethiopia.

Key Terms and concepts

- Narrow money
- Broad money
- Quasi money
- Interest rates

One of the major objectives and functions of the financial sector is to make credit available and allocate it efficiently to end users. The sector not only distributes the amount of credit needed but also collects back the loan advances with some margin of profit in the form of interest. Therefore, the principal and the interest is to be collected by financial institutions but this is not achieved without many difficulties. Sometimes borrowers are unable to repay their debts, and banks have large amount of non-performing loans (NPLs) and bad debts.

Historical Note

Government owned banks performed poorly during the Derg Regime due to its restrictive and discriminatory policies, lack of institutional arrangement and capacity. Banks were obliged to comply with the government plan by advancing credit and loans to public enterprises, state farms, cooperatives and the central government.

Money, narrowly defined in the Ethiopian context, includes currency in circulation outside the banking sector and demand deposit. A demand deposit is a deposit that can be withdrawn at any time without giving prior notice. In contrast, broad money supply is defined as narrow money plus savings and time deposits. Savings and time deposits together are known as quasi money. Hence, broad money supply is the sum of narrow money supply and quasi money. Between 1972 and 1991, the narrow money supply showed an annual average growth rate of 10%. For the same period, broad money showed an annual average growth of 12.5%. However, the expansion of credit to the non-government sector has shown a declining trend.

Table 7.5: **Components of Broad Money (in millions of Birr)**

Particulars	End of June			Annual Percentage Change		
	2006/07	2007/08	2008/09	2006/07	2007/08	2008/09
Narrow money Supply	2,9617.7	35,350.4	42,112.66	24.4	19.4	19.1
- Currency in Circulation	1,3708.4	17,654.1	19,715.01	20.0	28.8	11.7
- Demand deposit	1,5909.3	17,696.3	22,397.64	28.4	11.2	26.6
Quasi-Money	2,7034.2	32,831.8	40,397.09	19.8	21.4	23.0
- Saving Deposit	2,3715.2	29,477.6	37,148.72	15.8	24.3	26.0
- Time deposit	3,319.0	3,354.1	3,248.37	59.6	1.1	-3.2
Broad Money Supply	56,651.9	68,182.1	82,509.8	22.2	20.4	21.0

Source: *Annual Report of NBE, (2008/09).*

Activity 7.5

What lesson can you drive from Table 7.5? (*Focus on circulation of money*)

The annual growth rate of domestic liquidity per year, as measured by broad money (M2), was 21 % and reached 82.5 billion Birr compared to the 20.4% of 2007/08. The expansion in broad money was largely driven by higher net foreign assets and domestic credit. The growth in domestic credit was attributed to rises in credit to the non-government sector while credit to the government dropped by 0.9 percent. On the other hand, the rise in net foreign assets was due to higher inflows from net services, transfers, and external loans and grants.

The fiscal year 2008/09 witnessed a surge in all components of broad money. Narrow money rose by 19.1 percent to Birr 42.1 billion, driven by 11.7 and 26.6 percent increases in currency in circulation and demand deposits reflecting the growing economic activities and higher transactions demand for money. Similarly, quasi money surged to 23.0%, owing to growing financial intermediation as banks continued to expand their branches throughout the country.

One of the most important functions of commercial banks in the area of financial intermediation is deposit mobilization and lending activities. There has been growth in these activities in the post-reform period.

Minimum interest rates on savings and time deposits remained the same for 2007/08 and 2008/09, at 4%, while the maximum deposit rate rose to 5 percent from 4.5 percent for the same period. Hence, the average interest rate on savings deposits increased to 4.5% from 4.08 percents and that of time deposits increased to 5.26 percent from 5.16 percent. Similarly, the average lending rate rose to 12.25 in 2008/09.

Table 7.6: **Interest rate structure of commercial banks (in percent per annum)**

Rates \ Year	2005/06	2006/07	2007/08	2008/09
Deposit rate				
Saving deposit				
Minimum	3.000	3.000	4.000	4.000
Maximum	3.150	3.150	4.150	5.000
Average	3.075	3.075	4.075	4.500
Time Deposit				
Up to 1 year	3.604	3.639	4.666	4.580
1 – 2 years	4.005	4.112	5.228	6.204
Over 2 years	4.297	4.490	5.588	4.998
Average	3.969	4.080	5.161	5.260
Demand deposit (average)	0.058	0.062	0.041	0.057
Lending Rate				
Minimum	7.000	4.000	8.000	8.00
Maximum	14.000	14.000	15.00	16.500
Average	10.500	10.500	11.500	12.250

Source: *Annual report of NBE (20008/09).*

Content Check 7.3

1 Distinguish the difference between narrow money and broad money supplies.

2 How do you compare the performance of the financial sector of the Derg Regime with that of EPRDF?

7.4 PROBLEMS OF AND POSSIBLE REMEDIES FOR THE FINANCIAL SECTOR IN ETHIOPIA

At the end of this section, you will be able to:

- assess the problems of and identify possible remedies for the financial sector

Key Terms and concepts

- Problems and solutions
- Traditional/informal sector
- Formal sector
- Collateral

The major problem facing the financial sector in the country is under-development. This can take different forms: the economy is less and less monetized; that is, it has limited circulation of money and limited number of financial institutions throughout the country. Dealings and transactions are conducted in the traditional/informal sector in certain parts of rural areas as well as urban areas.

Hence there are different kinds of bottlenecks for the development of the formal financial sector. These include, among other things:

- *A good part of the economy is not monetized;*
- *Some borrowers, both private and public enterprises, fail to repay back loans at the agreed time in the required amount;*
- *Banks are now forced to sell collateral to enforce repayment of debts which takes time, a long process and effort;*
- *Lack of weak competition in the sector;*
- *Maintenance of large amounts of financial resources by some banks due to high collateral requirements and lack of viable projects;*

- *Shortage of trained and efficient human resources in the sector;*
- *Inadequacy of banks to convert cash into credit;*
- *Lacklustre financial deepening in the country;*
- *Very low level innovation in financial products and services; and*
- *The availability of medium-term financing for activities such as agricultural land development, irrigation, purchase of machinery and equipment, plantation, and food processing and packing are either very limited or unavailable.*

However, the sector has tremendous and unexploited potential for development. The spread of small financial institutions throughout the country can help to channel surplus funds to the formal financial sector. This can be done by mobilizing large amounts of local as well as foreign savings. Efforts are also required to expand the types of financial services provided by the existing institutions. A strong policy framework and a strengthened regulatory government body is required to avoid unfair practices in the banking and insurance services.

Content Check 7.4

1 Explain in detail the major problems of the financial sector in Ethiopia.

2 Explain in detail possible solutions for the problems faced by the financial sector.

UNIT REVIEW

UNIT SUMMARY

- Monetary policy refers to the management of money and its links to price, interest rates and other economic variables. The historical development of money started in barter systems, exchanging goods for goods, and then the market system changed and transactions started using coins and paper money. In different governments, different types of coins and paper money have been used. Leaving the long history aside, modern banking in Ethiopia started in 1905 with the establishment of Abyssinia Bank. Then different banks were established during the Italian occupation time.
- NBE was established and started operation in 1964 with different powers, roles and functions to control all banks in Ethiopia. During EPRDF different public and private banks and insurance companies have been established.
- The Imperial, Derge and EPRDF governments set and reformed different types of policies and reforms.
- The performance of financial sectors in Ethiopia is set to make credit available and to allocate it to end users. In the Derg Regime, government-owned banks performed poorly due to discriminatory and restrictive policies.
- The major problem of financial sectors are limited circulation of money and limited financial institutions to solve this problem, the current government is expanding financial institution at large.

REVIEW EXERCISE FOR UNIT 7

I ***Choose the best answer from the given alternatives.***

1 Which one of the following government institutions is directly responsible for the conduct of monetary policy?

A Ministry of Finance and Economic Development
B Ministry of Trade and Industry
C Commercial Bank of Ethiopia
D National Bank of Ethiopia

2 Which of the following cannot be regarded as a function of central banks?

A Issuing notes

B Acting as custodian of cash reserves

C Acting as custodian of foreign exchange

D Acting as controller of credit

E None of the above

II *Answer the following questions briefly.*

3 How do you compare the performance of the financial sector of the Derg regime with that of the EPRDF?

4 What was the first modern bank in Ethiopia?

5 Discuss the currency of Ethiopia in your group and compare it with other currencies like the Dollar, Euro, Sterling and Yen.

6 Explain in detail the major role of financial institutions.

7 Mention at least five major functions and roles of National Bank of Ethiopia.

8 What is OMO? And what are the instruments of OMO?